

**FUNDAMENTAL TAX REFORM:
THE EXPERIENCE OF OECD COUNTRIES**

By

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1. Introduction

Let me first congratulate the Tax Foundation for putting together an agenda which focuses on some of the key issues facing tax reformers today. The US has a President elected with a clear mandate for reform and, with his new majorities in the House and Senate, the power to implement fundamental tax reform.

Over the last 10 years, the US has spent significant political and intellectual capital in discussing fundamental tax reforms. In practice, however, reform has been limited to incremental changes to the existing system. This is not to undermine what has been achieved. There were some very significant changes to the tax code in 2004, particularly as regards international tax arrangements. Fundamental tax reform must by definition go beyond piecemeal changes, and beyond lowering (or raising) tax rates. It involves changing the way the tax system works.

The rest of the world has a direct interest in the outcome of these discussions. Where the US goes on tax reform will influence the options open to and taken by other OECD countries. (How will they react if the US does move from an income to a consumption tax?). Similarly the US can benefit from the experience of other OECD countries. There is little new in the tax world: almost every proposal on the table today – from flat taxes to expenditure taxes – has been tried by one or other country. Countries can look and learn from the experiences of their neighbors (see how the UK has drawn from the US on the earned income credit). And herein lies the interest of this conference. What better way to launch the US debate than to look at how countries as diverse as Canada, Russia, Slovakia, UK, Poland, and Ireland have approached reform.

It's not difficult to identify the main objectives of most tax reforms:

- A simple tax system.
- A fairer tax system.
- A system that promotes rather than inhibits growth.

And of course a system that delivers the revenues that governments need to finance expenditures. We must never forget that at the end of the day, tax systems are all about collecting tax dollars in the most efficient and fair manner to pay for public services.

Defining the objectives is the easy part of reforms; implementing them is the hard part. There are difficult trade-offs between:

- Simplicity and fairness.
- Fairness and efficiency.
- Efficiency and administrative feasibility.

There is also the challenge of how to build up political and popular support for reforms, especially reforms that would shift the tax burden between sectors, between groups in society. However, the potential efficiency enhancing gains of such reforms makes tackling these challenges worthwhile.

The US has many advantages in tackling these issues. Its tax burden is low and has remained stable since 1975. There is a greater willingness here for the government and the private sector to share the burden of social welfare and of an aging population. You have a dynamic economy with flexible labor markets. You are not constrained in your choices by any supranational authority as is the case for the 25 EU Member States. But, unlike Europe, the political process of tax reform is constrained by a system of checks and balances which can quickly turn into a gridlock. In most European countries once the government decides on a reform, it is quickly implemented. Building a bipartisan consensus will therefore require looking carefully at who will be the winners and losers from reforms. It also puts a premium on packaging the reforms.

2. An Overview of OECD Tax Systems

The background paper¹ prepared for this meeting provides a wealth of material (and the OECD publications and database² provide even more) on the main features of tax systems in OECD countries. I will just run through quickly some key comparisons:

Chart 1 (see Annex 1) shows the tax to GDP ratios and is probably the most quoted figure put out by the OECD. It gives an indication of the overall tax burden (all compulsory levies, including social security contributions) paid to all levels of government. The chart shows that the US is the second lowest tax country in the OECD (At 25% way below the OECD average of 36%).

Chart 2 (see Annex 1) shows how this ratio has changed since 1975. Low tax countries (e.g. Mediterranean) have increased their tax burden (process of leveling-up). The UK and US have almost exactly the same tax burden today as in 1975. Ex-communist countries have seen significant falls (process of leveling down). Also, as you can see from the background paper, tax burdens in most countries seemed to peak in 2000.

Chart 3 (see Annex 1) shows that 90% of revenues come from income taxes, social security contributions, and general consumption taxes. Corporate tax revenue represents less than 10% of total revenues and in some countries is significantly lower (Denmark 6%). You can see from the black segments the importance of VAT as a revenue raiser: almost a fifth of revenues come from this source.

1. Fundamental Tax Reform: The Experience of OECD countries by Jeffrey Owens

2. See Revenue Statistics of OECD Countries OECD 2004; Taxing Wages OECD 2004; Trends in Tax Reform OECD 2004. See OECD website www.oecd.org

Chart 4 (see Annex 1) shows the taxes used by State and Local governments. Income taxes and property taxes are predominant sources of local government tax yields and income taxes and sales taxes that of state governments. It is interesting to see how the UK and Ireland rely on only the property tax.

Chart 5 (see Annex 1) shows the top statutory tax rate faced by wage earners. These are not effective rates; they are the headline rates. The US comes out as just below the OECD average (US rate is federal rate plus Michigan and Detroit for state and local).

Chart 6 (see Annex 1) looks at the combined (federal and state effective) average tax rates on average earnings. The first blocks give the income tax (US at 15%), the second block the income tax plus employees' social security contributions (US 22%) and the third adds in employers' contributions (US just under 30%). So if you are an employer in Belgium almost 55% of your labor costs go to pay income tax and social security, which may act as a significant disincentive to take on new employees.

Chart 7 (see Annex 1) shows the headline rate of tax in 2003. The US comes out near the top (although recent amendments will bring down the rate on manufacturing profits) and Ireland at the bottom. These are the statutory rates. Effective rates are significantly lower than the statutory rate and would also change the ranking of countries.

Chart 8 (see Annex 1) looks at the statutory rate – personal and corporate – on dividends and as such takes account of different ways of integrating CIT and PIT. The US is near the OECD average.

The blue column in Chart 9 (see Annex 1) shows the standard rate of VAT/GST (29 out of 30 OECD countries now have a VAT). EU countries tend to have a high standard rate, especially in Northern Europe. Korea, New Zealand, and Australia have rates in the 10 to 12% range and Japan at 5% is the lowest VAT rate. The green bar shows the yield from VAT and sales taxes as % of total tax revenue. The OECD average is 18%. New Zealand's base is very wide hence the high tax yield. The US has the lowest percentage. Note how Ireland has the 3rd biggest reliance on VAT. (Low income tax but high VAT country).

