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Political Economy of Tax Reforms

Workshop Proceedings

Edited by Savina Princen

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This Discussion Paper collects the contributions of the speakers at DG ECFIN's workshop "Political economy of tax reforms" on 19 October 2015.

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Authorised for publication by Lucio Pench, Director for Fiscal Policy.

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Political Economy of Tax Reforms

Proceedings of the workshop organised by the Directorate General for Economic and Financial Affairs (DG ECFIN) held in Brussels on 19 October 2015

Edited by Savina Princen

Abstract

In the context of tax policy challenges in many EU Member States, the 2015 ECFIN taxation workshop addressed the political economy obstacles substantial tax reforms face and possible avenues to successful reform implementation. It presented concrete examples of tax reforms in Italy and Greece, discussed the political economy dimensions of specific tax areas and looked into issues related to tax fraud and tax coordination. The workshop hosted Commissioner Moscovici for the keynote address.

JEL Classification: H21, H23, H24, H25, H26, P48.

Keywords: political economy, tax reform, tax policy, property taxes, tax expenditures, tax transparency, tax coordination.

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1. SUMMARY OF THE WORKSHOP

*by Savina Princen**

In the context of tax policy challenges in many EU Member States, the 2015 ECFIN taxation workshop addressed theoretical and policy issues in terms of political economy of tax reforms. It presented concrete examples of tax reforms in several Member States, discussed the political economy dimensions of specific tax areas and looked into issues related to tax transparency. The workshop hosted Commissioner Moscovici for the keynote address. Organised in three sessions, the workshop involved speakers from academia and international organisations.

Lucio Pench (Director for Fiscal Policy in DG ECFIN) formally opened the workshop. He recalled that the theme of this 5th ECFIN tax workshop was a logical extension of previous editions, which covered a broad range of relevant tax issues. Over the past years, a common thread has been the idea that a carefully designed tax system can have a significant positive impact on a country's economy. It can help ensure stable public finances, it can boost growth and employment, and it can contribute to a fair distribution of income. This year's tax workshop discusses the question of why we often do not see this potential for tax reform materialise.

Florian Wöhlbier (Acting Head of the Revenue Management and Tax Policy Unit in DG ECFIN) presented the key messages from the 2015 edition of the joint DG ECFIN and DG TAXUD report "Tax reforms in EU Member States". The report presents recent trends in tax reforms in EU Member States and identifies tax policy challenges for Member States relevant for macroeconomic performance. Wöhlbier outlined important tax policy challenges in Member States and referred to reasons that might render reforms difficult to implement.

1.1. FIRST SESSION – OBSTACLES AND STRATEGIES FOR TAX REFORMS

The first session of the workshop, chaired by Lucio Pench, discussed the needs and drivers for reforms and how to make reforms happen. It addressed the theoretical aspects related to the political economy of tax reforms and presented examples of tax reforms in Italy and Greece. A general discussion with the speakers and the audience concluded the session.

Ian Preston (University College London) started his presentation by discussing optimal income tax models in the light of political economy models. Based on UK direct tax reforms over the last 30 years, he considered some of the factors influencing the political economy of reforms. He showed that, contrary to economic theory, growing pretax inequality has coincided with a drift down in the headline income tax rate and a stable effective tax rate. He has also showed that over most of that period average public opinion has moved against redistribution and public spending, both on average across the whole population, within cohorts and across generations. He explained that this may be connected to a decline in trust in the government to spend in the public interest.

Bert Brys (Head of the Country Tax Policy Team, Centre for Tax Policy and Administration, OECD) reviewed the political economy challenges of tax reforms and presented a number of strategies which may allow policymakers to overcome those challenges and make tax reforms happen. First, he presented the main political economy obstacles, highlighting the importance of political cycles and the visibility of tax policy decisions. He also showed how uncertainty may impede tax policy reform and how special interests may be very effective in influencing tax policy. Then, he presented some tax reform strategies that enable policymakers to reconcile the different goals that tax systems aim to achieve, whether related to income redistribution, efficiency or raising revenue. He highlighted the importance of underpinning tax reform design with a clear strategic vision and solid analysis and of framing tax policy debates. He closed his presentation by discussing the trade-off between comprehensive tax packages and incremental approaches to make tax reform happen.

* Savina Princen is economist in the Fiscal Policy Directorate of the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission. The views expressed in this contribution are those of the author and do not necessarily coincide with those of the European Commission.

Paola Profeta (Bocconi University) highlighted that tax reforms are a highly debated topic where political aspects become crucial. She explained that political constraints may account for a large part of the gap between the tax reform prescribed based on standard economic theory and the actually implemented tax reform. She presented some evidence on the action of political constraints in shaping tax reforms with a particular focus on the Italian case. After presenting a few general lessons drawn from a broad analysis on European labour taxes, she explained how political constraints may shape the equilibrium in taxation. To illustrate the view that tax reforms are used as an attempt to attract votes and respond to political incentives, she presented some Italian evidence about local property taxation. Individuals' political orientation and political competition seemed to be promising avenues to explain the design of specific tax policy reforms worldwide.

