平 19.5.17
企画 10-1-1
調査 5-1-1

CHALLENGES FOR TAX POLICY IN THE GLOBALIZED ECONOMY

IMF staff presentation to the Tax Commission

Tokyo, May 17, 2007

Outline of Presentation

- Introduction
- Grand designs for the tax system
- Tax reform for competitiveness and growth
- Concluding remarks

INTRODUCTION

Globalization—increased mobility of capital, goods, services and labor—poses many challenges…

…and these are amplified by:

- Fiscal pressures from ageing, an imminent concern in Japan
- Increased financial sophistication
- Emerging common concerns, notably climate change

Challenges include:

- Greater mobility of tax bases:
  - Location decisions for real investments are more tax-sensitive
  - Shifting paper profits is easier (through transfer pricing and financial arrangements)
  - Tax evasion—especially of residence-based capital taxes—is harder to stop

- Incidence of tax instruments changes

  Real burden falls on relatively immobile factor

  - which to a large degree may come to mean low-skilled labor…
  - ..and it is then better to tax this directly, through labor and/or consumption taxes (because doing so indirectly causes unnecessary distortions)

- Increased income inequality (and labor market problems) raises questions as to:
  - Relative roles of tax and spending measures
  - Scope for in-work benefits (such as earned income tax credit)

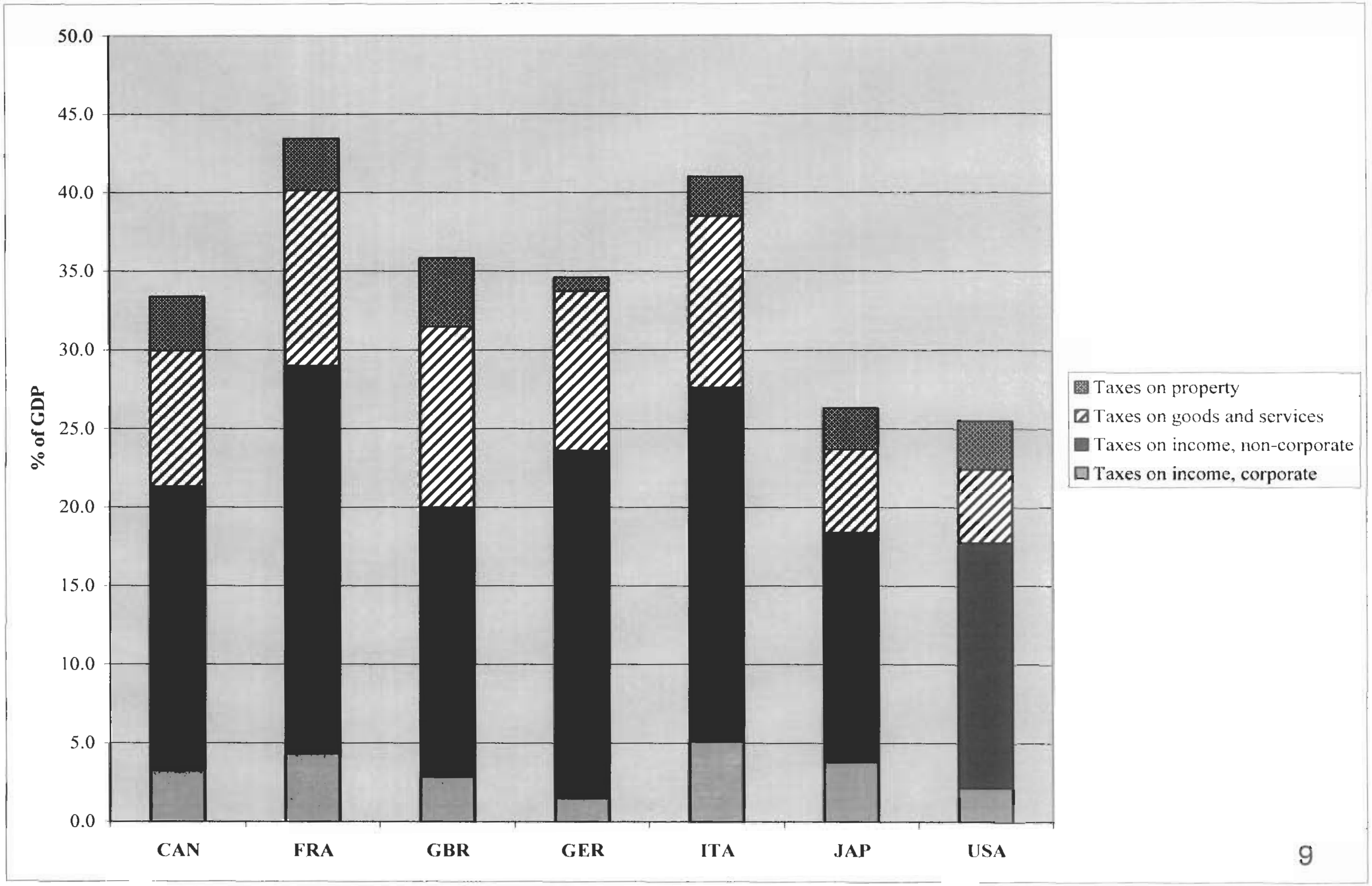
- Even without mobility, tax design can be used as a signal
  - Otherwise hard to explain very low rates of PIT in some of the recent ‘flat taxes’

- Stronger spillover effects raise question: What role (and form) for international tax coordination?
  - Is tax competition good or bad?
  - Is administrative cooperation enough?
  - What mechanisms for proper carbon pricing?