The conclusions that can be drawn from these comparisons are that the US is a low overall tax, high income tax country. The overall tax burden is low but it has a high reliance on income and corporate profit taxes and a low reliance on consumption taxes. Also its rates of income and corporate taxes are relatively high, although generous tax reliefs offset these rates, so that effective tax rates are significantly lower.

3. Recent Tax Reforms

What have been the main drivers of reform and what are the main features of tax reform in the OECD area?

- i) **Achieving a fairer tax system:** Fairness is about ensuring that taxpayers in similar circumstances pay similar taxes and that no group of taxpayers is able to shift its burden onto others. The concept of fairness is easy to state but difficult to implement.

Countries have tried to achieve fairness by eliminating special reliefs and thereby widening the tax base and ensuring that the tax system reflects accurately differences in taxable capacity.

But fairness also requires that honest taxpayers are not required to pay the taxes evaded by dishonest taxpayers. This aspect of fairness is particularly important in our societies since modern tax systems rely on voluntary compliance and government will not be able to maintain high voluntary compliance unless taxpayers have faith in the fairness of the system. Countries have tried to address this by trying to get the right balance between good taxpayer service and good enforcement. Commissioners are going out and making sure that tax is seen as an integral part of

good corporate governance, with corporate boards being encouraged to take responsibility for their tax strategies and the financial and reputational risks associated with such strategies. (A recent survey by Ernst and Young suggests that this is beginning to have an effect with boards becoming more averse to taking tax risks). All these changes recognize that punishing the past is not always the most effective way to promote future compliance.

- ii) **Providing a competitive fiscal environment** Liberalization combined with modern communication technologies has meant that we are rapidly moving beyond the rhetoric of globalization to the reality of globalization. Investment has become more footloose (look at the debate here and in Europe on outsourcing). High wealth professionals are now more geographically mobile (an architect can work out of London, Liechtenstein or Luxembourg). Even consumers have greater choices as to where to source their consumption. (look at the global market for digital music and software). None of this should surprise a US commentator where inter-state competition is a well established fact of life.

So large parts of the tax base are now more sensitive to tax differentials.

Today finance ministers inevitably begin their budget speeches by saying: “The measures I’m proposing will make the tax system more competitive”. (Not always true, but it’s a good opening line). Such measures usually take the form of offering lower rates of tax or preferential tax regimes for certain key activities in the economy (e.g. R&D).

The OECD growth project supports this position since it showed that low tax pressure tend to be associated with higher output and real incomes, although this is not a simple relationship.

The broader question in this debate on international competitiveness is what is the influence of taxation on FDI decisions? OECD work in this area³ suggests that taxation is only one factor in the decision on where to locate investment. Other factors include: size of local market; education; skills; labor costs; physical infrastructure (e.g. roads/airports); the legal and regulatory infrastructure; the rule of law.

It is the potential for long term profitability that will attract manufacturing FDI to any location. Nobody invests in Ireland, Slovakia, or Russia just because of the lower tax rates.

Nevertheless, empirical evidence is beginning to emerge showing that manufacturing FDI is becoming increasingly geographically mobile and sensitive to host country taxation. This should not surprise us given that many non-tax considerations have become more uniform across countries and therefore have less of an influence on business location.

And we know that tax is critical for the ways multinational enterprises structure and finance their investments.

So there are two apparent asymmetries that policymakers need to take account of in this debate:

- First, tax is only one factor in decisions of where to locate plants, but tax is a major factor in how to structure and finance the investment.
- The second asymmetry is that a low host country tax burden cannot alone attract FDI but host country tax obstacles can impede FDI. Russia in the 1990’s received less FDI than Hungary. Why? In part because of uncertainty over the tax system. This is not just a question of high tax

3. See for example, Corporate Tax Incentives for Foreign Direct Investment, OECD Tax Policy Studies No. 4, 2001

rate. Often more discouraging is the burden associated with a non-transparent system, and one subject to excessive administrative discretion and frequent change which can heighten investor uncertainty and perceived risk.

These competitiveness concerns have been major drivers of tax reforms in most OECD countries.

iii) **Making work pay**

A closely related issue is the need to make work pay: to avoid that the interactions of tax-benefit systems create disincentives for lower income groups to enter the labor force and to work harder once in the labor force. Today we have 8 OECD countries that have followed the US lead and introduced an earned income tax credit. Others have looked to reduce social security contributions paid at low income levels. Yet others have raised income tax thresholds. The OECD jobs strategy has shown that the US and other labor markets have benefited significantly from reducing the tax wedge on labor and we expect a continued emphasis in this issue in future reforms.

iv) **Simplicity**

Governments, tax administrators and taxpayers all want simpler tax systems.

There is nothing new here: Alexander Hamilton said: “Tax laws have in vain been multiplied, new methods to enforce tax collection have been tried but the public expectations have been uniformly disappointed”.

And yet, it is not easy to have simple tax systems, in a complex economic environment. As the Joint Committee here in the US put it: “it must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not”. This was in 1927! This problem is not confined to the US. In 1996 the UK Tax Review Committee commented that “much of the tax legislation is impenetrable and incomprehensible”. And this was a group of tax experts! Some countries have tried to tackle this problem by means of re-drafting the tax legislation in every day language (e.g. New Zealand); other countries by ‘hiding’ complexity from the average taxpayer. In almost two-thirds of OECD countries the majority of taxpayers do not have to complete any tax returns either because of withholding at source or because the tax returns are pre-completed. But the bottom line is that complexity reflects the policy choices made by government. True simplicity can only be achieved if you simplify the tasks that are asked of the tax system. Also simplicity is more easily achieved if there is a strong tradition of voluntary compliance with taxpayers respecting both the letter and spirit of the law⁴.

v) **The need for revenues**

Tax systems are there to deliver to governments the revenues they need to finance the defense, security, and other public services that governments are asked to provide. Some reforms – e.g. in Mexico – have been driven by the need of government for more revenues required to provide the physical and social infrastructure to achieve higher growth. Fundamentally tax reform, however, is always easier when it’s accompanied by a lowering of the tax burden.

vi) **The greening of tax systems**

4. See ‘Experiences and Innovations in other countries’ by Jeffrey Owens and Stuart Hamilton in “The Crises in Tax Administration”, Brookings Institutions, Press, Washington D.C. 2004

An increasing number of European countries – the Netherlands, the Nordic 's, and the UK – are using tax reforms to attain environmental objectives. In some countries this has led to CO₂ taxes; in others to taxes and levies on highly polluting products (plastic bottles). In practice, environmental taxes still make up a small amount of revenue (less than 0.5% of GDP, although this increases to 2.5% of GDP the energy taxes and taxes on vehicle ownership are taken into account. (The equivalent US Figure is less than 0.9 %). Some countries see here an opportunity for a triple dividend: more revenue; less pollution; less dependence on imported oil.