Nikos Tatsos (Panteion University Athens) discussed the main areas of tax reform in Greece and showed how tax increases were used to address the country's significant fiscal consolidation needs. He analysed the measures taken and their short run benefits but pointed out that they did not provide a long lasting solution. Moreover, he showed how some of those measures had harmful effects on social and equity grounds and prevented policy makers from taking the necessary measures for enhancing the efficiency of the tax system. He underlined that there is no evidence that tax evasion has been reduced in Greece and that a tax reform in order to be successful must fulfil certain conditions. He closed his presentation arguing that none of these conditions existed in Greece.

Karel Lannoo (CEO of the Centre for European Policy Studies) introduced the general discussion, by emphasising that taxation is an extremely sensitive issue for citizens, not only at national level but also at EU level, making reform very difficult. He reflected on the achievements made at EU level as regards tax harmonisation, the automatic exchange of information and the savings tax directive. The floor was then given to the audience, which raised questions related to tax reforms in specific countries and affecting specific tax areas.

1.2. SECOND SESSION – FOCUS ON POLITICAL ECONOMY DIMENSIONS OF SPECIFIC TAX AREAS

The second session of the workshop, chaired by **Valère Moutarlier (Director for Direct taxation, Tax coordination, Economic analysis and Evaluation in DG TAXUD)**, focused on the political economy dimensions of specific tax areas, in particular the resistance to reform property taxes and the political drivers of using tax expenditures. A closer look was also given to tax transparency and international tax co-ordination, in particular as regards corporate taxation.

André Masson (Paris School of Economics) focussed his presentation on the resistance to taxes on immovable property and wealth. First, he looked into the current economic arguments as regards taxation of immovable property, wealth and wealth transfers, while emphasizing the somewhat different proposals of reforms advanced by some French authors. He also gave specific attention to the social and economic implications of increasing longevity and 'patrimonialisation' (growing weight of wealth) in our societies. To mitigate resistance to tax reforms, he advocated 'solidarity deals', which offer various compensations for tax hikes.

Athena Kalyva (DG ECFIN) looked into the political economy aspects of tax expenditures. Against the background of recovering growth and remaining fiscal consolidation needs, reforming tax expenditures may offer a promising avenue to raise revenue and improve the efficiency of tax systems. However, not all tax expenditures are equal in terms of revenue forgone and economic effects. Hence, it is important to understand the political economy characteristics of tax expenditures, what makes some tax expenditures successful and what lessons could be learned related to the lack of evaluation and transparency of tax expenditures.

Michael Devereux (University of Oxford) focussed his presentation on the international corporate tax system and on the ongoing tax initiatives to further enhance tax transparency and to tackle tax fraud. He first highlighted that the compromise for the allocation of profit between countries is no longer suitable for taxing modern multinational companies, as it is open to manipulation by companies and as it incentivises tax competition between governments. He then discussed the ongoing initiatives by the European Commission and the OECD to tackle those issues but noted that the majority of the proposed measures did not target the fundamental problems. He argued that the international tax system can only be stable in the long run if there is no incentive for countries

to compete with each other, and thus, impose externalities on others. He, therefore, suggested basing taxation on the residence of, or consumption by, individuals.

Thomas Neubig (Deputy Head of the Tax Policy and Statistics Division, Centre for Tax Policy and Administration, OECD) started his intervention by stressing the success of the OECD Base Erosion and Profit Shifting (BEPS) project of gathering 40 countries together to agree unanimously on 15 action points to curb international tax avoidance. He also underlined the achievement of the OECD to reach a cooperative agreement in terms of automatic exchange of information. Against this background, he commented on the three presentations of the second session. As regards the difficulty of taxing capital income due to its mobility, he noted the importance of the automatic exchange of information, which enables countries to consider progressive taxation of capital income. As regards tax expenditures, he argued in favour of a cost-benefit analysis in addition to a culture of transparency and evaluation. Finally, as regards tax transparency, he underlined the importance of the BEPS action related to 'country-by-country reporting', which increases the transparency of multinational enterprises for tax administrations.

1.3. CLOSING SESSION

In the closing session, Pierre Moscovici, European Commissioner for Economic and Financial Affairs, Taxation and Customs, gave his keynote speech. He underlined that governments need to seek a balance between efficiency, equity and political feasibility, sharing his personal experience as Minister of Finance in France and as European Commissioner. The Commissioner stressed that some tax policy challenges are difficult for Member States to address in isolation, namely tax evasion and tax avoidance. He outlined three tracks for the Commission to help Member States implement tax reforms: the European Semester cycle, the on-going dialogue with Member States and EU level initiatives. During the closing panel discussion the relevance of political economy dimensions, whether at national, European or international level, were recalled.

