Fundamental Tax Reform: an International Perspective

by

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ABSTRACT

This paper examines trends in tax reforms. The analysis is limited to the experience of 30 OECD countries, and focuses particularly on changes since the year 2000. The paper analyses the general trend of reductions in both tax revenues and rates and the diversity in tax policies across OECD countries, reflecting the diversity in both economic circumstances and policy objectives. Developments in tax administration are also briefly dealt with. Some of the challenges for tax policymakers and administrators that are likely to arise over the next few years are identified, and possible alternative approaches to solving them put forward.

INTRODUCTION

Tax reform is an on-going process, with tax policymakers and tax administrators continually adopting their tax systems to reflect changing economic, social and political circumstances. Over the last two decades, almost all OECD countries have undertaken structural changes to their tax system which have significantly altered the way these systems function and their economic and social impacts[1]. In some countries, for example, many of the Eastern European economies in transition, the reforms have been profound and implemented over a very short period of time. In others, most of the European countries, the reforms have been a gradual process of adaptation but which over time have substantially redesigned their tax systems. One can argue about whether this second group of countries can be characterized as having undertaken “fundamental” tax reform, but this seems to be no more than a semantic debate. Few would disagree that the tax systems in operation in the 30 OECD Member countries today truly are fundamentally different from those which operated in the mid-1980’s.

These tax reforms have been driven by the need to provide a more competitive fiscal environment: one which encourages investment, risk-taking, entrepreneurship and provides increased work incentives. At the same time, governments are aware of the need to maintain taxpayers’ faith in the integrity of their tax systems. Fairness and simplicity have become the byword of reformers. Fairness requires that taxpayers in similar circumstances pay similar amounts of tax and that the tax burden is appropriately shared. Simplicity requires that paying your taxes becomes as painless as possible (not something easily achieved in modern societies) and that the administrative and compliance costs of collecting taxes are kept at a minimum.

Almost all the tax reforms of the last two decades involving the income tax can be characterized as rate reducing and base broadening reforms, following the lead given by the United Kingdom in 1984 and the United States in 1986. In the mid-1980s, most OECD countries had top marginal income tax rates in excess of 65 per cent. Today most OECD countries have top rates below, and in some cases substantially below, 50 per cent. Similarly, top statutory corporate income tax rates in the 1980s were rarely less than 45 per cent. In 2004, the OECD average rate was below 30 per cent and an increasing number of countries have rates below 25 per cent.

These reforms, however, did not until recently lead to a fall in the overall tax burden (measured by the tax-to-GDP ratio). From 1975 to 2004, most OECD countries experienced an increase in this ratio. Some, like Finland and France, saw the tax burden increase by almost a third. A small number of countries – notably the United Kingdom and the United States – experienced a stable tax burden. It does appear, however, that this long-term upward trend peaked in 2000 and the latest figures available to the OECD suggest that most countries are now below the peak 2000 level.

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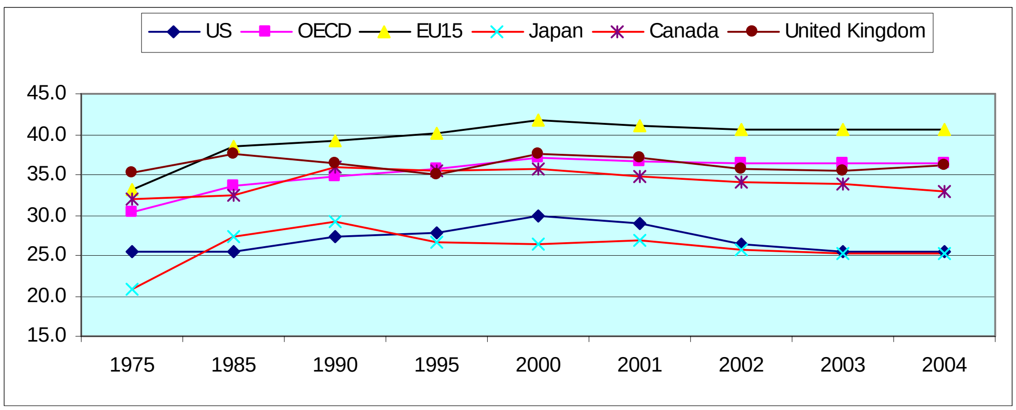
1 The paper draws heavily on three annual statistical outputs of the OECD’s Centre for Tax Policy and Administration: the Revenue Statistics, Taxing Wages and the OECD Tax Database. It also draws on three recent OECD monographs: *Recent Tax Policy Trends and Reforms in OECD Countries*, OECD (2004a); *Consumption Tax Trends*, OECD (2004b); and *Tax Administration in OECD Countries: Comparative Information Series*, OECD (2004c). These documents may be found at http://www.oecd.org/ctp.

Most reforms have also tried to shift the balance in the tax structure from taxes on income and profits towards taxes on consumption – a process facilitated by the increased use of value added taxes (the United States is now the only OECD country without this form of consumption tax).

This paper examines trends in tax reforms. The analysis is limited to the experience of 30 OECD countries and focuses particularly on changes since the year 2000. Section 2 documents the general trend of reductions in both tax revenues and rates. Section 3 examines the diversity in tax policies across OECD countries, reflecting the diversity in both economic circumstances and policy objectives. Section 4 deals briefly with developments in tax administration. Finally, Section 5 looks at some of the challenges for tax policymakers and administrators that are likely to arise over the next few years and sketches possible alternative approaches to solving them.

Figure 1. Tax-to-GDP Ratios in the OECD-area. 1975-2004[1]



1) 2004 figures are lacking for some countries, including Japan. For such countries 2003 figures are used.

Source: OECD(2005a).

TRENDS IN TAX REVENUES AND STRUCTURES

Tax Revenues

The evolution of tax revenue as a percentage of GDP in OECD countries since 1975 is shown in Figure 1. Between 1975 and 2000, there had been a persistent and largely unbroken upward trend in the ratio of tax to GDP across most of the OECD area. However, the unweighted OECD average peaked at 37.1 per cent in 2000 and then fell to 36.7 per cent in 2001 and 36.3 per cent in 2003. No overall OECD ratio is yet available for 2005 as a number of countries still have to report data, but provisional figures suggest a break in this downward trend, possibly in part reflecting stronger economic growth.

Despite this possible break in the recent downward trend, a number of countries experienced large reductions in tax-to-GDP ratios between 2000 and 2004, as illustrated in Table 1. The United States, for example, saw a reduction of 4.5 percentage points in its tax-to-GDP ratio, from 29.9 per cent to 25.4 per cent. Substantial reductions were also experienced in Finland (3.7 percentage points), Sweden (3.2 percentage points), the Netherlands (1.9 percentage points), Ireland (2.0 percentage points) and the

United Kingdom (1.4 percentage points). No country experienced an increase in its tax-to-GDP ratio of more than 2 percentage points over the same period, except Iceland (2.5 percentage points).

Personal and Corporate Income Tax Rates

One of the main factors behind the reductions in tax revenues since 2000 has been reductions in the marginal rates of personal and corporate income tax. Indeed, all of the countries with falls of more than two percentage points in their tax-to-GDP ratios have significantly cut income taxes, particularly personal income taxes.

TABLE 1
TOTAL TAX REVIEW AS A PERCENTAGE OF GDP

	1975	1985	1990	1995	2000	2002	2003	2004 Provisional
Canada	31.9	32.5	35.9	35.6	35.6	34.0	33.8	33.0
Mexico		17.0	17.3	16.7	18.5	18.1	19.0	18.5
United States	25.6	25.6	27.3	27.9	29.9	26.3	25.6	25.4
Australia	26.5	29.1	29.3	29.8	32.1	31.4	31.6	n.a
Japan	20.9	27.4	29.1	26.7	26.5	25.8	25.3	n.a
Korea	15.1	16.4	18.9	19.4	23.6	24.4	25.3	24.6
New Zealand	28.5	31.3	37.7	36.9	33.9	35.0	34.9	35.4
Austria	36.7	40.9	39.6	41.1	42.6	43.6	43.1	42.9
Belgium	40.6	45.6	43.2	44.8	45.7	46.2	45.4	45.6
Czech Republic				37.5	36.0	37.0	37.7	37.6
Denmark	40.0	47.4	47.7	49.5	50.1	48.7	48.3	49.6
Finland	36.8	40.2	44.3	46.0	48.0	45.8	44.8	44.3
France [1]	35.5	42.4	42.2	42.9	44.4	43.4	43.4	43.7
Germany [2]	35.3	37.2	35.7	37.2	37.2	35.4	35.5	34.6
Greece	21.8	28.6	29.3	32.4	38.2	37.1	35.7	n.a
Hungary				42.4	39.0	38.8	38.5	37.7
Iceland	29.8	28.7	31.8	32.1	39.4	38.5	39.8	41.9
Ireland	29.1	35.0	33.5	32.8	32.2	28.7	29.7	30.2
Italy	26.1	34.4	38.9	41.2	43.2	42.5	43.1	42.2
Luxembourg	37.5	45.1	40.8	42.3	40.6	41.3	41.3	40.6
Netherlands	41.3	42.8	42.9	41.9	41.2	39.2	38.8	39.3
Norway	39.3	43.0	41.5	41.1	43.2	43.8	43.4	44.9
Poland				37.0	32.5	34.7	34.2	n.a
Portugal	20.8	26.6	29.2	33.6	36.4	36.5	37.1	n.a
Slovak Republic					34.3	33.0	31.1	30.8
Spain	18.2	26.9	32.1	31.8	34.8	34.8	34.9	35.1
Sweden	42.0	48.2	53.2	48.5	53.9	50.1	50.6	50.7
Switzerland [3]	27.4	26.1	26.0	27.8	30.5	30.1	29.5	29.4
Turkey	16.0	15.4	20.0	22.6	32.3	31.1	32.8	31.1
United Kingdom	35.3	37.7	36.5	35.1	37.5	35.6	35.6	36.1
Unweighted average:								
OECD Total	**30.3**	**33.5**	**34.8**	**35.7**	**37.1**	**36.4**	**36.3**	**-**
OECD America	28.8	25.0	26.8	26.7	28.0	26.1	26.1	25.6
OECD Pacific	22.7	26.0	28.7	28.2	29.0	29.1	29.3	

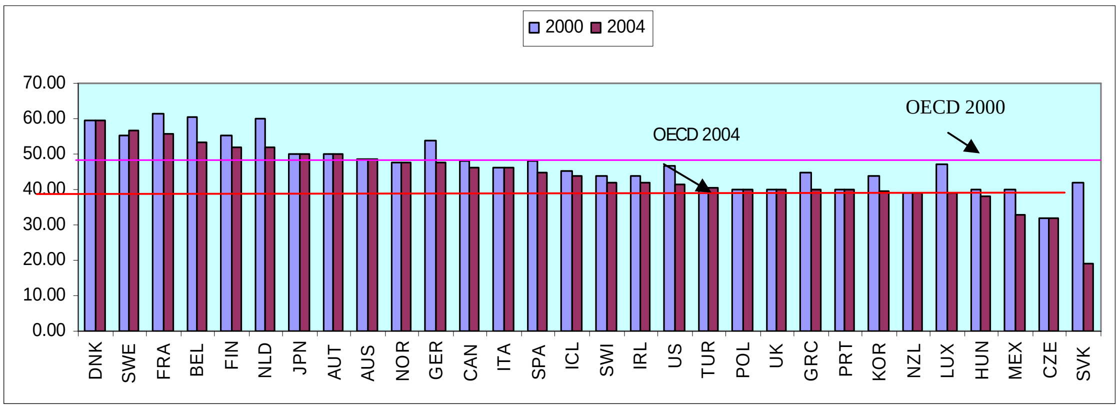
OECD Europe	32.1	36.4	37.3	38.3	39.7	39.0	38.9	
EU 15	**33.1**	**38.6**	**39.3**	**40.1**	**41.7**	**40.6**	**40.5**	**-**

n.a indicates not available.

1. From 1992, the total tax revenue has been reduced by the amount of the capital transfer that represents uncollected taxes.
2. Unified Germany beginning in 1991. Starting 2001, Germany has revised its treatment of non-wasteable tax credits in the reporting of revenues to bring it into line with the OECD guidelines.
3. The source for the 1975 figure is Swiss authorities, due to a change in the methodology which is only implemented in OECD

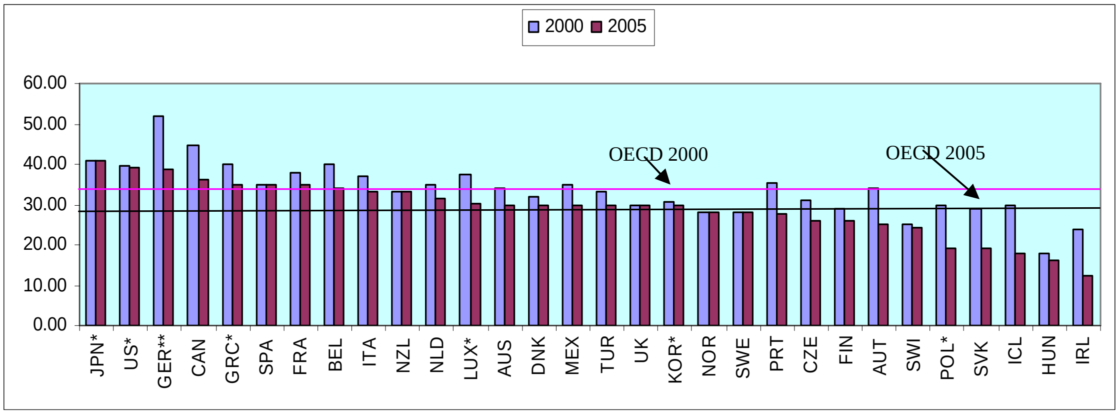
Source: OECD (2005a).