Many governments are, however, cautious about substituting environmental taxes for more stable revenue sources since by definition a successful environmental tax will tax itself out of business.

vii) Dealing with External Constraints

An old title, but I believe one of the drivers for reforms in Europe will be the European Court of Justice. Many of our well established concepts in international tax arrangements – distinctions between residents and non-residents, for example - are gradually being undermined by the European Court of Justice. The problem is that the ECJ can only say what measures are inconsistent with the Treaty of Rome. It has no mandate to say what should replace those measures found to be inconsistent. This is a debate that will have an impact on tax systems both within and outside of the EU and one that requires reflection on the longer-term implications (e.g. do we need to revisit the concept of non-discrimination in tax treaties ?).

Re-designing Personal Income Taxes

At the center of the tax reform debate in the OECD area is how to tax personal income. Countries have a number of choices to reform personal income taxes.

i. Comprehensive income tax

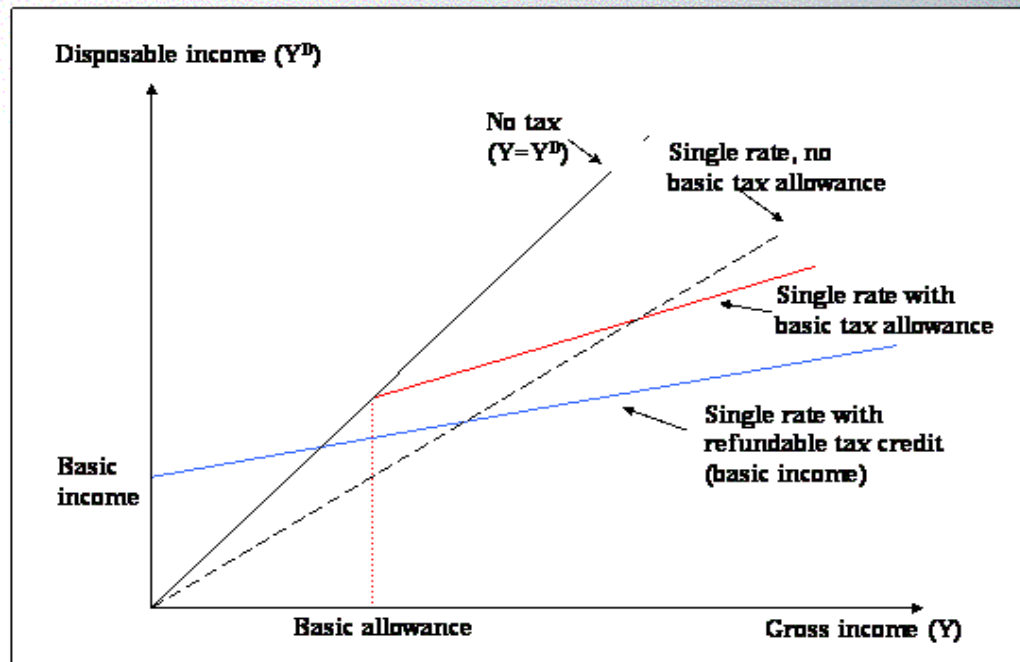
Most OECD countries have income tax systems that are based on an aggregation of income from all sources. Such systems are consistent with the principle of horizontal equity in the sense that individuals with the same level of income are taxed equally. They also make it easier to effectively redistribute income by way of progressive income tax rates, as it is more difficult to avoid such taxes through income shifting activities. In practice, most comprehensive income taxes provide a wide range of special treatments or exceptions for certain types of income or sectors. Also almost all of these systems provide generous tax relief for certain forms of savings, particularly those linked to retirement. Consequently, in practice, such systems are really based on a hybrid of income and consumption tax principles.

Flat tax system

Flat tax systems are one variant of comprehensive income taxes, at least if we talk about the “European” concept of flat taxes and not the “flat consumption/expenditure” type taxes that have been proposed here and which no OECD country has tried.

There are many myths and misconceptions that surround the flat tax debate. Chart 10 may help clarify our thoughts.

Chart 10: Flat Tax Rate Systems



The chart illustrates three different types of flat taxes:

- **Single rate, no allowance:** All (positive) income is taxed at a flat rate.
- **Single rate, basic allowance:** All (positive) income above a basic allowance or tax credit is taxed at a flat rate. Russia and Slovakia have this second option.
- **Single rate, refundable (non-wastable) allowance :** All income is taxed at a flat rate, but there is a refundable tax allowance or tax credit. This credit is of equal value to all individuals, regardless of their income levels. This is often called the “basic income flat tax”, where the basic income is supposed to replace all social security benefits in addition to introducing a flat tax rate on personal income.

A fourth type of flat tax, which is the one most commonly discussed in the United States, is the **flat rate consumption tax** (this is the so-called Hall-Rabushka’s flat tax proposal). In this system, all income that is not saved is taxed at a single rate. Income from savings is only taxed at the corporate level at the same flat rate. Perhaps the most controversial element of the more pure variants, one surely to attract stiff opposition if seriously considered, is non-deductibility of interest.

A common feature with all flat tax proposals is that the introduction of a single rate is combined with an elimination of all or most tax reliefs, and it is mainly this which makes flat tax proposals *simpler* than existing progressive systems. In addition, it will simplify the system if the same flat rate is introduced for both personal and corporate income as the incentives to income shifting between the personal and the corporate sector are reduced or even removed.

Those in favor of flat taxes also often argue that the reduction of tax reliefs in practice will lead to a *fairer* tax system and have a positive effect on redistribution, because the value of deductions increases with income in a comprehensive tax system (at least if marginal rates are progressive) and because high income persons are generally in a better position to take advantage of all allowances than low and medium income persons. In addition, it is often argued that a lowering of the tax rate will stimulate the economy and lead to increased employment, which will normally have a positive effect on income distribution.

