

CHALLENGES FOR TAX POLICY IN THE GLOBALIZED ECONOMY

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I. INTRODUCTION

Globalization—the increased mobility, to varying degrees, of capital, goods, services, and labor—poses a range of challenges for tax design. These are amplified by the increased sophistication of financial markets and have special urgency in Japan given the imminent and considerable fiscal pressures from an ageing population. Key challenges include:

- Increased mobility of factors and commodities means increased mobility of tax bases, and hence a risk of revenue losses: (1) Mobility of ‘real’ factors intensifies competition to attract, in particular, foreign direct investment, both to secure revenue and in search of growth-enhancing externalities; (2) Mobility of ‘paper’ transactions, through transfer pricing and financial operations, enables enterprises to shift taxable profit to low tax jurisdictions; (3) Tax evasion is facilitated. The difficulties other countries experience in relation to indirect taxation—smuggling and VAT fraud, for example—are likely to be less of a concern in Japan, in part because of its island nature. But, as elsewhere, difficulty can be anticipated in taxing residents on their worldwide income given the unreliability of self-reporting.
- More subtly, globalization changes the incidence of traditional tax instruments. Mobile factors can escape national taxes by relocating elsewhere, transferring the real burden of any tax notionally levied on them onto less mobile factors—often, less-skilled labor.
- Even without direct mobility links between countries, there are signs of ‘yardstick competition,’ with voters and potential investors taking a country’s tax system as a signal of its wider competence and attitudes towards enterprise.
- Globalization has in many countries been accompanied by (if not a cause of) increased income inequality, prompting lively debate, as in Japan, on the case for taxation to be used more purposively to pursue equity objectives. A central question here is whether spending or similar measures—such as introduction of an earned income tax credit—may be more effective, and more supportive of growth.
- Increased mobility strengthens cross-national spillover effects, and raises questions as to the optimal degree and nature of coordination in tax policy and administration.

The tax policy implications of globalization are far-reaching. This note highlights some of the most fundamental (leaving aside, for brevity, issues of international coordination).

II. GRAND DESIGNS FOR THE TAX SYSTEM

Many of the challenges from globalization apply most forcefully to the taxation of capital income. The long-standing theoretical arguments for taxing such income at a low or even zero rate are now reinforced by the increased practical difficulty of doing anything else. As a result, the income tax in many countries is undergoing redesign—sometimes piecemeal, but preferably guided by a coherent vision of the system it is intended to create.

There are four main grand designs for the income tax. The **comprehensive income tax** applies a progressive schedule to the sum of income from all sources, and has long been a textbook ideal. Difficulties in implementing it (notably in effectively taxing capital gains as they accrue) have long been recognized. But globalization has brought to the fore a more fundamental problem: taxing capital income at marginal rates as high as those applied to labor income—like the top rate of 50 percent in Japan—may drive an unacceptable amount of capital abroad.

Second, various forms of **expenditure tax** exclude from tax (at least) the normal return to savings, while retaining some progressivity in applying a higher rate to higher levels of spending. This eliminates the tax distortion to savings decisions, but, if the same revenue is to be raised, worsens the distortion to labor and/or other decisions. Few countries have explicitly adopted such a system, but the proliferation of savings incentive schemes—and the increased revenue importance of the VAT—mean that many have, in effect, moved quite substantially in this direction. While it is quite common to provide expenditure tax treatment for pensions, Japan has gone even further to provide an effective **subsidy**.

Third, the **dual income tax** (DIT), developed furthest in the Nordic countries, combines a progressive tax on labor income with a relatively low, single rate on capital income. The latter feature, largely an acknowledgment of the difficulty of taxing mobile capital income, may have increased progressivity: revenue from capital income taxation was arguably negative before the DIT (as a consequence of arbitrage opportunities and asymmetries in the deduction of capital costs). The current Japanese system has important similarities to the DIT, though with less uniformity in the treatment of capital income, which might thus provide a natural model for coherent reform. The main difficulty with the full DIT is in dealing with the self-employed, since the ease with which they can relabel income as from capital or labor calls for complex allocation rules (though this difficulty is lessened when the gap in rates is modest).