Figure 2. Top Statutory Personal Income Tax Rates on Wage Income. 2000 and 2004



Source: OECD (2005b).

Figure 3. Statutory Corporate Income Tax Rates. 2000 and 2005[1]



1) 2004 figures for countries marked * (for the US sub-central rates in 2005 are assumed to be equal to those in 2004). The government in Germany (**) has recently proposed to reduce the federal rate from 25 to 19 per cent, which will reduce the combined rate to from 38.9 to 33.6 per cent if implemented.

Source: OECD (2005b).

Figure 2 shows that the marginal statutory personal income tax rates for individuals with high wage income were eased between 2000 and 2004. The unweighted OECD-average was reduced by about 3.1 percentage points, and by about the same in the EU15[2]. The rates were reduced by more than 1 percentage point in 17 countries. Sweden is the only country where this rate (slightly) increased. The rate was reduced by 5 percentage points or more in Belgium, France, Germany, Greece, Luxembourg, Mexico, Netherlands and the Slovak Republic.

The picture is less clear, although similar, when comparing the "all-in" effective marginal tax rates, i.e. including both income taxes and employee social security contributions and taking account of standard tax credits, tax allowances and ceilings for social security contributions. On average, the top "all-in" tax rates were reduced by 1.2 percentage points in OECD and by 0.8 percentage points in the EU15.

The general trend towards reduced tax rates is even more pronounced in respect of corporate income tax rates. Figure 3 shows that the statutory corporate income tax rates in the OECD Member countries dropped on average by 4.6 percentage points between 2000 and 2005, from 33.6 per cent to 29 per cent. This trend seems to be widespread, as rates have been reduced in 24 countries and in none of the OECD countries was the rate increased. In the EU15 countries, the unweighted average corporate tax rate dropped by an average of 5 percentage points, from 35.1 per cent to 30.1 per cent.

The trend towards reduced rates started already in the mid-1980s in most countries, and even earlier in some countries. In the late 1970s it was not uncommon to find top marginal personal income tax rates above 70 per cent, while these rates are now well below 50 per cent in a majority of OECD countries. Similarly, the trend towards a reduction of corporate income tax rates started when several countries introduced tax reforms with base-broadening and rate cuts following the tax reforms in the United Kingdom and the United States in the mid-1980s. The more recent cuts in corporate tax rates have been

2 These are the EU countries prior to the recent expansion: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom.

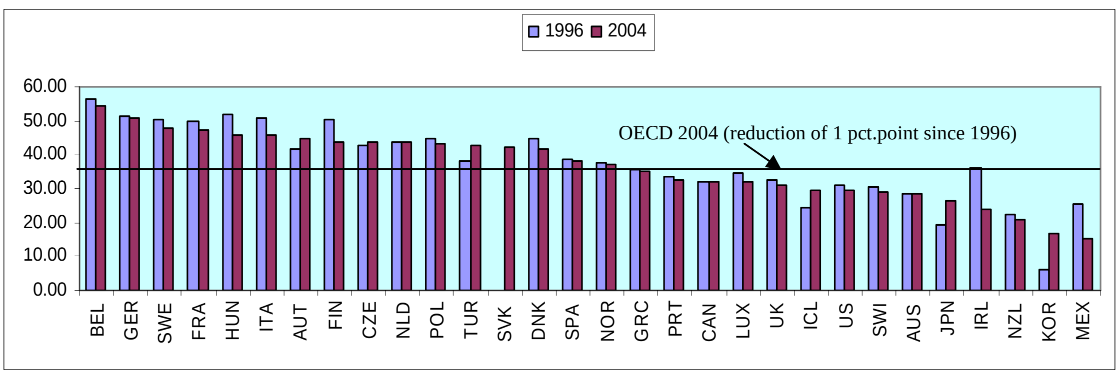
partly financed by base-broadening in many countries. In the OECD area, the average corporate tax rate has dropped by almost 8 percentage points since 1997.

Taxation of Labor

The total tax wedge on labor, or the difference between what employers have to pay in wages and social security charges and what employees take home after tax and social security deductions plus any cash benefits for which they may be eligible, can be a disincentive to work. Social security contributions have increased in a number of countries, but reductions in personal income taxes have meant that there has been a gradual reduction in the wedge for the average OECD country, and a faster reduction amongst the EU15 countries.

Figure 4 compares the total tax wedge (income tax plus employee and employer social security contributions) for a single worker at average earnings of a production worker for OECD countries in 1996 and 2004[3]. The unweighted OECD average has decreased by 1 percentage point since 1996, while the unweighted EU15 average fell by 2.5 percentage points. This rate fell by 1.5 percentage points in the United States and by 1.4 percentage point in United Kingdom during the same period, while the tax wedge increased by 7.6 percentage points in Japan and remained fairly stable in Canada. Although the largest reduction was in the EU15 area, the average rate in 2004 was still 4.3 percentage points higher than the OECD average and substantially above the levels in the United States, Canada and Japan.

Figure 4. Tax Wedge for Single Individual at Average Earnings[1]. 1996 and 2004



1) The tax wedge for single individuals (without children) is the sum of income tax plus employee and employer social security contributions as a percentage of total labor costs (gross wage plus employer social security contributions).

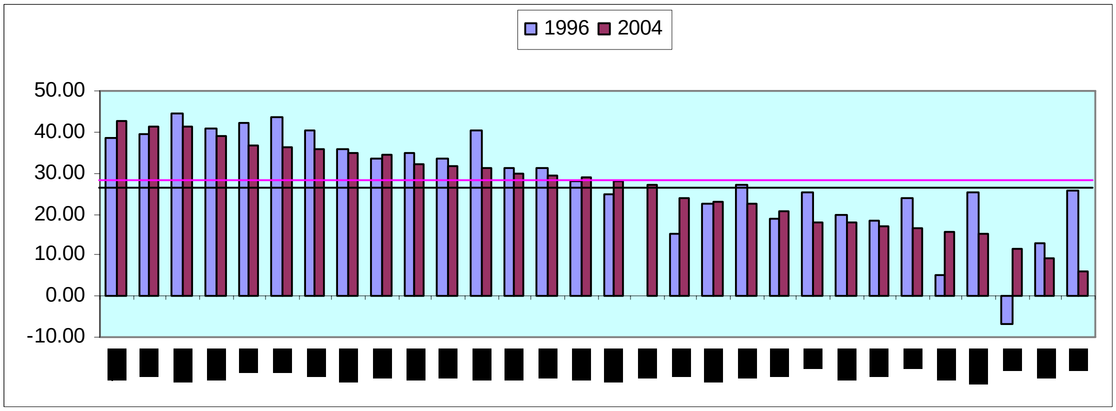
Source: OECD (2004d).

3 The earnings measure is gross wage earnings paid to average production workers, measure before deductions of any kind (e.g. withholding tax, income tax, private or social security contributions and union dues). The earnings measure also includes overtime pay, vacation pay, recurring (periodic) cash bonuses (e.g. Christmas bonuses and 13th/14th month bonuses) and other cash payments by the employers. Sick-leave pay and unemployment pay, either paid directly by firms on behalf of the government, or as part of a private insurance scheme, are excluded. Non-cash remuneration such as fringe benefits and remuneration under profit-sharing schemes which take the form of dividend contributions are also excluded.

The trend is similar for single individuals at 67 per cent and 167 per cent of average earnings. At 67 per cent of average earnings, the tax wedge was reduced by 3.3 percentage points in the EU15 and by 1.9 percentage points in the United States. The overall average was reduced by 1.1 percentage points, while the tax wedge was reduced by 0.1 percentage points in Canada and 0.4 percentage points in United Kingdom and increased by 7.4 percentage points in Japan. At 167 per cent of average earnings, there was an average reduction in the OECD of 0.4 percentage points tax wedge and by 2.0 percentage points in the EU15. The reduction in United Kingdom was 0.5 percentage points as compared to 1.9 percentage points in the United States and 3.3 percentage points in Canada, while it increased in Japan by 7.9 percentage points. However, the tax wedge in the EU15 in 2004 was still substantially higher than that in the United States, Canada and Japan at these income levels.

The tax calculations also take account of standard cash benefits and tax credits for families and for children, and will thereby pick up the effects of the increasing use of the tax system as a vehicle to deliver social benefits in many countries. Figure 5 illustrates the development in the tax wedge, including income tax plus employee and employer social security contributions and less cash benefits, for a married couple with one earner at average earnings and two children. The figure shows the wedge fell on average by 1.6 percentage points between 1996 and 2004, from a level of 28.2 per cent. Although the reduction of the unweighted EU15-average was substantially larger than that of the OECD (4.2 percentage points), the tax wedge in 2003 was still 2.5 percentage points above the OECD-average. For this family type, the tax wedge was substantially reduced in the United States and United Kingdom (by 7.5 and 7.4 percentage points respectively), while it increased by 0.3 percentage points in Canada and by 8.8 percentage points in Japan.

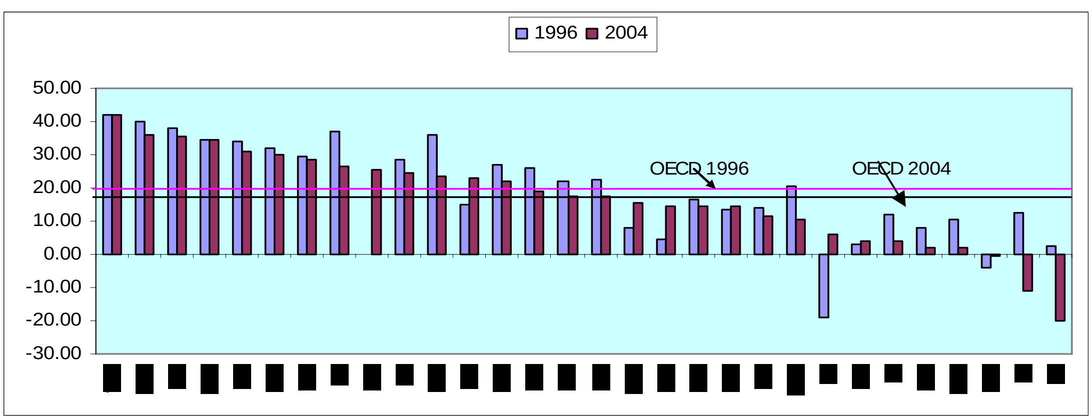
Figure 5. Tax Wedge for One-earner Family with Two Children at Average Earnings[1]. 1996 and 2004



1) The tax wedge is the sum of income tax plus employee and employer social security contributions less cash benefits as a percentage of total labor costs (gross wage plus employer social security contributions).

Source: OECD (2004d).

Figure 6. Tax Wedge for Single Parent with Two Children at 67 per cent of Average Earnings[1]. 1996 and 2004.



1) The tax wedge is the sum of income tax plus employee and employer social security contributions less cash benefits as a percentage of total labor costs (gross wage plus employer social security contributions).

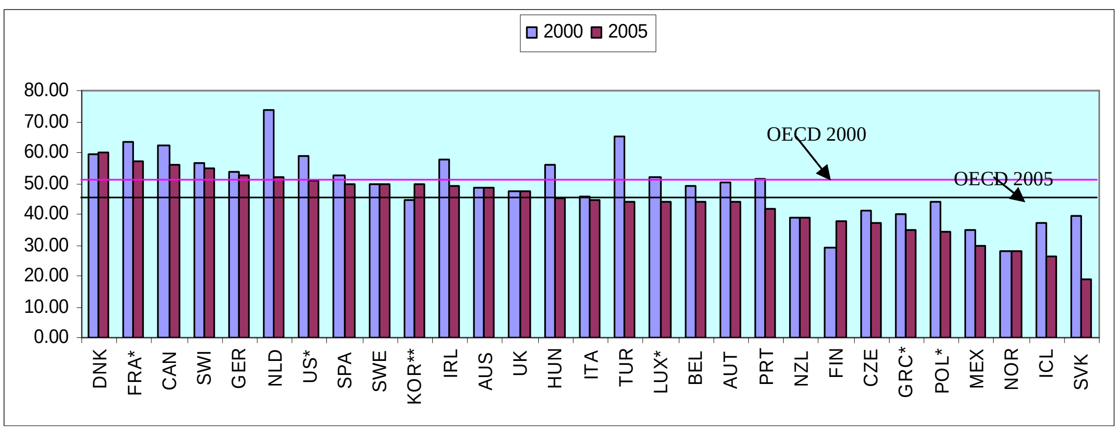
Source: OECD (2004d).