Four concluding comments on flat taxes :

- There is nothing magical about one rate. All countries have been moving away from multiple rate schedules. But one rate is probably simpler to operate.
- Flat taxes can be progressive and do not necessarily lead to lower effective tax rates at lower-middle income revenues.
- Flat tax systems can be designed to lower or raise existing revenue yields.
- To get the full benefits of a flat tax you need to get rid of the loopholes, allowances, etc.

Dual income tax

Dual income tax systems separate out the taxation of earned and unearned income. They were introduced in Denmark, Finland, Norway and Sweden in the early 1990s. The main guiding principle of the dual income tax is to combine a progressive taxation of labor income with a flat tax on corporate and capital income, all with a broad tax base and a fairly low tax rate. The systems are simple in that there is a flat tax rate on net income with relatively few tax deductions.

Put simply, dual income tax systems are mainly driven by a pragmatic recognition that if you try to tax capital income at too high a rate you will drive the capital to another country, whereas it is hard for wage earners to move, an argument that may be less applicable to high earning professionals.

The biggest problem that the Nordics have faced is how to counter the incentives to incorporate and for closely held businesses to convert wage income taxed at progressive rates into capital income taxed at a lower flat rate. Also some politicians are now questioning the fairness of taxing earned income at higher rates than unearned income.

Concluding Comments

It would be presumptuous of me to say what lessons the US can draw from all of this. But I do feel that the US reforms will be driven by concerns similar to those found in other OECD countries:

The desire to produce a tax system which favors wealth creation; removes tax-induced distortion; promotes a competitive environment; produces a fairer distribution of the tax burden; encourages voluntary compliance and penalizes tax cheating and reduces taxpayers' compliance burden.

The challenge facing tax reformers is what should be the trade offs between these sometimes competing objectives.

The United States may decide to scrap the entire income tax system and move to some form of consumption tax. This may be a European style VAT or a flat rate consumption type of tax. If the VAT system is chosen, there is a rich vein of OECD experience on which the United States can draw. A broad based VAT would be able to raise 0.5% GDP for each % point of the rate scale. Thus a 10% broad based VAT in the US would yield 5% of GDP which is equal to 3 times the yield from the corporate income tax. If a flat rate consumption tax is the favored option, then the United States will have 29 OECD countries as interested on-lookers and careful thought would have to be given to how to manage the interaction between any 'new' American and 'old' European tax systems.

If the United States decides to keep the existing income tax, it can still achieve a 'fundamental' reform by lowering significantly the tax rates and paying for this by broadening the tax base. Even though this would not represent a fundamental departure from the existing tax system, few would disagree that this would be a major change to the way the tax system functions. Business may find such reforms attractive at least insofar as the rate reductions are large and the system is stable over time. Such reforms could lead to a new compact between government and citizens: we, the government, will provide you with a fairer tax system with lower tax rates and you, the citizens, (both household and corporate) will pay tax at these rates.

Whichever approach to reform is adopted it will not be easy. Some groups of taxpayers will gain, others will lose. There will be transitional issues. Considerable attention will need to be paid to the *process* of reform. Box 1 set out the experience in this regard of OECD countries that have successfully completed fundamental tax reform.

Box 1. Pre-conditions for Successful Tax Reform

The experience of OECD countries suggests that 8 conditions are required for successful tax reforms:

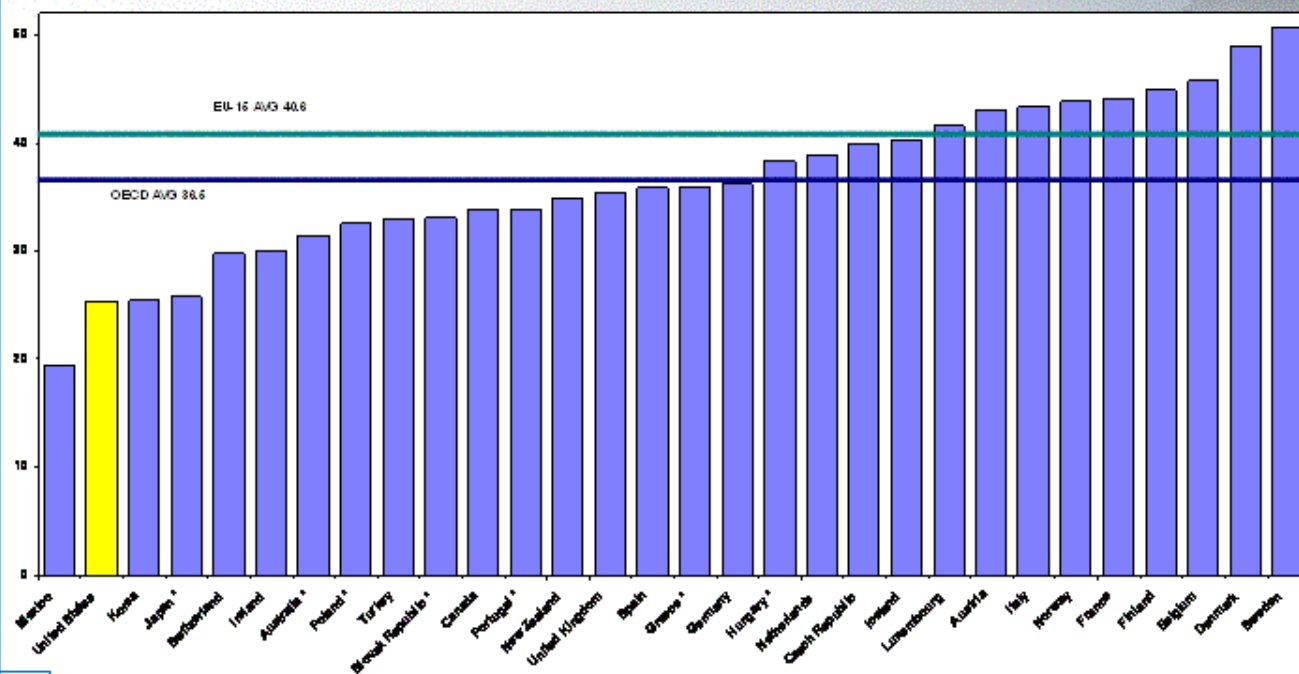
1. Political champions to mobilize support and counter special interests. This means politicians

who can fire the imagination of taxpayers by the boldness of their vision.