2. KICK-OFF PRESENTATION

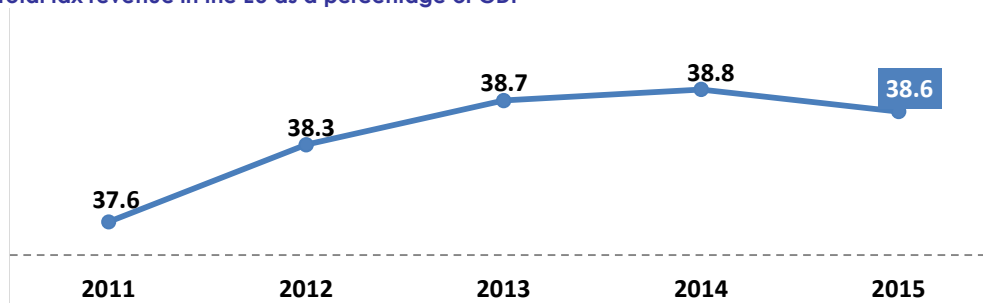
2.1. CHALLENGES FOR TAX REFORMS IN EU MEMBER STATES

by Florian Wöhlbier*

The 2015 edition of the joint DG ECFIN and DG TAXUD report 'Tax Reform in EU Member States 2015 - Tax policy challenges for economic growth and fiscal sustainability' (European Commission, 2015a) presents an overview of the recent tax reforms in EU Member States. In addition, it includes an indicator-based framework to help identify potential policy challenges in key areas of tax policy in EU Member States. The objective is to improve the contribution of tax policy to macroeconomic performance.

Tax reform can contribute to the stability of public finances, boost economic growth and employment, and improve social fairness. However, reform efforts are often limited given the size of the challenge faced, not least due to political constraints decision makers face. The tax reform report contributes to the discussion on tax reforms and serves as an analytical input to the 2016 European Semester, the EU's annual cycle of economic policy surveillance. In recent years, Member States have increased their total tax revenue, from 37.6% of GDP in 2011 to 38.8% in 2014. However, as seen from Graph 1, the tax revenues are expected to decrease slightly in 2015. Changes are partly due to discretionary measures in Member States, but cyclical effects also play a role.

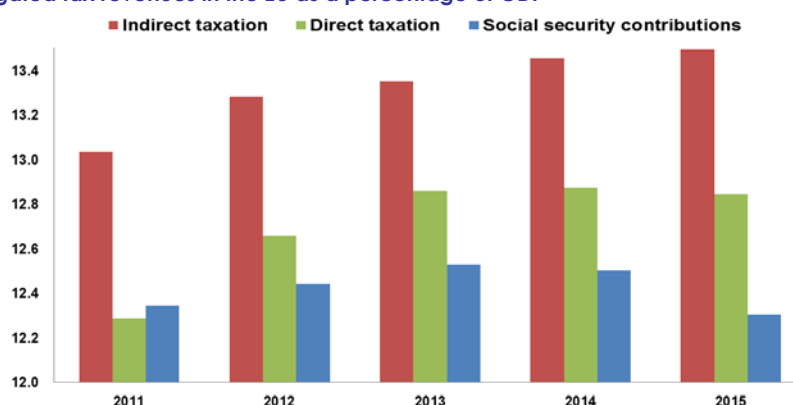
Graph 1: Total tax revenue in the EU as a percentage of GDP



Source: European Commission (2015a)

Graph 2 shows the development of different types of taxation – indirect taxes, direct taxes, and social security contributions – during the same period. The outlook of slightly lower tax revenue in 2015 is mainly caused by the expectation of a decrease in the social security contributions in Member States.

Graph 2: Disaggregated tax revenues in the EU as a percentage of GDP



Source: European Commission (2015a)

* Florian Wöhlbier is Acting Head of the unit dealing with 'Revenue management and tax policy issues' in the Fiscal Policy Directorate of the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission. The views expressed in this contribution are those of the author and do not necessarily coincide with those of the European Commission.

2.1.1. Identification of challenges – screening methodology

The tax reform report includes an indicator-based screening of Member States' performance in several areas of tax policy. The approach helps to identify the relatively good and poor performers by comparing it to the EU average. The methodology is a useful tool to identify areas where individual Member States could improve their tax policy. However, there is a clear need for additional country specific analysis before drawing any firm conclusions. The Commission carries out a more in-depth analysis for the individual Member States as part of the European Semester.