Figure 6 shows a similar tax wedge development for a single parent with two children, earning 67 per cent of average earnings. The tax wedge for this family type dropped on average by 2.7 percentage points, from 19.5 per cent in 1996 to 16.8 per cent in 2004, within the OECD area. The reduction was particularly large in United Kingdom, where the tax wedge dropped by 33.8 percentage points (from 12.6 per cent in 1996 to -11.2 per cent in 2004) due to the introduction of non-wasteable (i.e. refundable) tax credits. The reductions were also significant in the United States (from 11.8 to 4 per cent mainly due to the Earned Income Tax Credit) and Canada (from 10.6 to 1.8 per cent). The tax wedge for this family type dropped significantly in the EU15 as well, to a level that was less than 1 percentage point above the unweighted OECD average in 2004. In Japan, the tax wedge increased by 7.8 percentage points, to a level well above the OECD average.

Taxation of Dividends

The rate of taxation on dividends has been of particular interest in recent years, given the policy focus on the relevant advantages, disadvantages and methods of integrating corporate and personal level taxation of distributed income. Figure 7 reports the top marginal tax rates on distributions of domestic source profits to a resident individual shareholder, taking account of the fact that profits are usually taxed both at the corporate level and again when they are distributed as dividends (although double taxation may be reduced by introducing imputation systems, tax credits or reduced tax rates on dividends). The figures show that on average, the top marginal tax rate on dividends in OECD-countries was reduced by 5.3 percentage points between 2000 and 2005, from 49.9 per cent to 44.6 per cent. In the EU15, the unweighted average tax rate fell by 4.4 percentage points, from 51.7 per cent to 47.3 per cent. The reduction of the effective tax rate was 8.3 percentage points in the United States, due to the recent introduction of a reduced tax rate on dividends at the personal level.

Figure 7. Top Statutory Marginal Tax Rates on Dividend Income[1,2]. 2000 and 2005



1) This tax rate is the overall (corporate plus personal) top marginal tax rate on distributions of domestic source profits to a resident individual shareholder, taking account of imputation systems, dividend tax credits etc.
2) 2004 figures for countries marked * (US sub-central rates in 2005 are set equal to 2004 rates), 2003 for countries marked **. The Germany rate will fall from 52.4 to 48.3 per cent if the proposed reduction in federal CIT rate to 19 per cent is implemented.

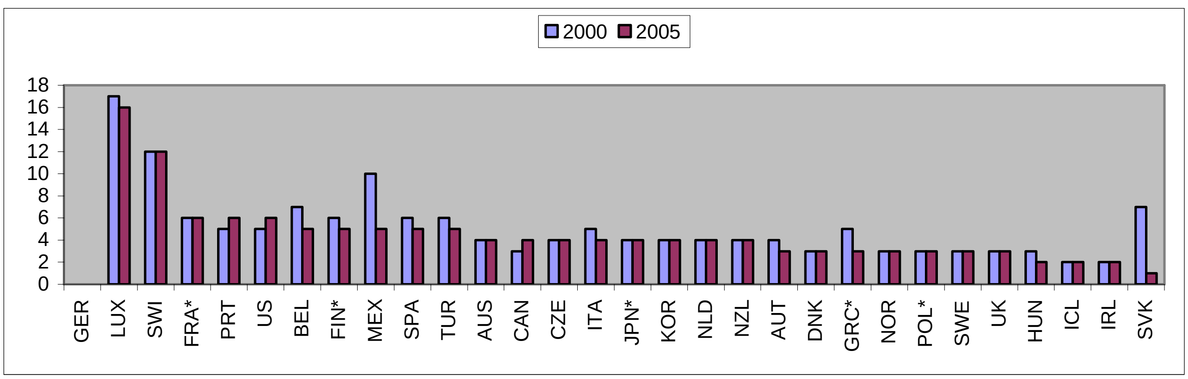
Source: OECD (2005b).

The reductions in the effective tax rate on dividends reflect the reduction of corporate income tax rates, personal income tax rates on dividend income, or both. A recent trend is the move away from full imputation systems in many European countries to systems where dividends are taxed at a lower rate at the personal level. Germany introduced the so-called half-income system in 2002, whereby 50 per cent of dividends are taxed as personal income. Several other countries have or are in the process of introducing a similar system, e.g. Finland, France, Italy, Portugal and Turkey.

Other Aspects of Personal Income Taxation

Figure 2 illustrated the personal income tax rate for high wage earners. For many OECD countries this is also the top marginal personal income tax rate on capital income. However, most OECD countries apply lower rates for certain types of capital income (e.g. dividends and capital gains) than the general income tax rate. In addition, some other countries apply a lower general personal income tax rate on capital income than on wage income, while several other European countries also apply a flat tax rate on capital income which is lower than the top rate on wage income. Figure 2 can therefore not be used to compare the taxation of capital income at the personal level between countries.

Figure 8. The Number of Brackets in the Taxation of Wage Income. 2000 and 2005



1) 2004 figures for countries marked *.

Source: OECD (2005b) and OECD (2004d).

Figure 8 illustrates yet another feature of personal income tax systems where countries differ substantially, namely the number of brackets in the taxation of wage income. The number of brackets in the personal income tax system varies from just 1 positive rate in the Slovak Republic to 16 in Luxembourg. Most countries apply a piecewise linear system, with Germany being the only country that has a formula-based system where the marginal tax rate increases continuously with income between a minimum and a maximum rate. Eleven countries (Austria, Belgium, Finland, Greece, Hungary, Italy, Luxembourg, Mexico, Slovak Republic, Spain and Turkey) reduced the number of tax brackets between 2000 and 2005, while the number of income brackets was increased in Canada, Portugal and the United States. The Slovak Republic is the first OECD country to introduce a single positive tax rate on all personal (and corporate) income above a basic threshold beginning in 2004.[4] The Polish government has recently announced its intention to introduce a similar system as of 2008.

Data show that there was real growth in the CPI-adjusted thresholds for paying income tax since 1985 in 14 of the 23 countries where comparable results are available, and by more than 40 per cent in 10 countries, while they were reduced in 7 countries.[5] Statutory tax rates at the threshold level were reduced in 13 of the 23 countries and increased in 9. Data also show that the tax and benefit systems in most OECD countries provided families with children higher income thresholds than families without children, and to a lesser extent, provided families (with/without children) with higher thresholds than single individuals.

Table 2 gives information on the thresholds and corresponding marginal effective tax rates for social security contributions and personal income tax for single individuals. The table shows that thresholds for paying income tax are generally much higher than thresholds for paying social security contributions. In fact, 21 of the 28 OECD countries that collect social security contribution have no threshold for all or some of the elements of such contributions. This means that one should be careful when comparing income thresholds between countries, as countries differ widely in their reliance on social security contributions. Another reason for caution in the interpretation of results is that all types of income taxes are included, which implies that some countries will be reported as having a zero threshold for income tax even if this is applicable for only one (minor) element of the income tax system.

4 Iceland applies a flat income tax rate (37.73 per cent in 2005) above a threshold. A surtax of 2 per cent (gradually reduced from 7 per cent in 2002) is levied on income above a threshold level that is equal to about 150 per cent of average earnings. Also proposals for flat taxes have been discussed in a number of other European countries.

5 See the Special Feature in Taxing Wages (OECD, 2002-2003), which also provides an analysis of the thresholds where income tax and social security contributions are first paid for a number of family types in OECD countries in 2003, and the marginal effective tax rates payable once those thresholds are exceeded.

TABLE 2

MARGINAL EFFECTIVE TAX RATES AT THE THRESHOLDS FOR SOCIAL SECURITY CONTRIBUTIONS AND INCOME TAX: SINGLE INDIVIDUALS 2003.

	Social security contributions		Income Tax		
	Threshold as a percentage of average earnings	SSC-METR[1]	Threshold as a percentage of average earnings	Income Tax METR [2]	Total METR [2]
Australia	n.a.	n.a.	2.7	17.0	17.0
Austria	17.8	18.1	54.0	21.1	39.2
Belgium	0.0	13.1	29.5	20.9	34.0
Canada	0.0	2.1	20.6	16.9	23.9
Czech Rep.	0.0	12.5	19.7	13.1	25.6
Denmark [3]	0.0	8.0	15.2	30.3	38.3
Finland	0.0	4.8	7.5	20.6	27.1
France [4]	0.0	13.6	0.0	7.6	21.2
Germany [5]	14.2	38.1	31.2	15.8	36.8
Greece	0.0	15.9	99.9	12.6	28.5
Hungary	0.0	12.5	51.9	17.9	30.4
Iceland	31.0	0.0	32.3	37.0	37.0
Ireland	55.4	4.0	43.1	20.0	20.0
Italy [6]	0.0	9.2	0.0	0.8	10.0
Japan	0.0	11.6	26.4	3.8	15.3
Korea	0.0	4.5	44.5	2.4	6.9
Luxembourg	0.0	12.9	42.1	7.1	21.0
Mexico [7]	0.0	1.3	86.2	13.0	15.5
Netherlands	0.0	1.7	16.7	1.7	35.0
New Zealand	n.a.	n.a.	11.7	15.0	15.0
Norway [5]	7.5	25.0	20.6	28.0	35.8
Poland	0.0	25.0	32.4	9.1	34.2
Portugal	0.0	11.0	56.1	12.0	23.0
Slovak Rep.	0.0	12.8	29.6	8.7	21.5
Spain	0.0	7.0	43.4	14.0	20.0
Sweden	6.6	7.0	7.7	25.4	32.4
Switzerland	0.0	11.3	14.8	3.9	15.2
Turkey [8]	0.0	15.0	0.0	0.6	15.6
United Kingdom	22.8	11.0	44.1	59.0	70.0
United States	0.0	7.7	19.2	82.6	90.4
OECD - unweighted average	*5.5*	*11.3*	*30.1*	*17.1*	*28.5*
OECD-median	*0.0*	*11.2*	*28.0*	*13.6*	*24.8*

1) The SSC METR is the marginal effective social security contribution rate at the threshold for paying social security contributions.
2) The Income Tax METR is the marginal effective tax rate on income, while the Total METR also includes the marginal effective social security contribution METR at the threshold for paying income tax.
3) The income threshold and METRs are at the threshold for paying state and local income tax, which is somewhat higher than the threshold for paying central tax.
4) The income threshold and total METR are including CSG and CRDS.
5) The high SSC METRs at the threshold level are due to the fact that social security contributions over the threshold are gradually phased in towards the statutory rates, which are 7.8 per cent in Norway and 21.05 per cent in Germany.
6) The income threshold and METRs are for state and local tax. Both are higher for central tax.
7) The rate is 2.45 per cent for earnings that are above about 3 times the federal minimum wage.
8) The income threshold and total METR are including the stamp duty.

Source: OECD (2003).

Value Added Taxes[6]

Value Added Tax (VAT) is now the most widespread consumption tax collection mechanisms in the world. Since Australia's successful adoption of Goods and Services Tax (GST; equivalent to VAT) as of July 2000, all OECD Member countries - with the exception of the United States - now operate VAT systems. Figure 9 shows that the standard rates range from 5 per cent in Japan to 25 per cent in Denmark, Hungary and Sweden. Figure 9 also illustrates that VAT has become a significant contributor to total tax revenues in many OECD countries. The average share of value added taxes as a percentage of total tax revenues was about 18 per cent in 2003, whereas revenues from sales taxes in the United States were about 8 per cent of total tax revenues. There has been a clear trend to move to general consumption taxes combined with a reduction in tax revenues from excise taxes. The overall share of total tax revenue from general consumption taxes has remained fairly stable over the past few years, although it has increased when compared with the situation in the mid-1970s.

Box 1. Main Characteristics of VAT

The key features of the VAT are that it is a broad-based tax levied at multiple stages of production, with (crucially) taxes on inputs credited against taxes on output. That is, while sellers are required to charge the tax on all their sales, they can also claim a credit for taxes that they have been charged on their inputs. The advantage of this is that revenue is secured by being collected throughout the process of production (unlike a retail sales tax) but without distorting production decisions (as a turnover tax does).