2. A package approach with pains and gains intricately linked. There will be losers, but these people should feel that they are in the same boat as the gainers and that these losses will eventually lead to gains.
3. Reforms based on clear principles which can be simply articulated and understood.
4. An open and inclusive process of reform. Reform should be bi-partisan if it is to stand a chance of achieving long-term stability.
5. Limited time between the initial announcement and implementation.
6. In a federal context, all levels of government must buy into the reforms since most reform will impact the revenue base of lower levels of government.
7. Reforms must extend to the tax administration. Put another way: administrative feasibility is an important criterion to judge tax reform.
8. From day one, an education and guidance package must be prepared.

A final comment or rather a question that European countries need to ponder. In 1900 the tax burden in the US was higher than in Germany and just below that in France and the UK. Even in 1970, the US tax burden was close to the European average. Since then, the European tax burden has increased significantly. The US has remained stable. Why? Does this reflect the choices made as to how to finance social welfare and health? (12% in the public domain in US; 20% in Europe). Do these choices mean that “discretionary” income available to Americans is really more than that available to Europeans? Does it reflect the constraints imposed by inter-state tax competition? Does it reflect the lack of a VAT? Or is the answer outside the realm of economics and more in the realm of attitudes towards the role of government?

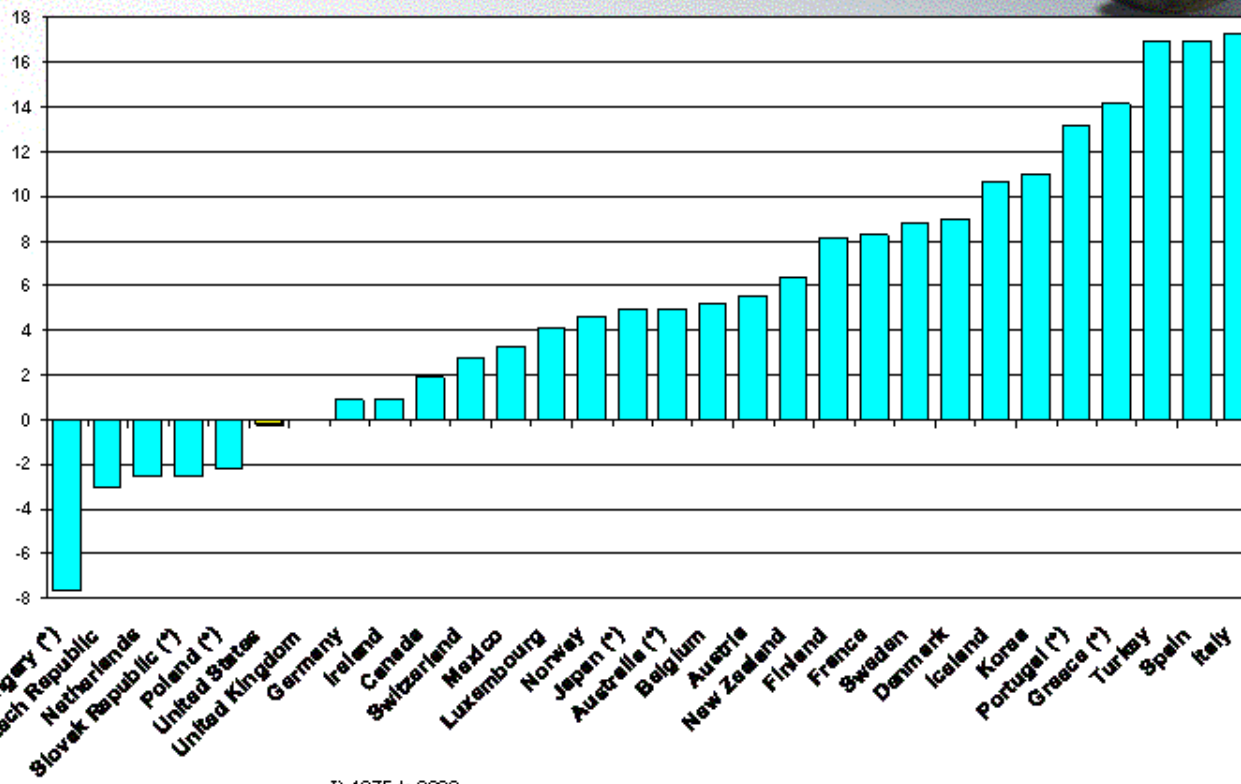
Chart 1: Tax Revenue as % GDP (2003)



Note: countries have been ranked by their total tax to GDP ratios.

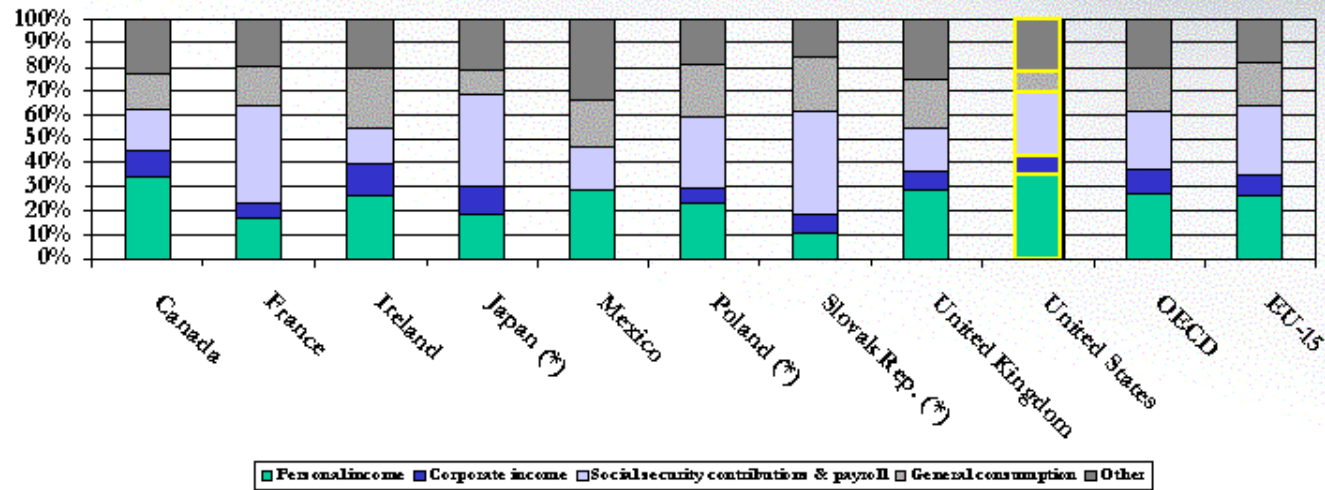
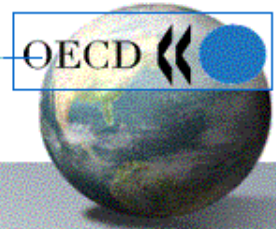
*) 2002 figures