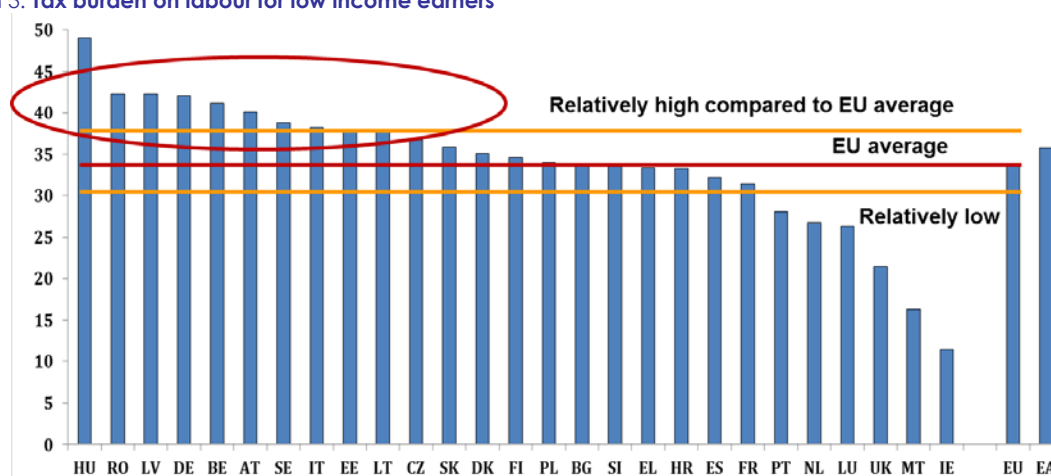
Benchmarking has received a lot of attention recently. The Five-Presidents Report from June 2015 (European Commission, 2015b) sets out a plan of three stages for strengthening Europe's Economic and Monetary Union. The suggested second stage ('completing the EMU'), inter alia, includes a set of commonly agreed benchmarks for convergence that could be given a legal nature. In September 2015, the Eurogroup agreed to benchmark euro area Member States tax burden on labour against the GDP-weighted EU average. The benchmarking exercise, together with a continued exchange of best practices within the Eurogroup, is expected to provide valuable support for further labour tax reform initiatives at the national level where applicable, thus giving incentive for carrying reforms forward in euro area Member States.

2.1.2. The tax burden on labour

The 2015 tax reform report covers a number of key policy areas.

One important area is the tax burden on labour, which is relatively high in many EU Member States. Labour taxes are considered to be relatively harmful to growth and employment, as they depress labour supply and demand by increasing the gap between the cost of labour and the employees' take-home-pay. The tax reforms report considers that a Member State has a potential need to reduce the overall tax burden on labour if the implicit tax rate on labour is relatively high compared to the EU average, or if the labour tax wedge for the average wage or at lower wage levels is relatively high compared to the EU average. Graph 3 illustrates that a number of Member States have a fairly high tax burden for low income earners, compared to the EU average. These Member States in particular, have a potential need to reduce the tax burden for low income earners.

Graph 3: Tax burden on labour for low income earners



Source: European Commission (2015a)

Although several Member States have carried out reforms in this area, these have often been relatively limited compared to the size of the challenge. The main challenge is finding the funds to finance a labour tax cut. Given strained public finances in many Member States, unfinanced cuts are generally not an option. As pointed out in the report, Member States are considered to have a potential scope to increase the least distortive taxes in order to finance a reduction in labour taxes if 'growth friendly' taxes such as consumption taxes, recurrent property taxes or environmental taxes are relatively low compared to the EU average. Although a number of Member States have a low level of 'growth-friendly' taxes, it may be politically difficult to raise these. There may, for

example, be negative distributional effects of a shift in the tax burden from labour to consumption taxes; such a shift might render the overall tax system less progressive.

2.1.3. Broadening the tax base and improving the design of the tax system

The tax report considers possible ways to improve the design of taxes in specific areas. Many taxes in the EU have a fairly narrow base, often as a result of extensive use of tax exemptions and deductions. This can make the tax system complex and difficult to assess. Improvements to tax design would make the tax system more efficient, and could provide an alternative to governments to increasing tax rates.

2.1.3.1. *Broadening the VAT base*

Consumption taxes, such as VAT, are considered relatively growth-friendly and are an important source of revenue for many Member States. A broad tax base combined with low tax rates is generally considered to be the most efficient design of VAT. Many Member States have a fairly narrow VAT base with a number of exemptions and reduced rates. The level is thus below the VAT level that could theoretically be collected if all consumption were taxed at the standard rate. The low level leads to a loss of revenue and economic distortions. The potential additional revenue from a broader tax base can allow the government to lower the standard VAT rate and/or reduce the tax burden in other areas such as labour.

During 2014, a number of Member States limited the use of reduced rates or raised these rates. However, other Member States took steps in the opposite direction and introduced new reduced rates, lowered existing reduced rates or extended the scope of their application. It is often politically difficult to address reduced VAT rates due to vested interests in Member States. At the same time introducing new reduced rates is a relatively simple (if not necessarily the most effective) tool to provide support to certain groups.

2.1.3.2 *Property and housing taxation*

Taxes on immovable property take various forms, including recurrent taxes, transaction taxes and taxes on capital gains. Taxes on immovable property generally contribute little to overall tax revenue in EU Member States. In 2012, revenue from this type of taxation was equivalent to 2.3% of GDP, and around a third came from transaction taxes. A number of Member States have high transaction taxes, which can lead to distortions and impede labour mobility. At the same time, many Member States have low recurrent property taxes, which have been found to be among the taxes least detrimental to growth.

Property tax systems relying heavily on transaction taxes, offer scope for reform, notably a shift towards recurrent property taxes. A reform could maintain a constant level of revenue while reducing the distortions caused by transaction taxes.

The generous mortgage interest deductibility in several Member States has generally been cut back in recent years. However, some Member States still have generous tax reliefs, creating an incentive to take up debt.