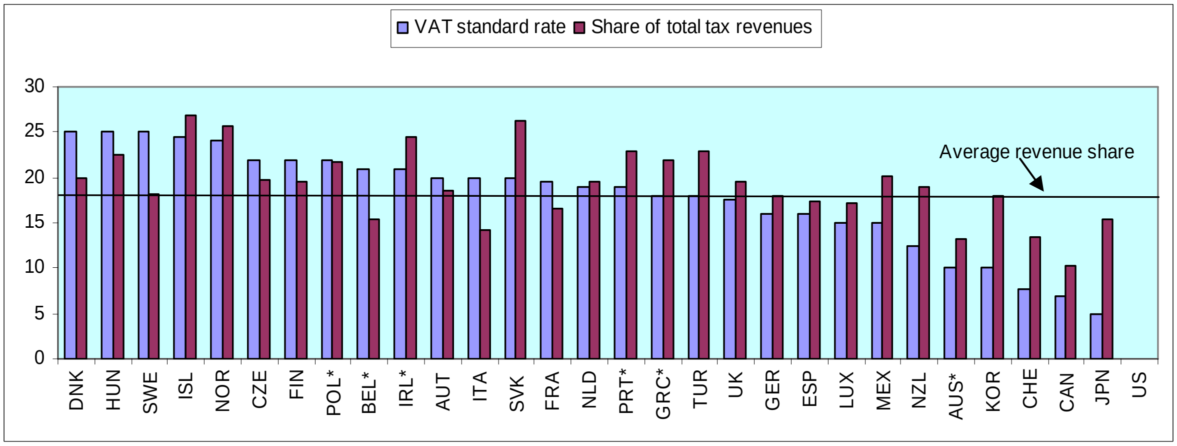
Suppose, for example, that firm A sells its output (produced using no inputs) for a price of US$100 (excluding tax) to firm B, which in turn sells its output for US$400 (again excluding tax) to final consumers. Assume now that there is a VAT at a 10 percent rate. Firm A will then charge Firm B US$110, remitting US$10 to the government in tax. Firm B will charge final consumers US$440, remitting tax of US$30: output tax of US$40 less a credit for the US$10 of tax charged on its inputs. The government thus collects a total of US$40 in revenue. In its economic effects, the tax is thus equivalent to a 10 percent tax on final sales (there is no tax incentive, in particular, for B to change its production methods or for the two firms to merge), but the method of its collection secures the revenue more effectively.

Zero rating refers to a situation in which the rate of tax applied to sales is zero, though credit is still given for taxes paid on inputs. Where a firm is provided with a full refund of taxes paid on inputs, tax along the production chain is fully relieved. In a VAT designed to tax domestic consumption only, exports are zero rated, meaning that exports leave the country free of any domestic VAT. This destination principle is the international norm in indirect taxation, with total tax paid on a good being determined by the VAT rate levied in the jurisdiction of final sale and revenue accruing to that jurisdiction. The alternative to destination-based taxation is origin-based taxation, under which the tax is paid at the rate of, and to, the country or countries in which the item is produced rather than consumed.

Exemption is quite different from zero rating in that, while tax is also not charged on outputs, tax paid on inputs cannot be reclaimed. Thus, no refunds are payable. In this case, because tax on intermediate transactions remains unrecovered, production decisions may be affected by the VAT.

6 This section is mainly based on *The Value Added Tax – Experiences and Issues* (background paper for a joint IMF/World Bank/OECD conference on VAT, held in Rome March 15-16, 2005,). See also: OECD (2004b) for a discussion of value added tax systems in OECD countries.

Figure 9. Standard Rates of Value Added Tax and Share of Total Tax Revenues. 2004[1]



1) 2003 revenues for countries marked *.

Source: OECD (2005a, 2005b).

The VAT was initially developed to meet rising revenue requirements that could not easily be satisfied by existing turnover taxes, the cascading nature of which could seriously distort economic decisions.[7] The adoption of the VAT, which started in France (in several steps from 1948), began slowly, but the pace has subsequently accelerated. The adoption of VAT as a requirement for entry to the European Union - where a primary attraction of the tax was the ability to transparently eliminate indirect taxation (or subsidization) of exports - prompted its expansion in the developed countries in that region (including non-member countries such as Norway and Switzerland, and, more recently, the 10 new access countries).

There is considerable diversity in the structure of the VATs currently in place. For example, the standard VAT rate is higher in Western Europe and in the transition economies than elsewhere, being lowest in the Asia and Pacific region. Moreover, Western Europe has the most complex VATs in terms of the number of rates. Further analysis indicates that those countries that have implemented a VAT are both relatively more developed and have a relatively higher ratio of international trade to GDP.

It is widely agreed that collection costs are significantly lower where the VAT has a simplified structure[8], with a single rate and high threshold being conducive to relatively low collection costs. Since compliance costs are largely independent of the amount of tax payable, however, they fall more heavily on smaller traders. This is borne out by a recent European Commission Staff Working Paper, which suggests significant differences in costs for small and medium-sized enterprises (2.6 percent of

7 Since a turnover tax is levied on turnover irrespective of value added, the tax collected on a given commodity will reflect the number of taxable stages in the chain of its production, resulting in a “cascading” tax burden. This gives producers an incentive to substitute away from taxed inputs, resulting in production methods that are privately profitable but inefficient from a wider social perspective. As a result, and as a further distortion, there is an incentive for industries to integrate vertically solely to reduce tax liabilities.

8 Some guidance can be found in the various studies of VAT collection costs for OECD countries. It has been estimated that administrative costs to the government for a broadly “best-practice” VAT are about US$100 per registrant per annum. Estimates of taxpayer compliance costs for such a VAT are around US$500 per registrant per annum.

sales) and those for large companies (0.02 percent of sales), Commission of the European Communities (2004). The evidence for OECD countries suggests that the VAT is less costly than the income tax, but the more relevant question is whether it is more or less costly than alternative forms of sales tax, and, in particular, than the taxes that it replaced.

SELECT ISSUES IN FUNDEMENTAL TAX REFORM

While the previous section concentrated on broad trends in the OECD, it is important to recognize the substantial differences between OECD countries in the tax policies that they follow and the main focus of their reforms. There are wide differences in tax-to-GDP ratios and in tax rates, in tax structures and in the design features of particular taxes. This section looks at some of the major issues which have driven the tax reform debate over the last 20 years. Space constraints mean that the section has to be selective.

TABLE 3
TAX REVENUE OF MAJOR TAXES AS A PERCENTAGE OF TOTAL REVENUE, 2003[1]

	Personal Income [2]	Corporate income [2]	Social security and other payroll	Property	Goods and services	Of which: General consumption
Australia	38.5	16.7	5.6	9.5	29.7	13.7
Austria	23.1	5.1	39.9	1.3	28.2	18.4
Belgium	31.4	7.4	31.8	3.3	24.6	15.6
Canada	34.6	10.4	17.5	10.0	26.1	15.1
Czech Republic	13.0	12.3	43.6	1.4	29.7	17.1
Denmark	53.1	5.9	2.9	3.8	33.0	20.1
Finland	31.0	7.7	26.7	2.3	32.0	19.4
France [3]	17.5	5.7	40.2	7.3	25.5	16.8
Germany	23.9	3.5	40.5	2.4	29.4	17.9
Greece	13.7	9.2	36.1	4.5	35.8	22.4
Hungary	18.9	5.8	32.9	2.2	39.4	26.1
Iceland	37.6	3.9	8.6	5.9	41.0	27.7
Ireland	26.5	12.9	15.4	6.5	38.4	24.5
Italy	25.1	6.6	29.5	8.0	25.7	14.2
Japan	17.5	13.0	38.5	10.3	20.3	9.5
Korea	12.7	15.3	19.8	11.8	37.1	18.2
Luxembourg	17.1	19.1	27.9	7.5	28.1	15.5
Mexico [4]	-	-	18.7	1.6	52.5	19.4
Netherlands	17.9	7.6	36.3	5.2	31.8	19.7
New Zealand	41.9	13.6	0.0	5.2	35.2	26.1
Norway	24.8	18.6	22.9	2.5	31.2	20.0
Poland	12.8	5.3	42.0	4.0	35.8	21.7
Portugal	15.8	8.7	31.7	4.1	36.7	22.9
Slovak Republic	10.8	9.1	39.6	1.8	36.2	22.0
Spain	18.6	9.0	35.3	7.5	28.2	17.2
Sweden	31.3	5.0	34.0	3.1	26.3	18.4
Switzerland	34.3	8.5	25.5	8.3	23.3	13.4

Turkey	15.7	8.0	20.8	3.2	49.5	24.9
United Kingdom	28.7	7.8	18.5	11.9	32.7	19.8
United States	35.3	8.1	26.4	12.1	18.2	8.4
OECD Total (Unweighted)	24.9	9.3	27.0	5.6	32.1	18.9
EU15 (Unweighted)	25.0	8.1	29.8	5.2	30.4	18.9

1) Rows do not add to 100 because some minor taxes are omitted and general consumption taxes (mainly VAT) are a sub-category of taxes on goods and services.
2) The breakdown of income tax into personal and corporate tax is not comparable across countries.
3) The total tax revenues have been reduced by the amount of capital transfer. The capital transfer has been allocated between tax headings in proportion to the report tax revenue.
4) Data for personal income tax and corporate income tax do not exist.

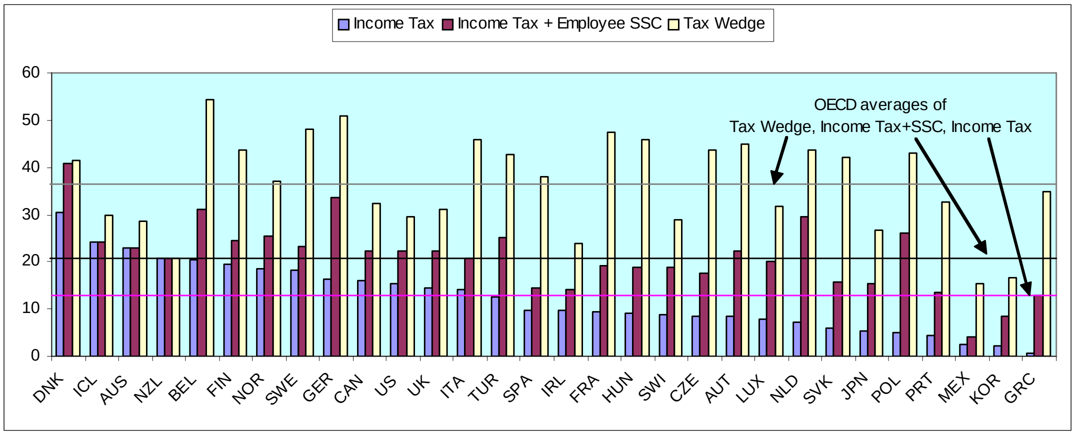
Source: OECD (2005a).

The Choice of Tax Structures

One of the major choices facing governments in the design of the tax system is what reliance to place on the different potential sources of tax revenue. Some countries decide to have a limited number of taxes; others a very wide range of tax sources. Some rely primarily on consumption taxes; others on income and capital taxes; in some countries social security contributions are the main source of revenues. Nevertheless, as can be seen from Table 3,[9] the OECD averages show that the vast bulk of tax revenue, *i.e.* over 90 per cent, comes from three main sources: income taxes, taxes on goods and services, and social security contributions (other payroll taxes are zero or very small in most countries). The United States collects more in personal income tax and property tax but less in consumption taxes in contrast to the European Union which relies relatively more on social security contributions. Japan is similar to the United States in its low share of consumption taxes, but collects much less in personal income tax, offsetting this with higher levels of corporate tax and social security contributions. There are also substantial differences across countries in the share of taxes on property, which are generally lower in continental Europe than elsewhere. Differences between countries are in part due to changes in economic structures, e.g. business cycles and the rate of inflation.

9 A cautious interpretation of the first two columns of numbers in this table is called for. The split between personal and corporate income tax, can be seriously misleading for two reasons. First, many OECD countries have some form of integration between corporate and personal income taxes, so that a portion of corporate taxes are refunded to the shareholders as a reduction in personal income tax. This is reflected in the statistics as a reduction in the revenue from personal income taxes, but it could be just as well regarded as a reduction in corporate tax revenue. Second, OECD countries vary in the extent to which businesses are incorporated. For example, German firms are much less likely to be incorporated than firms in Japan and the United States. This means that Germany reports a much lower share of tax revenue coming from corporate income tax.

Figure 10. Income tax and social security contributions in OECD countries[1,2]. 2004



1) Single individual at average earnings of a production worker.
2) The tax rates are measured as a percentage of total labor costs (gross wage plus employer social security contributions).

Source: OECD (2004d).

Figure 10 illustrates the difference between OECD countries in their reliance on income tax and social security contributions in the taxation of labor income, showing notable differences in the level of personal income taxes for someone at average earnings, ranging from below 5 per cent in four countries to above 30 per cent in Denmark. Countries also differ in relation to their reliance on social security contributions, from New Zealand which does not levy any such contributions to several countries where the main part of the tax wedge on labor is social security contributions.