Chart 2: Change in tax to GDP ratios 1975 to 2003



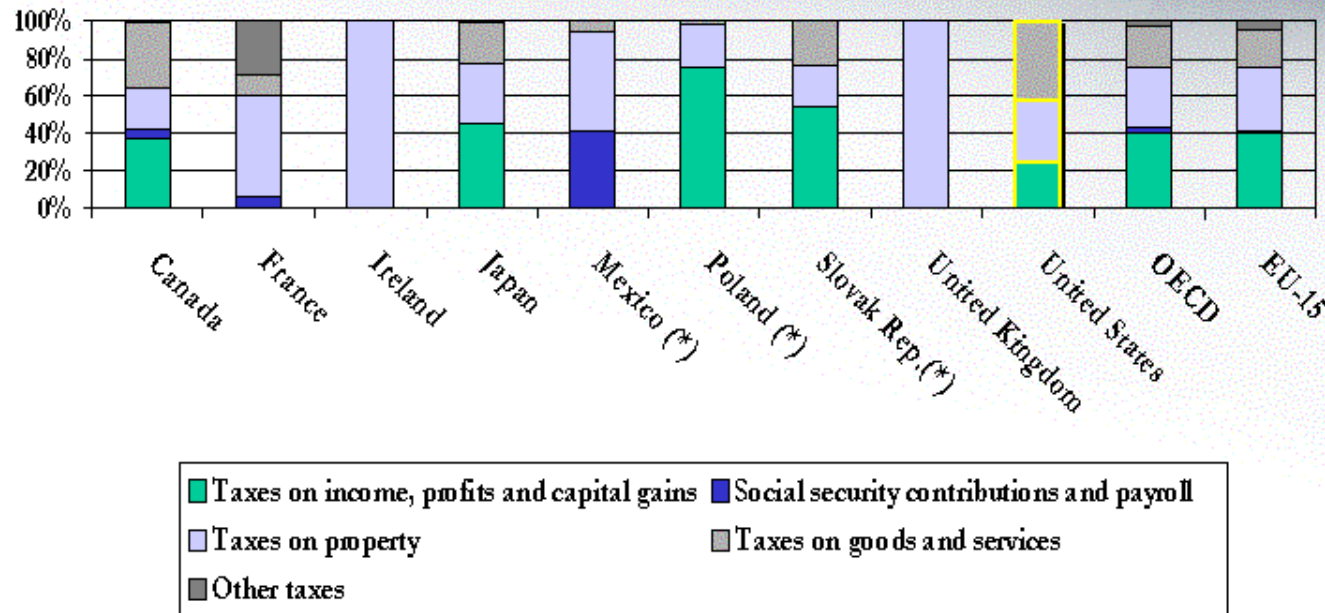
*) 1975 to 2002

Chart 3: Source of tax revenue, 2003



*) 2002 figures

Chart 4: Structure of state and local government tax receipts, 2003



*) 2002 figures

Chart 5: Top statutory PIT rate on wage income, 2003

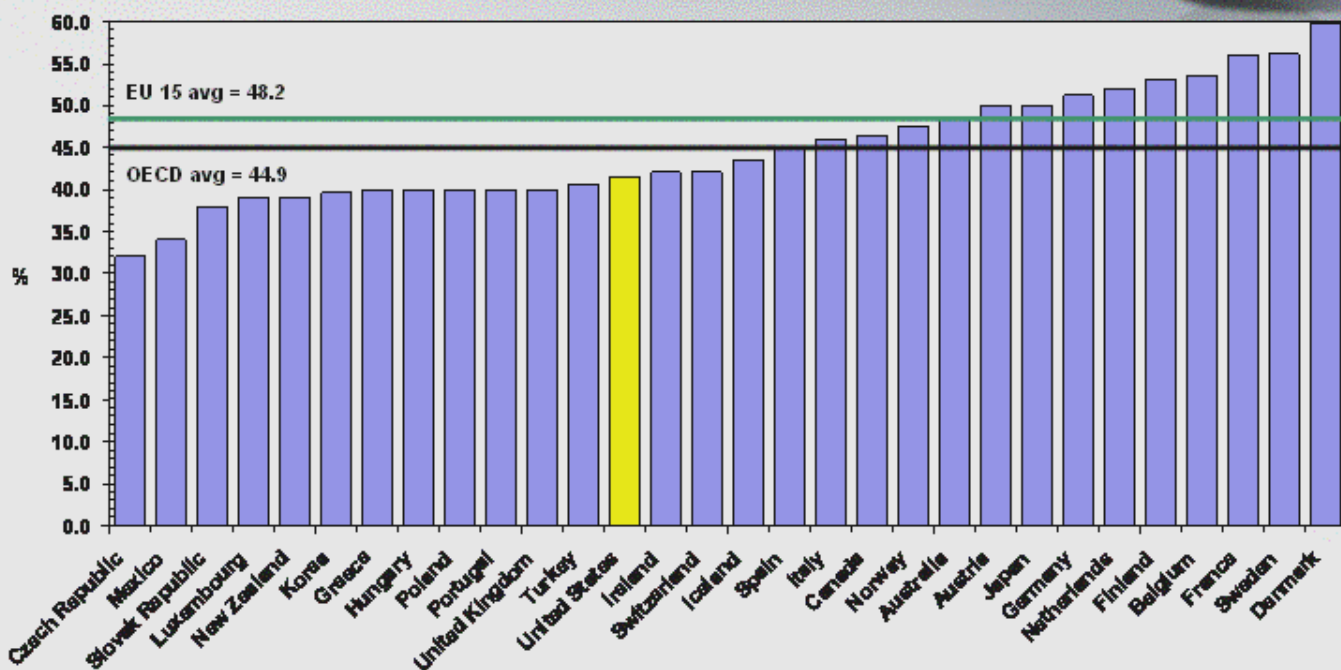