Reform in housing taxation has been relatively limited. Housing taxes typically involve different levels of government, which could make tax reform more challenging. Increases in recurrent housing taxes, which have generally to be decided upon at local level, are rather visible for taxpayers, while cuts in transaction taxes are decided upon at central or state level. The mortgage interest deductibility may be particularly difficult to address as taxpayers have based important and long-term decisions on receiving tax relief.

2.1.4. Tax governance and redistribution

2.1.4.1 *Tax evasion and avoidance*

A significant amount of revenue is lost due to tax evasion and avoidance, making it a particularly important challenge for Member States. Addressing tax evasion and tax avoidance requires action at the national level but

supplementary action at EU level and internationally is necessary to address for example aggressive tax planning by multinational companies.

Various measures have already been taken at EU level. The most recent EU initiatives include the transparency package and the action plan for the fair and efficient corporate tax system in the European Union. At the same time, many if not all Member States are undertaking action in this area. The majority of Member States' tax authorities are working increasingly close with other national law enforcement agencies and with tax authorities in other countries.

2.1.4.2 Distributional effects of the tax system

A country's tax system serves not only to finance government expenditure, but also offers a means of redistributing income. The report shows that while inequality measured by market income (income derived from work and capital) rose significantly during the crisis years 2007-2013, income inequality as measured by disposable income (after taxes and benefits) remained broadly stable. This shows that tax and benefit systems had a significant effect in mitigating the changes in market income inequality.

There is, however, a significant variation between Member States and the level of inequality increased in some Member States even taking into account the effect of taxes and benefits. Furthermore, low-income households in some Member States have seen their living standards deteriorate disproportionately. Inequality can impact the overall growth of the economy negatively. Overall, fairness is an important aspect to consider when designing tax reforms.

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3. SESSION I – OBSTACLES AND STRATEGIES FOR TAX REFORMS

3.1. POLITICAL ECONOMY OF TAXATION: NEEDS AND DRIVERS FOR TAX REFORMS

by Ian Preston*

3.1.1. The need for political economy

The tools of economic theory offer compelling insights into practical principles for well-designed tax reform. Combined with the ability of empirical economics to accurately estimate relevant features of income distributions and of economic behaviour, theory can help in the understanding of where tax systems can be improved and how. Yet this is not enough. Implementation requires that reforms be sustainable, given public opinion, within political institutions. If they are not then their desirability on the basis of economic principles and evidence will count for little. In this note, I consider some of the factors influencing the political economy of reforms to UK direct taxation over the last 30 years.

3.1.2. Tax policy in practice

The starting point for traditional analysis of income taxation, whether it be from the perspective of public economics or political economy, is an economic labour supply model where individuals concerned like consumption and public spending and dislike effort. Governments have to choose multiple tax rates and allowances subject to a fiscal budget constraint. Assuming, for example, that administrative constraints impose linearity on the tax system makes the policy space analytically tractable.

The optimum income taxation literature (Mirrlees, 2006; Tuomala, 1990) considers the choice of tax rate which maximises some social welfare function and concludes that the tax rate should be related to pretax economic inequality, because that determines the potential social welfare gain from redistribution, and the strength of labour supply disincentives, since that determines the efficiency cost. The political economy literature, on the other hand, considers tax rates from the viewpoint of political sustainability but concludes that tax rates should depend on broadly similar things - pretax economic inequality, because the relative positions of median and mean incomes determine where the pivotal voter lies and the potential resources for redistribution, and the strength of labour supply disincentives, because that determines the efficiency loss (see Romer, 1975; Roberts, 1977; Meltzer and Richard, 1981; Bolton and Roland, 1997; McCarty, Poole and Rosenthal, 2006, for example).

Yet if we look at reforms to direct taxation over the last 40 years in the UK, for example, these considerations provide a poor guide to what has happened¹. Pretax inequality on standard measures increased significantly in the latter half of the 1980s and has been comparatively stable since and the ratio of mean to median pretax income has been rising (see Figure 1). One might then naively expect tax rates to have risen. Not so: the basic rate of income tax - the headline tax rate - has fallen in successive reforms (see again Figure 1). This is somewhat misleading for a number of reasons: this has arisen partly from a re-labelling of direct taxes - National Insurance rates have risen; this is partly a switch from direct to indirect taxation - the standard rate of VAT has also risen; and changes to allowances have happened which affect the number of people subject to different rates. Nonetheless, over the 40 years the effective tax rate on a standard taxpayer² has been fairly stable, if anything slightly decreasing, as has been the tax share of GDP, so there has been no evident rise in tax rates. (If we choose to look directly at redistribution rather than at the level of taxes we also see no structural shift towards greater redistribution.)