Another possible explanation of the differences can be found by comparing Figure 2 with Figure 4 in Section 2. The latter figure compares the *average* taxation of labor income in different countries, and with the overall OECD average, while the first provides information on the top *marginal* rates. It is evident from these figures that even if the top marginal rate is close to the OECD average, the average rate may be much lower than the overall average in the OECD. An example is the U.S. where the tax base is more narrowly defined than in many other OECD countries, probably mainly as a result of a more extensive use of tax relief and special tax privileges. (This is probably also the main explanation for the relatively low revenue share from corporate income in the United States in Table 3, even though the statutory corporate tax rates in Figure 3 are above the OECD average.)

Basic concepts for the Taxation of personal income: the main choices facing governments

Much of the tax reform debate over the last decade has focused on what should be the basic approach to the taxation of personal income. Governments can chose between three main types of personal income tax systems:

- *Comprehensive income tax*. Net income from all sources is aggregated (capital income, labor income, other income less all deductions) and, above the basic allowance, is taxed according to a progressive rate schedule. This implies that wage and capital income are taxed at the same rates, and that the value of tax allowances increase with income.

- *Dual income tax*. Combines a flat income tax rate on comprehensive net income above the basic allowance with additional taxation of gross income from labor and pensions above certain thresholds. This implies that labor income is taxed at higher rates than capital income, and that the value of tax allowances is independent of the income level.
- *Flat income tax*. Comprehensive net income above the basic allowance is taxed at a single positive rate. This implies that wage and capital income are taxed at the same rate, and that the value of tax allowances is independent of the income level.

In practice, no OECD country has fully implemented any of these three main types of income tax systems. All OECD countries have special tax treatment for certain types of income (e.g., fringe benefits, certain types of capital income and owner-occupied dwellings), and many countries levy social security contributions only on certain types of income (mainly labor income). In other words, most countries use "semi-comprehensive", "semi-dual" or "semi-flat" income tax systems.

Despite academic discussions, the tax reforms of the last two decades have not resulted in any OECD country adopting an expenditure (consumption) taxation. Nevertheless, most OECD countries have in practice a mixture of income and consumption taxes.

Comprehensive income tax

A comprehensive income tax following the Schanz-Haig-Simons definition implies a tax base that includes the market value of consumption plus changes in net wealth on an accruals basis. It would be very difficult to follow this income definition is in practice, mainly because it would impose fairly high compliance and administrative costs. Nevertheless a majority of the OECD countries have tax systems that in principle are based on a comprehensive income tax base.

The attractions of such systems are that:

- by aggregating all sources of income from each taxpayer a comprehensive income tax is better placed than a schedule system to achieve horizontal equity;
- at the same time this aggregation may make it easier to use the income tax system to achieve a redistribution of income by means of the application of progressive rate schedules;
- comprehensive income tax systems also make it more difficult to engage in re-characterization of income flows.

In practice, these advantages are not fully realized because almost all comprehensive income taxes are:

- Mainly based upon realized rather than accrual income. Capital gains, for example, are frequently not taxed or if they are taxed are only taxed on realization and at significantly lower rates.
- Imputed income from owner occupied dwellings is rarely included in the income tax base.
- Fringe benefits, while taxed in most countries, are taxed at lower rates than wages and salaries.
- Stock options are usually taxed at very favorable rates.

Progressive comprehensive income taxation may also fail to achieve horizontal equity, because it discriminates against variable income. This may discourage seasonal work, investments in human capital and the demand for risky assets. Another potential problem with a comprehensive income tax system is that it does not take account of the fact that capital is more mobile across borders than labor, and that it therefore is easier to evade high taxes on capital income by moving savings abroad and not report the true income to the tax authorities.

Dual income tax

The desire to reduce tax distortions, in particular in the taxation of corporate and capital income, but at the same time to redistribute income through the income tax system were the main driving forces behind the introduction of dual income tax systems in Finland, Norway and Sweden, and to a lesser extent in Denmark, 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 with a broad tax base and a fairly low tax rate.

Norway introduced the purest form of dual income tax, with the following main characteristics:

- A flat personal income tax rate of 28 per cent on net income. Net income included wage, pension and capital income less tax deductions, and the same rate was introduced for corporate income. This implied:

  - a symmetrical treatment of all capital income, e.g. with no double taxation of dividends and capital gains on shares and full deductibility of all interest expenditures;
  - a reduction of the number and the value of tax allowances, as all remaining allowances are only deductible against the flat 28 per cent tax rate.

- A progressive taxation of wage and pension income in addition to the flat rate, by introducing a surtax on gross income from wages and pensions above a certain threshold level. The highest surtax rate on wages and pensions was 13 per cent when the tax reform was implemented in 1992, but it was increased to 19.5 per cent in 2000.
- To ensure an equal tax treatment of all labor income, income from self-employment and persons working in their own companies is split into a labor and a capital income component by use of the so-called split model. The part considered as labor income is then taxed according to the progressive rate schedule, while the part considered as capital income is taxed at the flat rate.

Sweden introduced a personal income tax rate of 30 per cent and a corporate income tax rate of 28 per cent, and also abandoned the principle of full integration of corporate and personal taxation of dividend income and capital gains. Finland introduced a full imputation system for dividend income at a rate of 28 per cent, but with double taxation of capital gains and a simplified version of the taxation of income from self-employment.

In principle, the dual income tax system achieves a degree of horizontal equity in that taxpayers with the same level of capital income are treated equally and taxpayers with the same level of labor income are taxed equally. Horizontal equity is not achieved for taxpayers with the same aggregate income but with a different mix of labor and capital income[10]. It also combines having a fairly neutral and low taxation of the internationally most mobile factor of production (capital), while being able to partly redistribute income through a progressive taxation of labor income. The systems are also simple in the sense that there is a flat tax rate on net income, with relatively few tax deductions.

However, no country has introduced a pure dual income tax system where *all* capital income (personal and corporate) is taxed at the same flat rate, whereas labor and pension income are taxed at progressive rates. The main exception is imputed income from owner occupied dwellings, which is taxed more favorably than other forms of capital income. In addition, certain other tax favored savings schemes

[10] However, the potential for some individuals to incorporate and have what is in reality (high-taxed) labour income to be taxed as capital income may reduce the actual horizontal equity in the taxation of labour income.

have been kept, e.g. a favorable treatment of pension savings. Sweden also applies a classical system for the taxation of dividend income, which implies that domestic savers face a higher nominal tax rate on savings in the form of shares than on most other financial instruments.

A further complication of dual income tax systems is that the large difference in top marginal rates on labor and capital income provides a major incentive to have income characterized as capital income rather than labor income for tax purposes. This is especially the case in Norway and Finland where full imputation systems are applied. This obviously complicates the tax system. Extensive income shifting, e.g. by way of individuals incorporating themselves, may also reduce the horizontal equity between individuals who are able to get some of their income from labor taxed as capital income and individuals who do not. Furthermore, such income shifting will obviously weaken the actual redistribution effects of high taxes on labor income.

The Netherlands has tried to overcome some of these difficulties by installing in 2001 its "Box" system. The objectives of the system were to reduce tax rates and broaden the tax base, to replace tax allowances by tax credits and to replace the wealth tax and the taxation of personal capital income with taxation of an imputed income from capital. One of the main arguments for taxing an imputed income from capital is to ensure that all forms for personal capital income are taxed equally. The main features of the system are:

- Box 1 includes wage income, income from self-employment, social security payments, pensions and imputed income from owner-occupied houses, less allowable deductions (e.g. personal allowance, deduction of childcare expenses and certain other deductions). The net income is taxed at progressive rates, ranging from about 30 per cent (including social security contributions levied on net income) to a top rate of 52 per cent.
- Box 2 includes taxable income from a substantial business interest. This is defined as income from dividends and capital gains where the shareholder controls (directly or indirectly) at least 5 per cent of the shares in a private or public limited company. The net income from such activities is taxed at a flat rate of 25 per cent.
- Box 3 is the taxation of capital income, including income from non-substantial business interests. Instead of a tax on the actual capital income, a 30 per cent flat tax rate is applied on a notional return of 4 per cent on the net value of the assets owned by the shareholder (average of net assets 1 January and 31 December). In practice, this is equivalent to a tax on net wealth of 1.2 per cent (30 per cent tax rate times 4 per cent return). In order to insert a progressive element in the system, there is a basic tax-free allowance.

It is also of interest to note that the corporate income tax rate was reduced from 35 per cent to 34.5 per cent as of 2002, and that it has been further reduced to 31.5 per cent as of 2005.

Flat income taxes

Over the last two years flat taxes have been at the center of the tax reform debate in an increasing number of OECD countries. There are several possible definitions of a *flat tax*, as is also illustrated in Figure11:

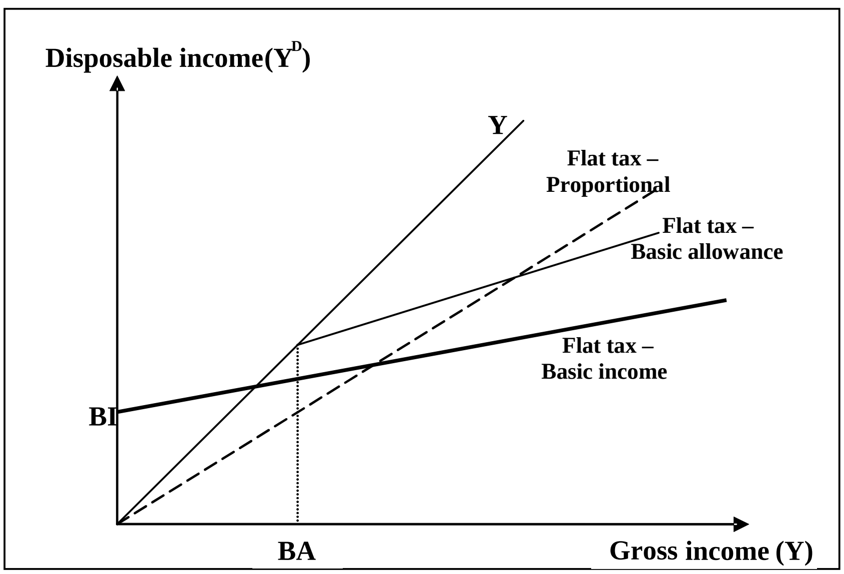
- Single rate, without any basic tax allowance, under which all (positive) income is taxed at a flat rate ("Flat tax – proportional" in Figure 11).
- Single rate with a basic tax allowance, so that all (positive) income above a basic allowance is taxed at a flat rate ("Flat tax – basic allowance" in Figure 11).
- All (positive) income above a basic allowance is taxed at a flat rate, except for income from savings which is not taxed at the personal level (similar to Flat Tax B in Figure 11). This is

equivalent to a consumption tax with a basic allowance, and is often referred to as the Hall-Rabushka's flat tax proposal, (Hall and Rabushka, 1985, 1995). The Hall-Rabushka proposal includes in addition the same flat tax rate on all business income (incorporated and unincorporated business income), which means that all income from savings and investments will be taxed as business income and not as personal income. Thus, there is no double taxation.

- Single rate, with a refundable tax credit (basic income). The tax credit is of equal value to all individuals, regardless of their income levels (thus, it is in practice a negative income tax at low income levels). This is also called the "basic income flat tax", where the basic income (BI) should replace all social security benefits in addition to having a single tax rate on personal income (Figure 11), (Atkinson, 1995).

This brief categorization of "flat tax" shows that it is misleading to talk in abstract terms about "flat taxes" without specifying how the tax is designed.

Figure 11. Different types of flat tax – an illustration



Estonia was the first European country to introduce a flat tax, when a 26 per cent was introduced on personal and corporate income[11] in 1994, and they are in the process of reducing the rate gradually to 20 per cent from 2007. The other Baltic States soon followed the Estonian example, as have several other Central and Eastern European countries and Russia where a flat personal income tax rate of 13 per cent was introduced in 2001.[12] In 2004, Slovakia introduced a 19 per cent rate that applies to both corporate and

11 As of 2000, corporate income tax is only taxed (at source) when distributed as dividends.

12 Proposals are under discussion to review the rate.

personal income (as well as VAT). This is the first OECD country moving to a flat income tax.[13] However, similar systems are currently debated in the Czech Republic, Hungary and Poland.

The flat income tax in the Slovak Republic can be used to illustrate the main characteristics of this approach to taxing income. In 2003, the personal income tax system in the Slovak Republic had five income brackets, with tax rates varying from 10 per cent to 38 per cent. A taxpayer at average earnings would face a marginal tax rate of 20 per cent. The corporate tax rate was 25 per cent, while the VAT rate was 20. In 2004, all of these rates were replaced with a flat tax rate of 19 per cent. The introduction of the flat rate was combined with a large increase of the basic allowance (it was more than doubled) and with a significant elimination of tax relief which lead to a broadening of the tax base.