Chart 6: Income tax and social security contributions as % of labour costs, 2003

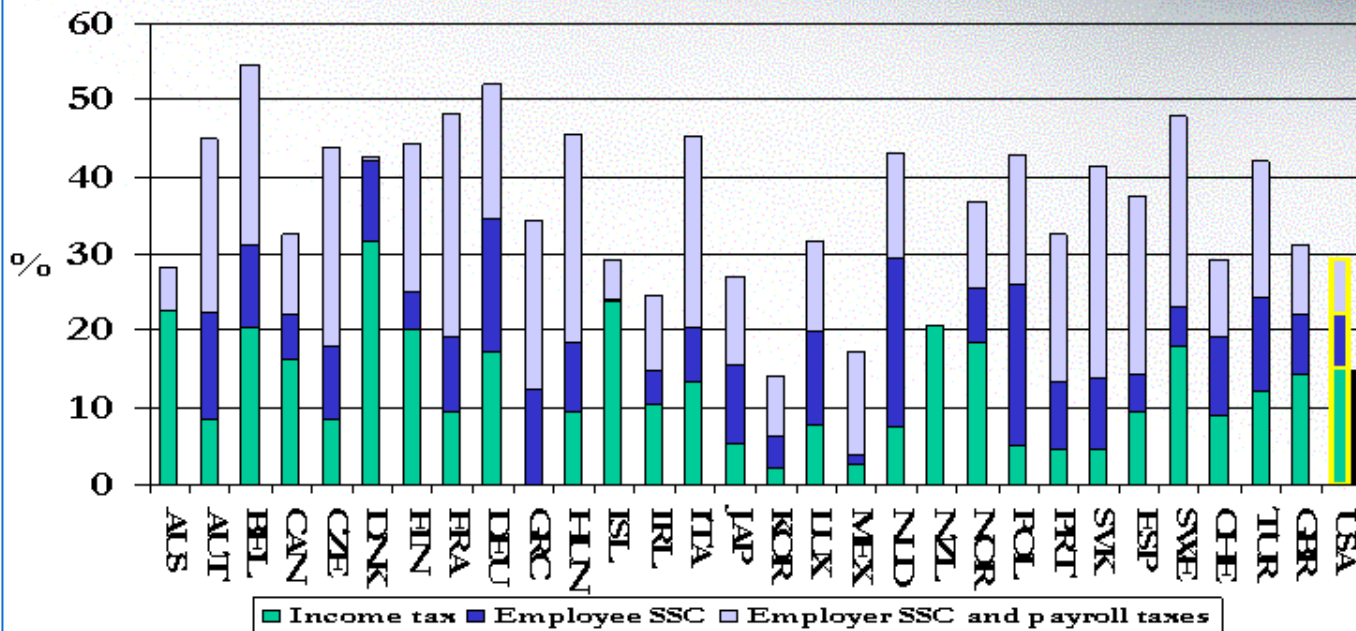


Chart 7: Basic statutory corporate tax rates, 2003

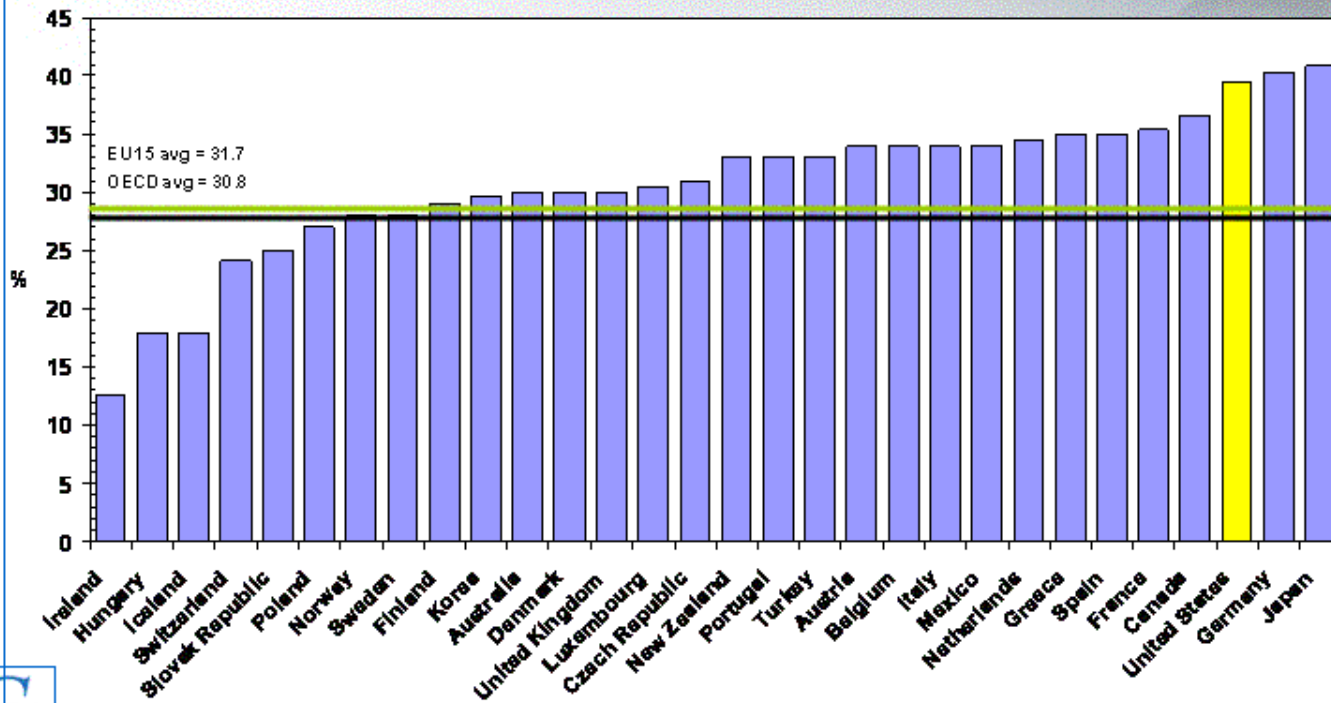
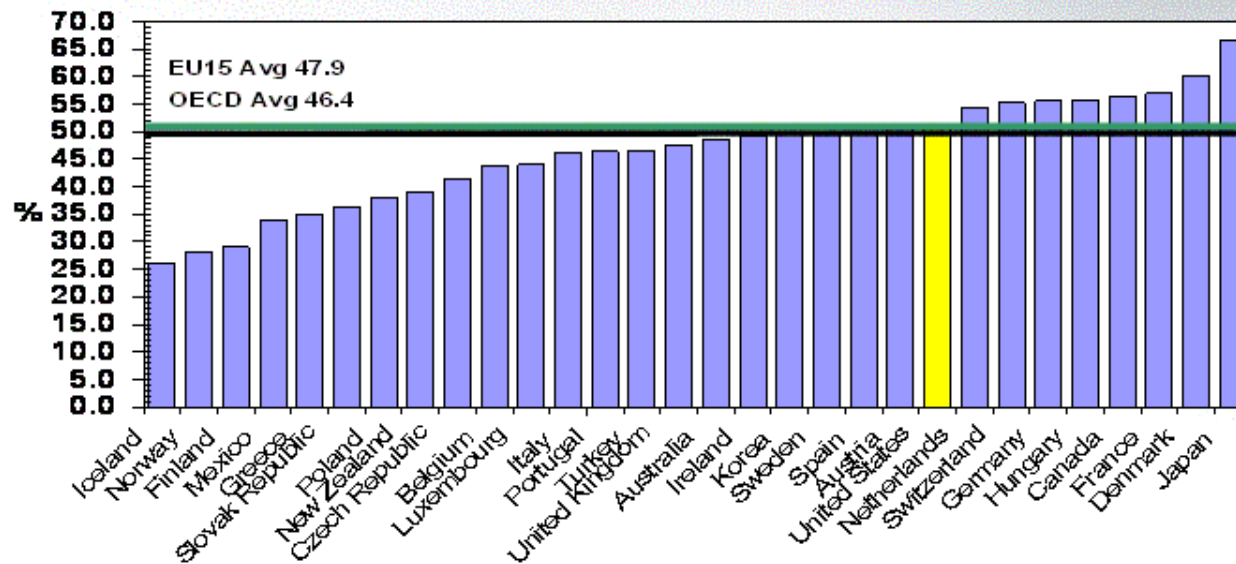


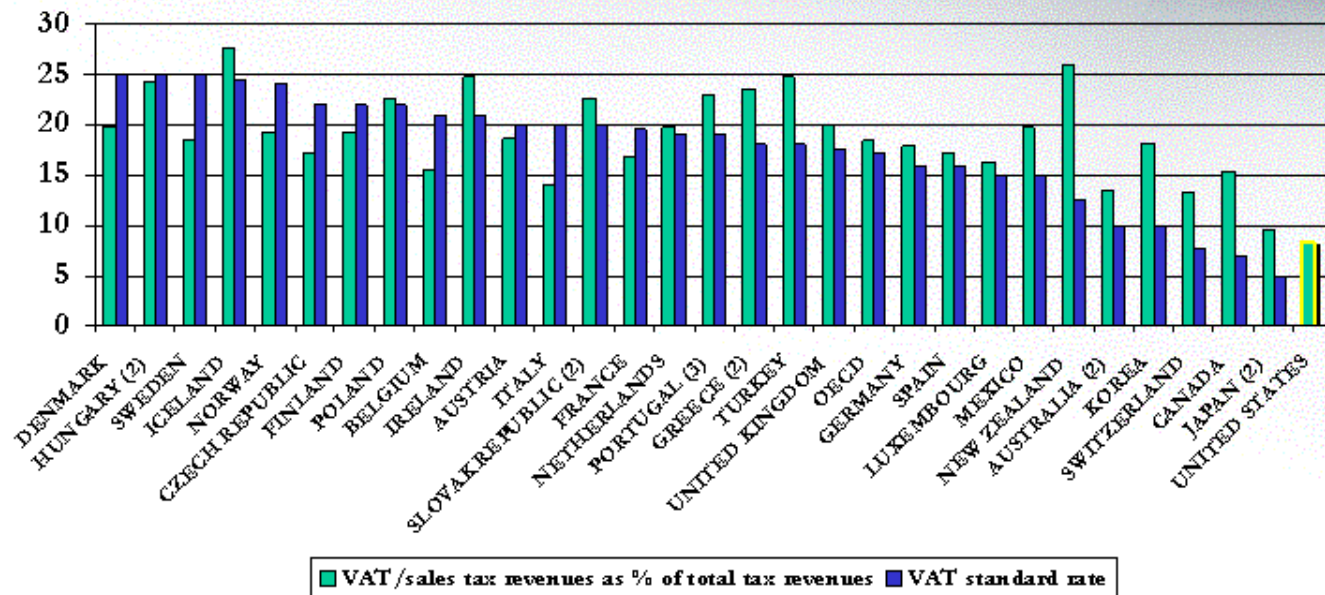


Chart 8: Top statutory personal plus corporate tax rates on dividend income⁽¹⁾, 2003



1) This is the overall (corporate plus personal) top marginal tax rate on distribution of domestic source profits to a resident individual shareholder, taking account of imputation systems, dividend tax credits etc.

Chart 9: VAT – tax rates and revenues 2003 ⁽¹⁾



- 1) Countries ranked from highest VAT standard rate to lowest rate
- 2) 2002 revenue figure
- 3) 2001 revenue figure