Coordination issues not addressed in this presentation

As background:

Tax structures in the G7 (including social security)



GRAND DESIGNS FOR THE TAX SYSTEM

Coherent tax reform requires a view of the system it is intended to create…and increased capital mobility, plus growth concerns, is causing a fundamental rethink

Four main models of income tax:

- Comprehensive income tax
- Expenditure tax
- Dual income tax
- Flat tax

Discuss these, then role of other taxes

Comprehensive income tax

A progressive schedule applied to the sum of income from all sources…

…recommended by Shoup, and in current law

- Well-known technical problems—e.g. in taxing accrued capital gains

- But more fundamental difficulties from taxing capital income at top rate on labor income (such as the 50 percent in Japan)

Expenditure tax

Excludes (at least) normal return on saving, with progressive tax on spending

- Efficiency case for ET arguable, as rate on labor income must rise to maintain revenue
- May improve vertical equity to extent consumption reflects lifetime income
- Most countries have substantial elements of ET treatment (including through VAT)

Dual income tax

A progressive tax on labor income plus a relatively low flat rate on capital income

- Motivated partly by increased difficulty of taxing capital income
- ..and recognition that it may achieve more equity (and revenue) than progressive taxation of capital income

The Nordic DITs: Tax rates (in percent)

	Finland	Norway	Sweden
Labor tax	30-53	28-48	32-57
Capital income tax	28	28	30
Corporate Income tax	26	28	28

- Present Japanese system has many of characteristics of the DIT

- Main difficulty with DIT is treatment of the self-employed, who can easily relabel capital as labor income and vice versa
  - Approach has been to impute a return to capital and tax rest as labor income

The 'flat tax'

Defining feature is a single positive rate on labor income (above some exemption)

- Beyond that, great variation…
  …e.g. in whether aligned with CIT rate

- 'Second wave' began with Russia in 2001
  – which was associated, notably, with an increase in PIT revenue

The flat taxes

	Year of Reform	Rates at Reform (now)		Previous Rates PIT / CIT
		PIT	CIT	
Estonia	1994	26 (23)	26 (23)	16 – 33 / 35
Lithuania	1994	33 (27)	29 (15)	18 – 33 / 29
Latvia	1997	25	25 (15)	25 and 10 / 25
Russia	2001	13	37 (24)	12 – 30 / 35
Ukraine	2004	13	25	10 – 40 / 30
Slovakia	2004	19	19	10 – 38 / 25
Georgia	2005	12	20	12 – 20 / 20
Romania	2005	16	16	18 – 40 / 25

What lessons?

- Hard to disentangle effects of flatness from those of tax cuts
  - Simplicity benefits seem limited
  - But FTs have been used as an opportunity to reduce exemptions
- For Russia, panel data suggests:
  - No strong real supply-side effects
  - Compliance may have improved
  - Tax cuts did not pay for themselves

Role of other taxes

- Balancing direct and indirect taxes

  In practice: In those OECD countries with a VAT (i.e. all except the U.S.), it:

  - Is levied, on average, at a standard rate of 17.5 percent (compared to 5 in Japan)
  - Raises 7.5 percent of GDP (compared to 2.5)
  - Has been increasing in importance

This is the aspect of tax design in which Japan is most unusual…

….as it is in having one of the best-designed VATs, with:

—a single rate

—C-efficiency (= 100 percent under a single rate tax on all consumption) of 65 percent (compared to 53)

- In principle: A VAT is equivalent to a tax on wage income and accumulated assets. So:
  - Proper balance between wage taxation and VAT in part determined by compliance risks
  - And a primary distributional impact is as a windfall tax on past savings

- Inheritance and gift taxes
  - Face many of same challenges as capital income tax
  - Commonly eroded by exemptions

- Property taxes
  - More important as a source of revenue in Japan than elsewhere
  - Attracting increasing interest as benefit tax suitable for local government