TABLE 4

AVERAGE INCOME TAX AND TAX WEDGE AS A PERCENT OF GROSS EARNINGS FOR A SINGLE INDIVIDUAL BEFORE AND AFTER SLOVAK REFORM (2003 vs. 2004)

	67% of Average Earnings		**100% of Average Earnings**		**167% of Average Earnings**	
	2003	*2004*	*2003*	*2004*	*2003*	*2004*
Income tax	4.8	3.7	6.3	7.9	10.7	11.3
Tax wedge[1]	40.3	38.8	41.4	42.0	44.6	44.5

1) As defined in Figure 4.

Source: OECD Secretariat

Table 4 compares tax rates in 2003 and 2004 for single individuals at different percentages of the average earning of a production worker, and it illustrates that the average income tax fell at 67 per cent of these earnings and that it increased at 100 per cent and 167 per cent of these earnings, that average income tax rates remained fairly low and stable at these three income levels. The high rates are largely a result of the heavy reliance on social security contributions, where the rate for employees in 2004 is 13.4 per cent while it is between 34.7 and 36.5 per cent for employers. In addition, employee social security contributions are deductible for income tax purposes. The reliance on personal income tax as a revenue source for the Slovak Republic is relatively low both prior to and after the introduction of the flat tax. The heavy reliance on social security contributions, which is levied on gross wage income, also imply that labor income in practice still is taxed much more heavily than capital and corporate income.

Recent tax reforms show that some countries are moving towards a more comprehensive income tax, others towards dual income taxes, and yet others toward flat taxes. It is therefore useful to compare these different approaches in terms of their impacts on simplification, efficiency and equity.

Flat tax proposals typically combine the introduction of a single tax rate with proposals for extensive base-broadening initiatives, while progressivity is achieved by using a basic tax allowance. Dual income tax systems combines a single tax rate on capital income and a progressive rate schedule for labor

13 Iceland also applies a flat income tax rate above a threshold (the rate was 37.73 per cent in 2005). However, they have an additional surtax of 2 per cent (which has been gradually reduced from 7 per cent in 2002) that is levied on income above a threshold level that is equal to about 150 per cent of average earnings.

income, typically with a broad tax base. Comprehensive income tax systems usually combine a progressive rate schedule for all sources of income with more extensive use of tax relief than in flat and dual income tax systems, although New Zealand has a broad tax base. A comparison of the main features of the three types of tax systems can therefore to a large extent be summarized as a discussion of the relative importance of the rate schedule and the tax base on simplicity, efficiency and equity.

Simplification

A significant part of the popular debate on tax reform in many countries is concerned with the need for a significant simplification of existing tax systems. In fact, one of the main arguments used in favor of flat tax rate systems is that they reduce compliance costs for the taxpayer and are easier to administer for the tax authorities compared to comprehensive and dual income tax systems.

However, the main complexities in the tax system arise from the definition of the tax base (e.g., whether the income in question is taxable or not, as well as the use of special tax rates or tax relief for certain activities) and not from the rate structure itself. Once the tax base is defined, it is not much more difficult to operate a progressive rate schedule (with a limited number of tax brackets) than a single rate above a basic allowance.

Having a flat rate schedule for all types of personal and corporate income may, however, reduce problems of income shifting between the personal and the corporate sector, thus reducing complexity. Income shifting between different sources of income, which is a problem in dual and semi-dual income tax systems, is also avoided. However, the existence of social security contributions will imply that such incentives for income shifting continue in flat income tax rate systems.

Efficiency

The economic costs of tax distortions in the income tax system are mainly driven from the level of the tax rates and whether or not different types of activities are taxed in a similar manner. Moving from a progressive to a single rate system within a revenue-neutral perspective implies that tax rates will increase for some taxpayers and be reduced for others, making it an empirical question whether the total economic costs of tax distortions will be reduced or not. However, there are also some tax distortions that are specific to a progressive tax system, e.g. that progressive tax rates discriminate against variable income (which may have a negative effect on the incentives for higher education etc.). Base broadening is probably more effective in reducing tax distortions and making the tax system more efficient than a move to a single flat rate.

Equity

Flat tax income taxes are in practice better at achieving horizontal equity (treating taxpayers in an equal situation in an equal manner) than comprehensive and dual income tax systems. Comprehensive progressive systems normally make extensive use of tax relief and incentives for income shifting may also be larger due to differences between top personal and corporate income tax rates. Dual income tax systems tax labor income more heavily than capital income.

However, a progressive income tax schedule in itself is more effective in achieving vertical equity (the distribution of after-tax income should be narrower than the distribution of income before tax) than a single rate system, at least for a given level of the basic tax allowance. So the choice between progressive and flat tax rate schedules from an equity perspective depends in part on how to strike the balance between horizontal and vertical equity.

Base broadening has also an impact on income distribution. A broadening of the tax base is likely to increase horizontal equity, as this implies that the preferential tax treatment of certain taxpayers will be limited. It may also have a positive effect on vertical equity. Although certain types of tax allowances and tax credits favor low-income households, e.g. earned income tax credits, other types of allowances and credits are often in practice most widely used by high-income individuals (e.g. for savings, educational and health expenses, donations). And even if such tax relief are kept, a move from a progressive to a flat rate schedule implies that the value of such deductions decreases for high-income earners – thus, in part counteracting the effects of reduced tax rates.

Making Work Pay Policies

In recent years one of the main drivers of tax reform has been the need to reduce disincentives for households to enter the labor market and once in the labor market to increase their work efforts. Following the example of the United States with its Earned Income Tax Credit (EITC), a number of OECD countries have recently introduced in-work tax credits to help 'make work pay' for the low-skilled. The main objectives of such making work pay (MWP) policies are:

- To increase employment. This is done by reducing the costs of hiring disadvantaged workers, or by increasing the incomes of those who accept low-paid work.
- To increase incomes of disadvantaged groups. Linking an increase in transfers to those with low incomes to their employment status appears sometimes to be politically more acceptable than achieving this end via a general increase in social transfers or reduction in taxes to all those with no income from work.

The appeal of MWP policies spans political divides, and governments of both the right and left have introduced or extended such policies in recent years. The political attraction is that such policies appear to achieve both employment and distributional objectives *at the same time,* unlike some other alternative policies. Nonetheless, most OECD countries have not introduced these policies or they have followed alternative approaches, such as cuts in employers' social security contributions.

TABLE 5
IN WORK CREDITS IN 2001

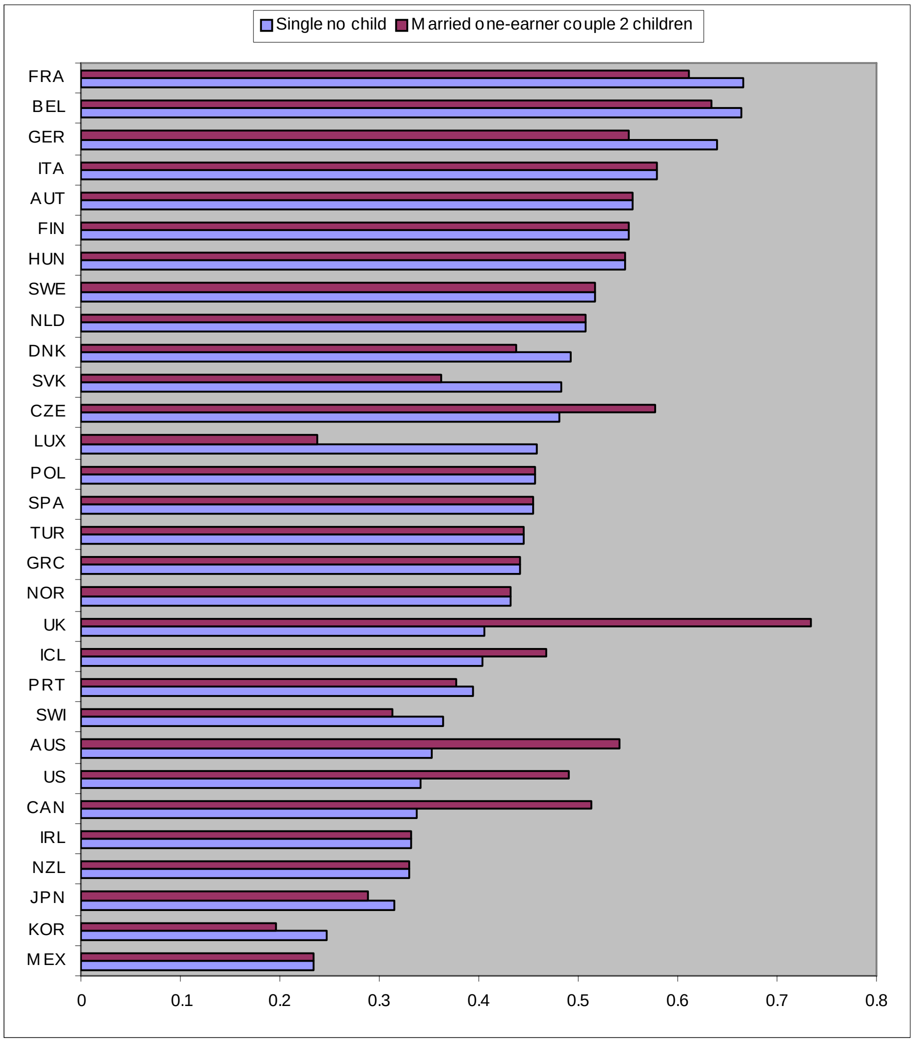
	Target group	Non-wasteable	Approximate Maximum Income Increase (Euros/dollars)	Phase in	Phase out	Hours criterion
Belgium[1]	Individual	Yes	440	Yes	Yes	No
Canada (Quebec)[2]	Families	Yes	3150	Yes	Yes	No
Finland	Individual	No	290	Yes	Yes	No
France[3]	Individual	Yes	230	Yes	Yes	No
Ireland[4]	Families	Yes	2 260 or more	No	Yes	Yes
Netherlands	Individual	No	920	Yes	No	No
New Zealand[5a]	Families	Yes	7800	No	Yes	Yes
New Zealand[5b]	Families	Yes	780 per child	No	Yes	Yes
United Kingdom[6]	Families	Yes	6 150 or more	No	Yes	Yes
United States[7]	Families	Yes	4 000	Yes	Yes	No

1) Introduced in 2002.
2) Most Canadian provinces have a scheme similar to this. There are no Federal MWP programmes.

3) PPE is an individual tax credit which increases when gross income rises from 30 per cent to 100 per cent of the SMIC (minimum wage).
4) FIS equals 60 per cent of the difference between net family income and an earnings limit. For a family with one child the weekly earnings limit is around €170. Figures given here reflect an assumption of hourly earnings of €5.33 and a 40 hour week; with lower earnings and hours, the maximum receipt could be higher.
5a) Family Tax Credit. The child minder must work at least 20 hours per week (lone parent) or 30 hours per week (combined hours for a couple with children). The maximum payment equates to the net income subsidy for a lone parent working 20 hours per week at the minimum wage, needed to reach the guaranteed minimum net income of NZD 15 080 p.a. in 2001
5b) Child Tax Credit. The entitlement abates with family income after full abatement of the non work-tested Family Support, and is therefore available to a number of middle to higher income working families as well as to all low income working families.
6) WFTC (replaced in 2003) was calculated by adding credits for adults and children and then deleting 55 per cent of the difference between net income and GBP 92.90 per week. The family is here assumed to have gross earnings of €5.33 per hour and a 40 hour week; with lower earnings and hours, the maximum receipt could be higher. Child-care supplements are ignored.
7) Earned Income Tax Credit. For taxpayers with two or more children, the credit is 40 per cent of up to $10 020 of earned income in 2001. EITC reaches its maximum amount of $4 008. The credit starts to reduce in value when income exceeds $13 090 (at a rate of 21.06 per cent) and phases out when it reaches $32 121.

Source: OECD (2004e).

Figure 12. Marginal Effective Tax Wedge for Single Individuals and One-earner Families in OECD countries[1,2]. 2004



1) Both family types at average earnings of a production worker.
2) The tax wedge is calculated as income tax plus employee and employer social security contributions less benefits as a percentage of total labor costs (gross wage plus employer social security contributions).

Source: OECD (2004d).

Table 5 summarizes some of the main in-work credits and benefits that are used in OECD countries, and Figure 12 shows the impact of these plans by presenting the marginal effective tax wedges for single individuals and one-earner families.

Improving the competitiveness of Corporate Taxes

Recent tax reforms in the corporate tax field can be seen as a continuation of efforts to improve efficiency in the allocation of real capital and to strengthen the competitive position of firms, while at the same time protecting domestic tax revenues and aiming for an equitable sharing of the tax burden between capital and labor income. Statutory corporate income tax rates have been reduced in many countries, sometimes significantly, and corporate tax bases have been broadened with special corporate tax preferences unwound or scaled back, enabling a (partial) financing of a reduction in statutory rates.