The fourth grand design is the **flat tax**, now adopted in a dozen or so countries. It applies a single marginal tax rate on all labor income (above some exempt amount). There is considerable variation within this family of taxes: some but not all, for example, apply the same rate to corporate income. There are few signs of a significant labor supply responses from these reforms but some indication of improved compliance. Sometimes seen as inherently regressive, the distributional implications of the flat tax are usually **ambiguous**: the better off pay less tax, but, since it has been common to increase the basic exempt amount, so too do some of the poorest. The simplification benefits are likely to be limited, but the experience with the flat tax reforms illustrates how broadening the income tax base—a recurrent concern in the Japanese context—can be made more **palatable** by combination with rate-reduction.

Related issues concern taxes on property values and transfers: except for those that bear on location-specific attributes they are subject to challenges similar to those faced by taxes on capital income (to which they are equivalent in important respects). To the extent they bear on attributes specific to particular locations and/or proxy a user fee on local services, **property taxes** are often a preferred marginal source of finance for lower-level governments.

Inheritance and wealth taxes have often been undermined by exemptions and the difficulty of

closing avoidance opportunities, and in some countries encounter increasing resistance as rising house values bring more taxpayers into the base. As the burden on capital income is reduced, however, the objection that these amount to double taxation loses force.

Globalization also raises profound issues for the **balance between direct and indirect taxation**. The VAT is well-established as the consumption tax of choice for most countries, with signs that it has not only provided a net addition to revenue but also allowed a reduction in reliance on other and more distorting taxes. Japan has one of the best-designed VATs in the world, but is an outlier in the low rate applied and relatively little revenue consequently raised. This—and evidence that greater reliance on consumption taxes is associated with faster growth—makes the VAT a prime candidate as a means of the needed revenue enhancement. Since the VAT is akin to a tax on wage and profit income (one being levied on households' uses of funds, the other on their sources) combined with a lump-sum tax on accumulated savings, the key distributional issue raised by a VAT increase is inter-generational.

III. TAX REFORM FOR COMPETITIVENESS AND GROWTH

The corporate income tax (CIT), widely seen as key to growth prospects, has evidently been subject to international tax competition. Strikingly, however, revenue raised by the CIT has remained broadly unchanged in the OECD. This reflects the base-broadening that has typically accompanied rate cuts. However, other factors may have been at play: the GDP-share of profits may have risen, especially in the financial sector; and/or, given the asymmetric treatment of gains and losses, the robustness of CIT revenue may reflect increased volatility of profits.

Designing growth-supportive tax regimes, and protecting revenues, requires attention to both marginal and the average effective rate of tax (METR, AETR). The METR bears on how the tax system affects the level of investment once it has been determined in which country to invest. The AETR is relevant in the choice of the country in which to invest. (A tax on pure profits at 20 percent, for example would have an METR of zero but an AETR of 20 percent). Increased recognition of the importance of the AETR has refocused attention on the statutory rate, which also drives companies' profit-shifting between jurisdictions. This rate remains high by international standards in Japan, and pressures for further rate reduction are likely.

CIT competition has meant not just rate cuts, but also experiments in restructuring. Prominent examples are Belgium's "allowance for corporate equity" system and Estonia's taxation of only distributions. Both eliminate the (increasingly arbitrary) tax discrimination between debt and equity at corporate level, and move the CIT closer to a pure profit tax.

Measures to promote **R&D** can have a powerful effect on measured R&D, but the extent to which this generates genuine social rather than private benefit is unclear.

Concerns with sustainable growth also call for a policy in the **taxation of energy**, including fuel excises (relatively low in Japan) that balances objectives for revenue, competitiveness, security of supply, and externalities (both national and global).