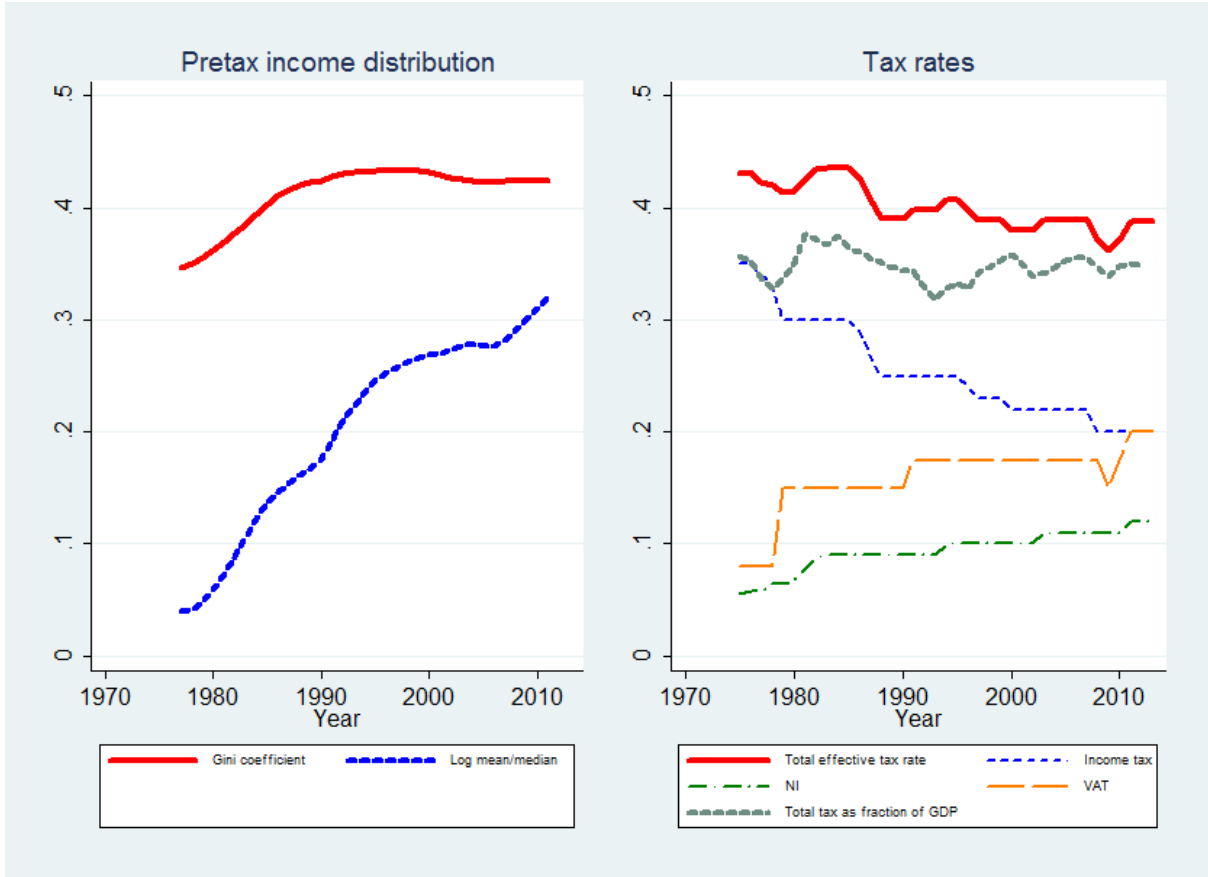
* Ian Preston is Professor of Economics at University College of London, Research Fellow at the Institute for Fiscal Studies and Deputy Research Director of the Centre for Research and Analysis of Migration. My thoughts have been shaped especially by discussion with Jim Alt and Luke Sibieta, my two co-authors for Alt, Preston and Sibieta (2010), to whom I am particularly grateful.

¹ The empirical inadequacies of such a model are well recognised - see Perotti (1996), for example.

² I calculate the effective tax rate t_E given the basic rate of income tax t_I , the main rate of national insurance t_N and the standard rate of VAT t_V by $1 - t_E = (1 - t_I - t_N) / (1 + t_V)$.

This leaves a naive political economy story looking underwhelming as an explanation. Why does the most salient tax rate fall, the effective tax rate remain stable and redistribution not increase more strongly when pretax inequality is rising? In the following, the roles of shifting voter opinion and electoral politics are considered.

Figure 1: Income distribution and taxes



Source: Author's calculations from Office for National Statistics data and Institute for Fiscal Studies