Such reductions in statutory corporate tax rates are generally viewed as attractive by investors, while also assisting tax administration efforts by reducing tax-planning pressure on the tax base. Alternative strategies have been adopted in some OECD countries to further improve the competitiveness of firms – for example, strategies providing direct support for investment in information technology to enhance productivity and tax incentives for R&D and special provisions for small and medium-sized enterprises. While certain similarities may be observed, the examples cited below reflect diversity across OECD countries in tax systems, the fiscal environments and corporate tax policy strategies.

Reducing Corporate Tax Rates

The corporate tax reform announced in Belgium in October 2001, with effect from 2003, involved an enlargement of the corporate tax base, enabling a significant reduction in the statutory corporate tax rate, with the net budgetary impact expected to be nil. The reduction in the statutory rate would see the basic nominal rate falling from 39 to 33 per cent (excluding the crises surcharge), and a lowering of the reduced rate for small and medium-sized enterprises.

Significant corporate tax rate reductions are also on stream in Canada, made possible largely as a result of strong economic growth and following significant base broadening in recent years. In 2000, the general federal corporate income tax rate in Canada was 29.12 per cent, inclusive of surtax, and provincial rates averaged 14 per cent. The corporate tax rate was relatively high compared to other countries (particularly when Canada's capital taxes were factored in – see below), and moreover, other countries had reduced or announced reductions in their statutory corporate tax rates. A key principle of the tax reduction plan announced in 2000 was that the business tax system must be internationally competitive, with high corporate tax rates viewed as impacting negatively on economic growth, productivity, employment, wages and income.

The tax rate reduction drive in Canada is targeted at high-taxed sectors, or more specifically, at income that had been subject to the basic (general) rate. Prior to the general rate reduction, small business income and manufacturing and processing (M&P) income were already subject to a relatively low effective tax rate (owing to a special small business deduction, and an M&P profits deduction). In its 2000 budget, the federal government announced that the federal statutory corporate tax rate applicable to high-tax sectors would be reduced within 5 years from 28 to 21 per cent, beginning in 2001 with a 1 percentage point reduction. Later in the year, following strong revenue growth, the federal government announced an accelerated timetable for phased-in reductions in the basic rate, to 25 per cent in 2002, 23 per cent in 2003, and 21 per cent in 2004. In addition there is a surtax of 1.12 per cent. Taking the federal lead, many of the provinces announced reductions in their general corporate income tax rates as well. These combine to give a reduction in the average provincial general rate from roughly 14 per cent in 2000, to about 12.5 per cent in 2004.

In September 2003 the government in Finland agreed upon a corporate tax reform, which will be introduced in 2005. The most important measures of the reform are the lowering of the statutory corporate tax rate from 29 to 26 per cent and the personal capital income tax rate from 29 to 28 per cent. The dividend imputation system will be abolished and replaced by a partial inclusion system that includes a certain percentage of dividends in the personal income tax base (more on this below). In addition, the wealth tax thresholds will be increased and the tax rate lowered. With corporate tax rates having been reduced in many countries, a main goal behind these tax reform measures is to improve the international competitive position of the Finnish tax system. In particular, the reform is aimed to spur entrepreneurship and promote corporate investment, growth and capacity to generate employment.

While corporate tax rates were effectively increased in France during the mid-1990s, the tax rate applied to corporate profits was decreased from 42 per cent in 1998 to 35.4 from 2002.[14] These rate cuts have been financed by base broadening measures, in particular by reducing depreciation rates and modifying the system for taxation of dividends distributed between companies. The tax cuts for small and medium-sized businesses were larger, and the reform of the corporate income tax rate was supplemented by a reform of the local business tax (taxe professionnelle).

Fundamental tax reform has also been underway in Germany, beginning in 2001, aimed at improving the international competitiveness of the German economy. As from 2001, the statutory federal corporate tax rate was cut to a uniform 25 per cent. Under the previous split-rate regime, the rate was dependent on whether profits were distributed (30 per cent) or retained (40 per cent). These changes were accompanied by a fundamental change in the way in which corporate and personal income taxes are integrated (see below). The German government has recently proposed to cut the statutory federal corporate tax rate further to 19 per cent.

Significant cuts in personal income taxes in Germany are also providing a competitive boost to unincorporated businesses, a particularly important component of the German economy. These cuts follow an increase, in three steps, in the basic personal allowance from approximately EUR 6,288.89 in 1998, to EUR 7,699.38 in 2005. Over the same period, the basic rate of tax is being reduced from 25.9 per cent to 15 per cent, with the top rate cut to 42 per cent. As of 2005, the top rate is to be applied to taxable income in excess of EUR 52,151.77.[15]

To maintain a low rate, broad base system, the main corporate income tax rate in the United Kingdom was cut from 33 to 31 per cent in 1997 and further to 30 per cent in 1999. Rate cutting was accompanied by several base broadening measures, including the abolition of the Advanced Corporation Tax and the system where certain tax-exempt shareholders (pension funds etc.) could get the value of the dividend tax credit paid out in cash. As in many other countries, the tax cuts were larger for small and medium-sized companies, where the small companies' rate was reduced to 19 per cent in 2002 with a starting rate of zero.

Significant statutory corporate rate reductions have also been witnessed in the Czech Republic and Slovak Republic. In 1990, corporate income tax was introduced in the Czech Republic with rates ranging from 20 to 65 per cent, depending on the nature of the taxpayer and the amount of tax base.[16] At the time of the creation in 1992 of two new independent states, the Czech Republic and the Slovak

14 The statutory rate is 33.33 per cent when excluding the remaining part of the 1995-surtax (3 per cent) and the 3.3 per cent *Contribution sociale sur les bénéfices* levied on firms with a turnover and profit above €7.6 million and a profit above €763 000.

15 Additionally, sole traders or entrepreneurs deriving income from trade or business and liable to local trade taxes (*Gewerbesteuer*) are afforded relief with the crediting of the trade tax against income tax liability. As a result, the majority of SMEs are given full relief from trade tax. Furthermore, the restructuring of unincorporated companies by way of a tax-neutral transfer of reserves is facilitated by reintroducing the so-called "Co-partner tax remission". This provision makes the transfer of a company easier and helps SMEs cope with inter-generational succession.

16 Under the communist regime, profit tax rates varied widely and were subject to yearly negotiation, and set with reference to firm profitability and national policy objectives. With the fall of the communist regime in November 1989, reforms of the tax system began immediately.

Republic, the corporate tax rate was 45 per cent.[17] Since then, both countries have been reducing their statutory corporate tax rate. By 2002, the rate had fallen to 31 per cent in the Czech Republic, and to 25 per cent in the Slovak Republic. It is noteworthy that, despite the rate reductions, corporate tax revenues as a percentage of GDP increased steadily in the Czech Republic between 1998 and 2002 while remaining fairly stable in the Slovak Republic. The Czech Republic slashed its corporate tax rate further to 28 per cent in 2004. Also in 2004 the Slovak Republic reduced the tax rate to 19 per cent, when a flat tax on personal and corporate income was introduced.

Iceland is among the other OECD countries that have cut their corporate income tax rates in recent years, when their rate was cut from 30 per cent to 18 per cent in 2002. Ireland, while reducing its general corporate income tax rate from 31 per cent in 1998 to 12.5 per cent in 2003, had to increase the 10 per cent special tax rate for manufacturing to 12.5 per cent in order to comply with the EU Code of Conduct on Business Taxation.

Also, 2004 witnessed very significant corporate income tax rate reductions in a number of OECD countries. In addition to the rate cuts noted above for Belgium, Canada, Finland, Germany, the Czech Republic and the Slovak Republic, Hungary reduced its statutory corporate rate by two percentage points to 16 per cent, while Mexico took one percentage point off to lower its rate to 33 per cent. Portugal cut its corporate tax rate by over 5 percentage points, to 27.5 per cent, while Poland cut its rate by a staggering 8 percentage points, to just 19 per cent. In addition, Austria has decided to reduce its corporate income tax rate from 34 per cent to 25 per cent from 2005.

Other measures to improve the business environment

While reductions in statutory corporate tax rates may attract the greatest amount of public attention, adjustments aimed at addressing unintended effects and costs on business are equally noteworthy developments. Indeed, much if not most corporate tax policy making involves reviewing tax systems with an eye to ensuring that not just the main tax parameters but also the more detailed rules are enabling to business and supportive of policy goals.

In contrast to other countries which have largely relied on statutory corporate rate reductions as a means to encourage investment, Japan has recently embarked on an alternative strategy to bolster the competitiveness of Japanese firms. In October 2002, Japan announced that it would initiate a tax reduction in 2003 which would exceed one trillion yen under a multi-year reform bill, with a focus on stimulating the competitiveness of corporations in high-growth potential industries.

Under the reform environment in Japan in 2002, with many corporations not making sizable taxable profits, the effectiveness of a reduction in the general statutory corporate tax rate was doubtful to policy-makers. Moreover, it was recognized that general tax rate cuts would benefit corporations making profits mainly through dividends and other income from overseas – profits arising from investments made overseas and in the past. Such tax relief would have no direct effect on creating jobs and increasing consumption in Japan. Also, personal income tax rates had been lowered just prior to this period, in part to stimulate household demand, and little scope was seen to reduce personal tax rates further.

In contrast, targeted corporate tax incentives aimed at R&D and information technology were viewed as providing more focused tax relief to promote investment in fixed capital and intangibles. The pre-reform system gave incremental R&D tax credits (as opposed to volume-based credits), with progressive tax credit rates on the level of incremental R&D investment. However, corporations that had

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17 Also, in 1992, the final withholding tax rate on dividends and interest was 25 per cent. This withholding tax rate was reduced to 15 per cent in 1994 in the Slovak Republic, and in 2000 in the Czech Republic.

already made a large investment in R&D were expected to be generally insensitive to an incremental credit. Furthermore, the 2002 economic environment was not conducive to an increase in R&D investment by corporations. Thus, replacing the incremental credit with a volume-based proportional R&D tax credit was tabled for consideration as part of 2003 tax reform. The measures ultimately included in the 2003 reform were expected to result in tax reductions of approximately 1.8 trillion yen (U.S. $14.9 billion) in the fiscal year 2003.

Several other countries have introduced special tax incentives for R&D investment. E.g., the United Kingdom has introduced a tax relief on R&D expenditure at a rate of 125 per cent for large companies and 150 per cent for small and medium-sized companies.

In a move to further improve the competitiveness of firms in Canada, the federal government announced that it would also review its Large Corporations Tax (LCT), set at 0.225 per cent on taxable capital employed in Canada in excess of $10 million, and reduced by the corporate income surtax.[18] While corporations are able to credit corporate surtax against LCT (a form of minimum tax), concerns had been expressed that the tax on capital employed in Canada, being profit-insensitive, put Canadian firms (particularly early-stage firms and those subject to cyclical effects) at a competitive disadvantage. A review at the federal level led to the announcement in Canada's 2003 budget of a phase-out of the LCT.

By temporarily increasing the amount of investment small business can write-off immediately and by allowing all businesses to write-off immediately one-half of qualified investment, the United States has enacted substantial short-term tax relief for businesses. These provisions are intended in part as a short-term stimulus to aggregate demand. If made permanent, however, they would represent a substantial step towards cash flow taxation.

Corporate and personal tax integration

In order to reduce the double taxation of corporate profits, in 2003 the United States reduced the maximum statutory federal tax rate on dividends and capital gains to 15 per cent. This tax cut is expected to help to remove taxes from decisions concerning where to invest, whether to finance with debt or equity, and whether to pay out profits as dividends or instead repurchase shares or retain the income within the corporation. The tax cut was also expected to help stimulate the economy in the short run by boosting investment and the value of the stock market.

The integration of corporate and personal income tax systems has long been a hallmark of many European tax systems. Thus it is interesting to observe that at roughly the same time as the United States has moved to integrate its corporate and personal tax systems, many European countries are moving in the opposite direction towards classical tax treatment. The differences in policy approaches reflect different policy environments, underscoring the dependence of tax system design on the policy environment, including market characteristics.[19]

Where the marginal source of finance for domestic investment is domestic equity capital, then integration relief provided to domestic shareholders can be expected to lower the cost of capital for firms, spurring investment. While this effect may be broadly observed in the United States, it may not be in a number of European countries. In the small open economy context where large multinationals rely on foreign capital raised in international capital markets, the cost of finance is exogenously determined,

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18 A separate capital tax is levied on financial institutions.

19 In deciding the relative merits of reducing/eliminating imputation credits to shareholders, one consideration for European countries is the view of the European Court of Justice (ECJ) that dividends received from foreign companies must be taxed in the same way as dividends received from domestic companies (i.e. if imputation credits are provided to shareholders, they must be provided for both domestic and foreign-source dividend income).

independent of the degree of integration of domestic corporate and personal tax systems. In such cases, integration relief may serve to boost domestic savings, but may not lower the cost of capital to firms. A number of European countries have chosen to reduce the degree of integration relief offered, while in certain cases targeting such relief to small and medium-sized firms that may have limited access to international capital markets.