TAX REFORM FOR COMPETITIVENESS AND GROWTH

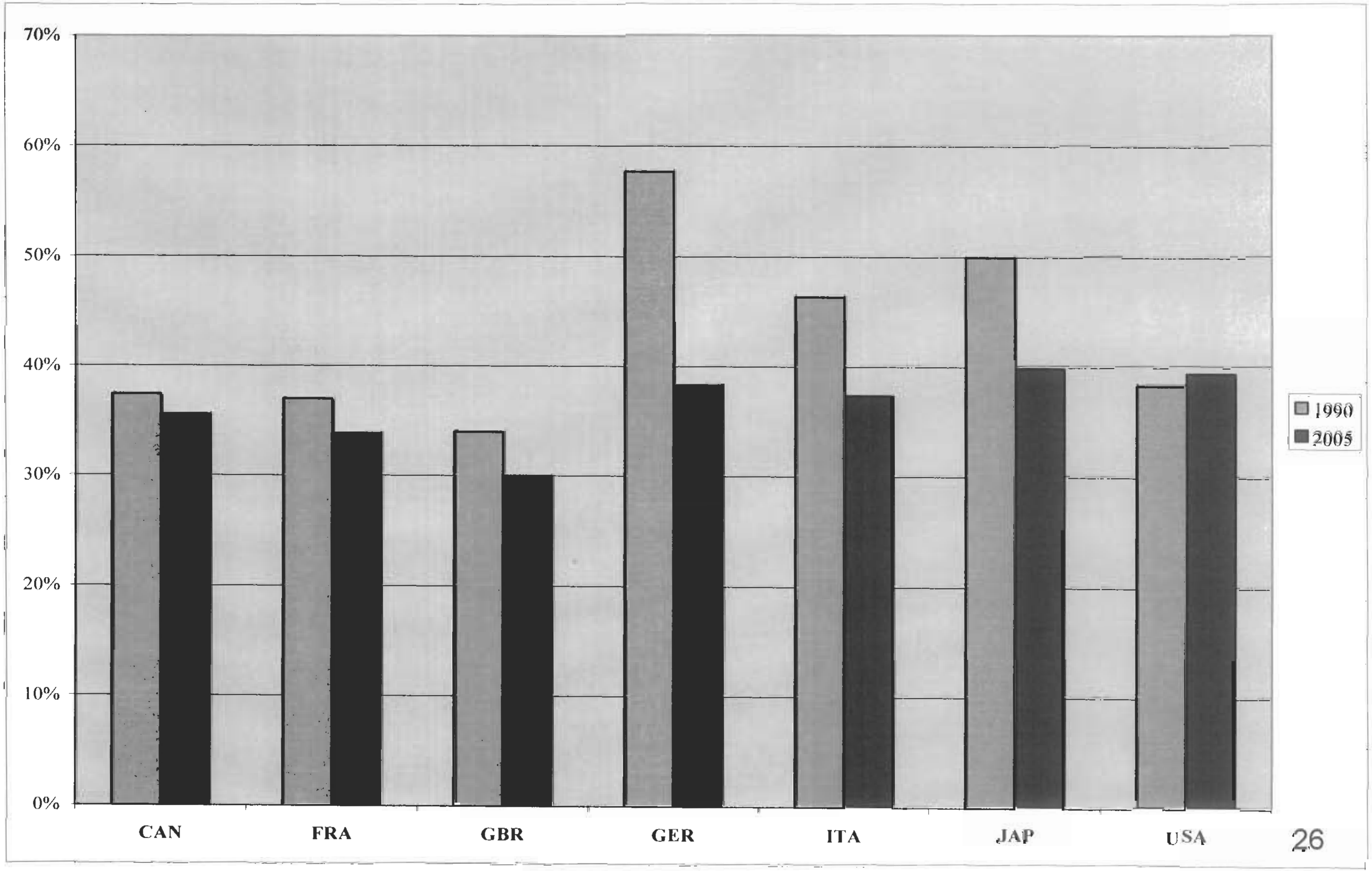
Natural and appropriate to focus on CIT…

…but it is not all that matters: evidence e.g. that growth faster when reliance on consumption taxes greater

Statutory rates have evidently been subject to tax competition…

…and Japan now has a relatively high rate:

Statutory rates of CIT in the G7



Impact of CIT on investment depends on:

- <u>Average</u> effective tax rate, which affects *where* to invest
  - This depends largely on statutory rate…
  - …so that, given also the impact on transfer pricing and profit shifting, downward pressure is to be expected in Japan

- Marginal effective tax rate, which affects *how much* to invest
  - which remains somewhat high in Japan…
  - …partly reflecting high statutory rate, but also suggesting relatively little scope for base-broadening

Other current CIT issues:

- Recent experiments with fundamental restructuring of CIT:
  - Belgium's 'Allowance for Corporate Equity' (with deduction for normal return on equity)
  - Estonia: taxes only distributions

  Both move the CIT towards a tax on pure profit

- Incentives for R&D increase measured R&D—but how much social benefit?

Energy taxation—an emerging concern

Petroleum excises may need reassessment:

- They serve many purposes, dealing with congestion, accidents, carbon emissions…

  …with evidence that too low (too high) in U.S. (U.K.)

- Case for 'unbundling' these components, with a clear role for a uniform carbon tax

CONCLUDING REMARKS

- Tax systems are everywhere are in flux

- Many challenges are common, but the solutions may be country-specific

- Japan faces many challenges, but has advantages to build on, such as:
  - Being an island can help indirect taxation
  - Not least, the VAT has many strengths