3.1.3. Voter opinion

3.1.3.1 Voter opinion over time

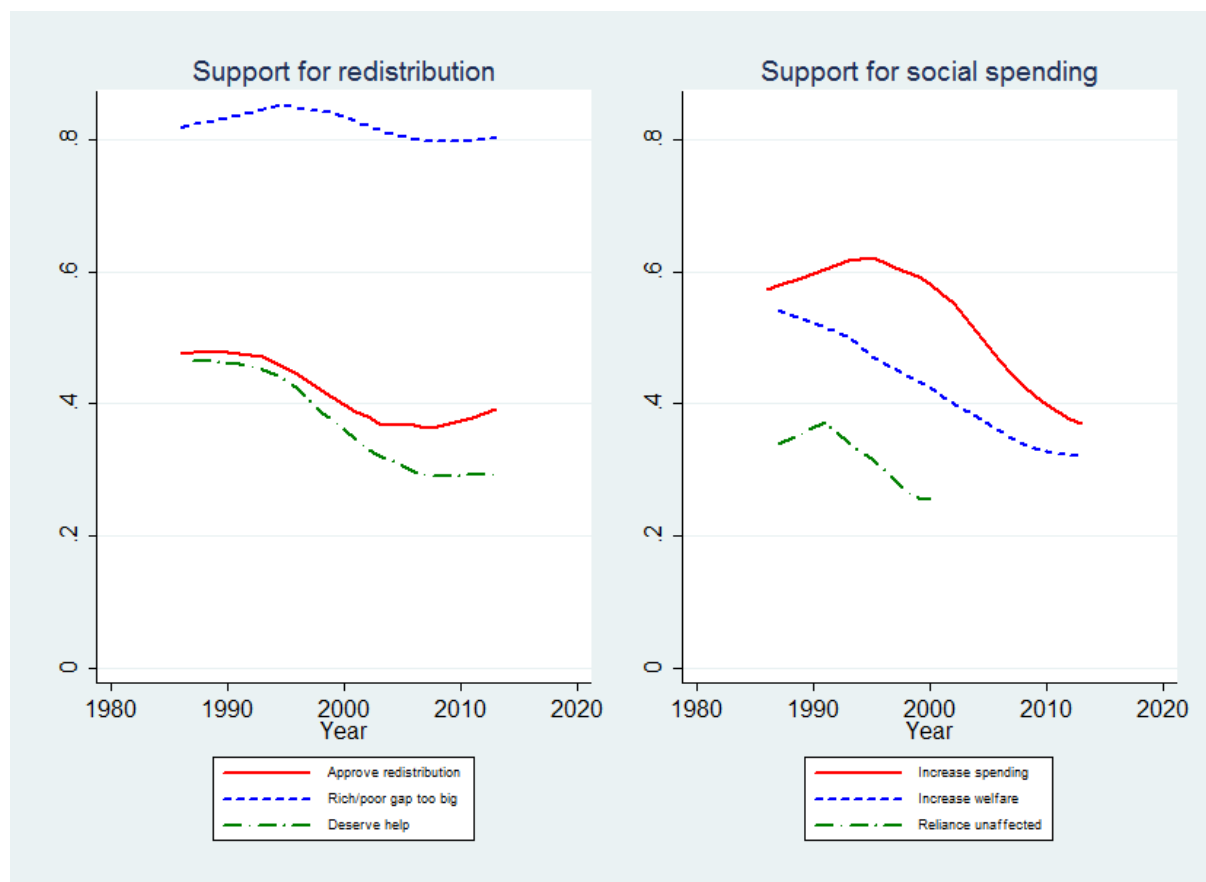
The best source of evidence on opinion in the UK is the British Social Attitudes (BSA) survey, a consistent and reliable annual representative survey of the British electorate covering around 3000 households per year. Data used here cover the period from 1986-2013³.

There are several questions asked about support for redistribution over those 28 years. For example, respondents have been asked whether they agree that the gap between incomes of rich and poor is too large and whether they agree that government should redistribute from the better-off to the less well-off⁴. Proportions agreeing are shown over time in the left hand panel of Figure 2⁵. Another question illustrated on the same figure focusses specifically on whether those receiving social security at the bottom end of the distribution genuinely deserve help. Dissatisfaction with the size of the gap is consistently much higher than support for redistribution, suggesting either a preference for other policies to reduce the gap or a belief that redistributive taxation is ineffective or outside the proper business of government (see Sefton, 2005; Orton and Rowlingson, 2007). A similar pattern is seen in responses to all three questions. Dissatisfaction with the size of income gaps, support

³ The period covered is therefore almost a decade longer than in Alt, Sibieta and Preston (2010) whose results are extended here to the period beyond the financial crisis and subsequent fiscal authority policies beginning in 2007.
⁴ For precise question wording, check the much fuller discussion in Alt, Sibieta and Preston (2010).
⁵ In this and similar figures, the illustrated relationship is smoothed by taking running means.

for redistribution and appreciation for deservingness of welfare recipients all decline noticeably from the mid-to-late 1990s but then level off or even pick up again after the financial crisis.