In Sweden, relief from double taxation is limited to equity interests in small- and medium-sized companies that generally have limited access to international capital markets. Individual shareholders of unlisted Swedish companies are exempt from tax on dividends received up to a threshold amount (equal to 70 per cent of a 'normal' return on equity, determined by applying a specified interest rate on government debt to the acquisition value of shares).

As of 2002, the full imputation system in Germany was replaced by the so-called half-income system, under which only one-half of distributed profit is exempted from the shareholder personal income tax base. With the half-income system replacing the imputation credit approach, corporate income tax is no longer fully offset at the shareholder level.

As noted above, Finland has recently decided to replace its full imputation system by a partial inclusion system from 2005, similar to the German half-income system. Under the previous system, full relief was provided at the shareholder level for corporate tax paid on distributed income. In the new system, 70 per cent of dividends from listed companies will be taxed as personal capital income at a rate of 28 per cent (that is, a 30 per cent exclusion is provided). For unlisted companies, the same treatment will apply for dividends exceeding €90,000 per person dividends. However, dividends paid by unlisted companies will remain tax-free at the shareholder level if the shareholder interest is not larger than 9 per cent of the net value of the company. Dividends exceeding the 9 per cent limit will be taxed as earned income.

Portugal also replaced its imputation system in 2002 with a partial inclusion system that includes half of dividends received in taxable income. Similarly, France adopted a half-income inclusion approach beginning 1 January 2005. Turkey has also decided to introduce a half-income system. In Italy, the former imputation system was replaced in 2004 with a modified classical system that includes 40 per cent of dividends received, 10 percentage points less than under the half-income inclusion approach applied in Portugal, France and Germany, while restricting the relief to shareholders owing at least 5 per cent of the share capital (25 per cent in unlisted companies).

It may also be noted that the United Kingdom has reduced the degree of integration provided. In particular, the dividend (imputation) tax credit attached to domestic dividends has been reduced to one-ninth (and is non-wasteable).

REFORMING THE OPERATION OF TAX ADMINISTRATIONS

The borderline between tax policy and tax administration is rarely clear. Policy reforms are, in part, driven by what is administratively feasible. Also, in practice the tax administration will be engaged in day-to-day reform of the tax system. It is, therefore, of interest when looking at tax reform to also examine recent trends in the reform of tax administration in OECD countries.[20]

[20] This section draws on work of the CFA's Forum on Tax Administration, including a number of publicly-released documents. See: OECD (2004c and 2004f).

Institutional arrangements for revenue administration

Tax reforms in OECD countries have been accompanied by changing institutional arrangements for the administration of tax laws. These include the creation of unified and semi-autonomous bodies (in 15 OECD countries) with a broad range of powers that are responsible for the administration of most, if not all federal/national taxes; single directorates with little autonomy within the formal structure of the Ministry of Finance (in 6 countries); and multiple directorates with little autonomy within the formal structure of the Ministry of Finance (in 9 OECD countries). To a large extent, these varied institutional arrangements reflect underlying differences in the political structures and systems of public sector administration in countries, as well as longstanding historical practice. In 11 countries, the tax body is also responsible for the collection and enforcement of social contributions, while in 17 countries the collection and enforcement of these has been entrusted to a separate body. In six OECD countries, there is now a unified body responsible for both tax and customs administration operations, but there does not appear to be any trend in this direction. There is, however, a clear trend to allocate other tasks of a non-taxation nature to the national revenue body. Such tasks include government valuation tasks, the payment of various social welfare benefits, the collection of non-tax government debts (e.g. child support, student loans), and the maintenance of population registers.

Organization of tax administration operations

A revenue body's organizational structure can have significant implications for overall operational efficiency and effectiveness in delivering its primary mandate. Particularly over the last 10-15 years, there has been a clear trend in the way the organizational structures of national revenue bodies have evolved.

The earliest organizational model employed by tax administrators was based principally on "type of tax" criterion. This entailed the operation of separate multi-functional departments for each tax that were largely self-sufficient and independent of each other. While this model served its purpose, it was eventually seen to have numerous shortcomings, including: (1) an inherent duplication of functions; (2) inconvenience for taxpayers with multiple tax dealings; (3) complicated compliance management implications; (4) a propensity for uneven and inconsistent treatment of taxpayers across taxes; and (5) under-utilization of staff. To address these sorts of problems, there has been a clear trend in tax administrations to organizing their operations largely on a 'functional' basis.

Under the 'functional' basis, staff are organized principally by functional groupings (e.g. registration, accounting, information processing, audit, collection, appeals, etc.,) and generally work across taxes. This approach to organizing tax work was introduced to enable greater standardization of work processes across taxes, to simplify computerization and arrangements for taxpayers, and to generally improve efficiency. Today, over two-thirds of OECD countries have adopted the functional model as the primary method for structuring tax administration operations.

A more recent trend among a number of OECD countries has been to organize operations principally around 'taxpayer segments' (e.g. large businesses, small/ medium businesses, wage earners, etc.). The rationale for organizing operations around taxpayer segments is that each group of taxpayers has different characteristics and tax compliance behavior and, as a result, presents different risks to the revenue. This is the model that was adopted for the US Internal Revenue Service, as part of the 1998 Restructuring Act. Proponents of the 'taxpayer segment' type of structure contend that grouping key functional activities in this way increases the prospects of improving overall compliance levels. While application of the 'taxpayer segment' model is still in its early stages of use, many countries have partially applied this approach by establishing large taxpayer units to fully administer the affairs of their largest taxpayers.

Managing taxpayers' compliance

In order to address tax compliance risks more effectively, there has been a trend in recent years in more advanced OECD countries to adopt a more strategic approach to managing these risks, applying modern risk management techniques. This development, which is in line with the adoption of modern corporate governance practices, gives recognition to the fact that the more serious tax compliance risks require a range of treatment strategies, and has been found to be a useful way of communicating to staff what the revenue body is trying to do and what is expected of them.

In practical terms, the application of this more strategic approach has led to better targeting of compliance improvement efforts, more effective matching of compliance improvement strategies with the underlying behavior to be addressed and, for some countries, demonstrated improvements in specific areas of taxpayers' compliance.

All of these changes in tax administration recognize that improving tax compliance must be an integrated part of any countries tax reform strategy.

CHALLENGES FACING TAX REFORMERS

Tax reform is an on-going process. Tax systems need to adapt continually to changing economic, social and technological changes. In this rapidly changing environment it is dangerous to assume that the future will just be a continuation of the past. This concluding section identifies some of the pressure points on tax systems that are likely to arise over the next decade.

Pressures on public expenditures

Population aging will place increased demands on governments' pension and healthcare systems. Many governments will also be under pressure to upgrade physical infrastructures: communication links; sewerage; public housing. Progress in medical technology will lead to more pressures on health spending and dealing with an increasingly volatile international environment will require increased expenditures on policing and military activities.

Pressure on the revenue side

The following factors will constrain the ability of governments to raise revenue in response to the pressures described above:

- The need to avoid increasing unemployment: increasing social security contributions and payroll taxes would increase the tax wedge on labor and this could reduce labor force participants. A number of countries (e.g. Belgium) are seriously considering shifting from social security contributions to other taxes (e.g. VAT) as the main source of finance for social programmes.
- The increased mobility of the tax base: Governments are facing difficulties in maintaining their existing tax bases. The tax base associated with capital income and high wealth individuals is becoming increasingly geographically mobile, in part reflecting the relatively easy access of corporations and wealthy households to tax havens. A growing proportion of the consumption tax base – particularly that associated with digital products (e.g. music, software) – is also already highly mobile.
- Changing attitudes to tax compliance: Attitudes towards tax compliance are shifting, with more taxpayers being prepared to engage in aggressive tax planning, often involving the use of tax

havens. In Europe, the tax base is also threatened by a spate of recent decisions by the European Council of Justice which has ruled a number of anti-abuse provisions (e.g. thin capitalization rules) to be inconsistent with the EU Treaty of Rome.

The responses of governments

Governments will respond to these pressures in different ways. Some may be met by an increased use of the private sector to deliver and finance public goods (although in most OECD countries we have probably reached the limits of privatization). Some governments may respond by increasing or abolishing the official age of retirement and cutting entitlement to core social programmes. All will look further at how to improve the efficiency of the public sector and in some cases this will involve an increased use of private-public partnerships. On the revenue, we can expect to see governments increasingly disguising taxes as compulsory levies, with the distinction between a tax and a fee becoming blurred. Also, governments may force companies to set up and finance certain social schemes (e.g. disability, work related injury schemes). We may also see an intensification of the trend to decentralize expenditure functions and to have these financed by taxes on land and buildings, which tend to be the least mobile of tax bases.

Governments will also increase the pressure on tax authorities to improve tax compliance. This will involve better risk management techniques, less tolerance of aggressive tax planning and improving the service provided to taxpayers. At the same time we will see more action at the international level to counter international tax evasion and avoidance. Offshore financial centers and bank secrecy jurisdictions are coming under more pressure to implement exchange information provisions. All countries will need to examine how to improve the effectiveness of such provisions.

Some General Principles of Good Tax Design

As each country pursues its tax reforms to respond to the pressures described above they will be guided by their specific circumstances. Nonetheless, recent experience of OECD countries suggests that there are some general principles of good tax design which could contribute to individual solutions that each country will need to develop:

- Simplification. Many countries have attempted to simplify their tax systems but more can be done in most countries. Simple tax systems, characterized by low rates applied to a very broad tax base, generally lead to fewer economic distortions, greater certainty for the taxpayer, as well as lower administrative and compliance costs. If politicians are serious about reducing the complexity of the tax code, however, they first need to review the policies that the code is trying to implement.
- Fairness. It is possible to identify two aspects of fairness: vertical equity and horizontal equity. While countries differ widely in their views as to the aspects of the tax system needed to achieve the appropriate degree of vertical equity, there is general consensus on the concept of horizontal equity – that people in similar situations should pay similar amounts of tax. The special tax exemptions, reliefs and regimes that abound in OECD countries often violate the principle of horizontal equity, while achieving little of real value. The elimination of these, or their replacement with policies that achieve their objectives more efficiently, would produce a gain in revenue while improving economic efficiency. Similarly, these lower rates applied to a broader base should be vigorously enforced. This will require that as governments pursue their tax reform agenda, they also examine the operation of their tax administrations. Good tax compliance, which is an essential element of fairness, requires that governments get the right balance between taxpayer service and tax enforcement. Those taxpayers who want to pay the right amount of tax

have the right to expect that the tax administrations make this task as easy and painless as possible. Honest taxpayers also have the right to expect that those who cheat on their taxes will be identified and reprimanded. Only if we get this balance right will we maintain taxpayers' faith in the system.

- Removal of tax obstacles to growth. Complexity and special tax exemptions can also create serious obstacles to growth, creating uncertainty and giving companies greater financial returns from distorting their decisions to take advantage of special tax provisions than from simply improving efficiency and meeting consumer needs.
- Move to more efficient tax bases. Countries could consider altering the balance between different tax bases. The efficiency of many tax systems has been improved by using a broad-based VAT to replace a patchwork of individual excise duties and sales taxes. Could countries that finance pensions and healthcare from taxes on labor diversify their funding to less distortionary taxes, e.g. by increasing the share of revenue from consumption and property taxes? Consumption-based tax systems would also reduce or remove the negative effects on pension savings and other forms of savings imbedded in an income tax system, if the increased revenue from consumption taxes is used to reduce income tax rates. Furthermore, such a tax shift could increase participation of women and older people in the workforce - allowing incomes, consumption and therefore the tax base to grow. This is a far better alternative to raising taxes on labor and capital and seeing these tax bases diminish further.

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 and considerable attention will need to be paid to the *process* of reform. The experience of OECD countries suggests that a successful tax reform process requires 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. It also requires 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 their losses will eventually lead to gains. Reforms based on clear principles which can be simply articulated and understood, and which are based upon an open and inclusive process of reform, stand a better chance of achieving long-term stability. It also appears helpful to limit the time between the initial announcement and the implementation. In a federal context, all levels of government must buy into the reforms since most reforms will impact the revenue base of lower levels of government. Reforms must also extend to the tax administration. Put another way: administrative feasibility is an important criterion to judge tax reform.

Some countries (e.g. Netherlands, New Zealand, Slovakia) have been very successful in introducing reforms, managing to simplify their tax system, and at the same time remove tax induced distortions. Others have been less successful (e.g. France and Germany) probably because they have not been bold enough in their reforms. What is clear is that in today's rapidly changing environment, governments will need to continually review their tax systems to ensure that they meet their social and economic objectives.

ACKNOWLEDGEMENTS

The views expressed in this paper do not necessarily reflect the views of the OECD or its Member countries. The author would like to thank his OECD Secretariat colleagues Chris Heady, Steve Clark, Augusta Badriotti and Ulf Pederson for their input into this paper, which draws heavily on work that is currently being undertaken by the OECD's Working Party on Tax Policy.

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