Figure 2 – Opinion by year 1986-2013



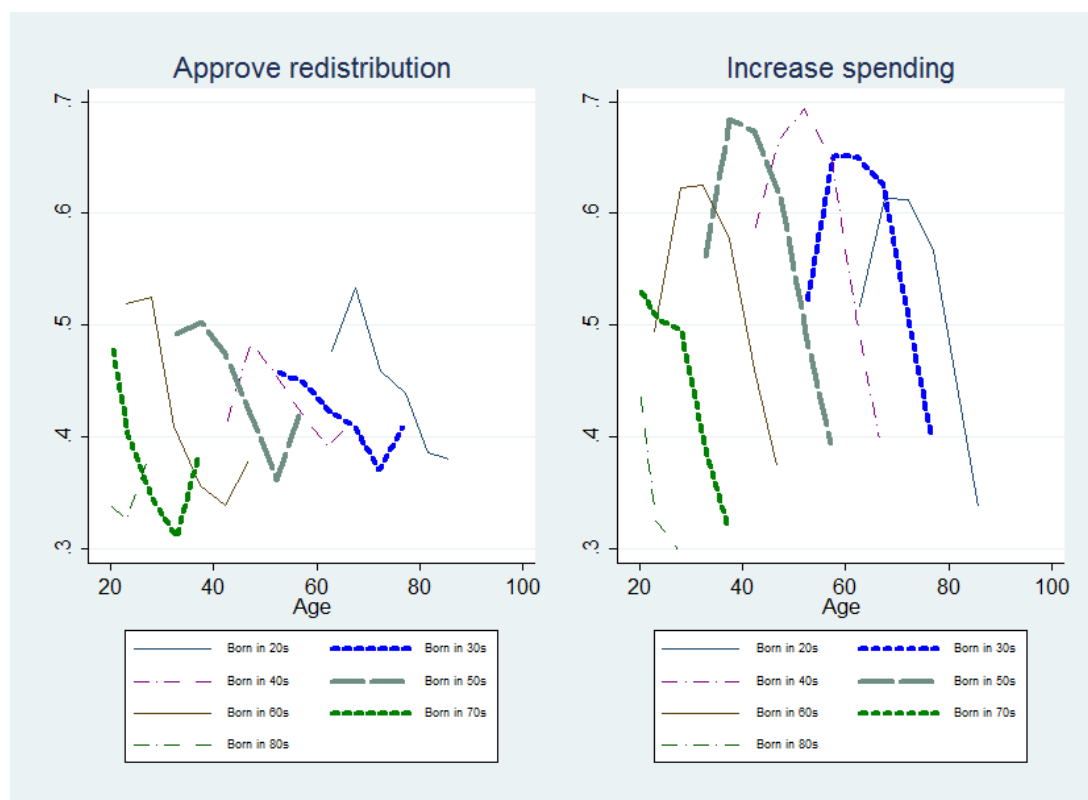
Source: Author's calculations from British Social Attitudes data

Funds raised through taxation can achieve redistributive aims by being disbursed as welfare benefits or public spending on, say, health or education. Survey questions have asked about support for increased spending on all together and specifically on welfare benefits, even if it should involve higher taxes. The right-hand panel of Figure 2 shows a sharp continuing decline in support for spending on these items throughout recent years, not evidently arrested in any way by the crisis possibly because of its perceived adverse effect on public finances. A question on whether welfare spending discourages self-reliance was asked only in earlier years; the perception that it does not also shows a decline.

3.1.3.2 Voter opinion and age

Incomes are, of course, neither fixed nor certain and income taxation, besides affecting inequality within years, also provides redistribution within lifetimes and between generations. It is possible to follow generations across repeated cross-sections by grouping respondents according to date of birth. Figure 3 does this, plotting support for redistribution in one panel and support for increased spending on social benefits, health and education in the other against average age for seven different date-of-birth cohorts. Interestingly, the patterns over time seen in the aggregate - declining support for redistribution reversing in the most recent years and ongoing recent declining support for public spending - are a common feature across generations (except possibly for the very oldest). Equally significantly, younger cohorts are typically less supportive than were older ones at similar ages, particularly in later years, suggesting a possible cross-generational decline in positive attitudes to redistribution and public spending.

Figure 3 – Opinion by year, different cohorts 1986 – 2013



Source: Author's calculations from British Social Attitudes data

3.1.3.3 Voter opinion and income

The standard political economy explanation relies on the idea that support for redistribution is strongest among low income households. Figure 4 shows the evidence, using the same six questions.

Support for positions positive towards redistribution and public spending are plotted here against position in the income distribution⁶. Approval of government redistribution is modestly negatively related to income but not in anything like as strong a fashion as would be predicted by cruder models of political economy⁷. The poorest households are most supportive of higher spending but highest income respondents are not notably less prepared to recognise need or more inclined to worry about effects on self-reliance⁸. Nor is there any pronounced income-related pattern to support for public spending⁹.

To an extent this may be because voters' information about their own positions in the income distribution may be poor¹⁰. A question in BSA 2004 explored this by asking individuals what proportion of the population they believed to be worse off than them. Figure 5 shows that self-assessed position is far more concentrated around the centre of the distribution than would be so if perceptions were accurate¹¹ and the correlation with true position is positive but far from perfect (see Taylor-Gooby, Hastie and Bromley, 2003; Evans and Kelley, 2004; Sefton, 2005). A question fielded in the 1990s asking individuals to rate their own incomes as high, medium or low and to give an opinion on whether taxes on different income levels should be reduced or increased did show

⁶ Relationships illustrated are after subtraction of year effects and smoothed by taking running means.

⁷ Georgiadis and Manning (2012) investigate the association with several other personal characteristics.

⁸ Cavaillé and Trump (2015) argue that taking from the rich and giving to the poor are distinct facets of social attitudes.

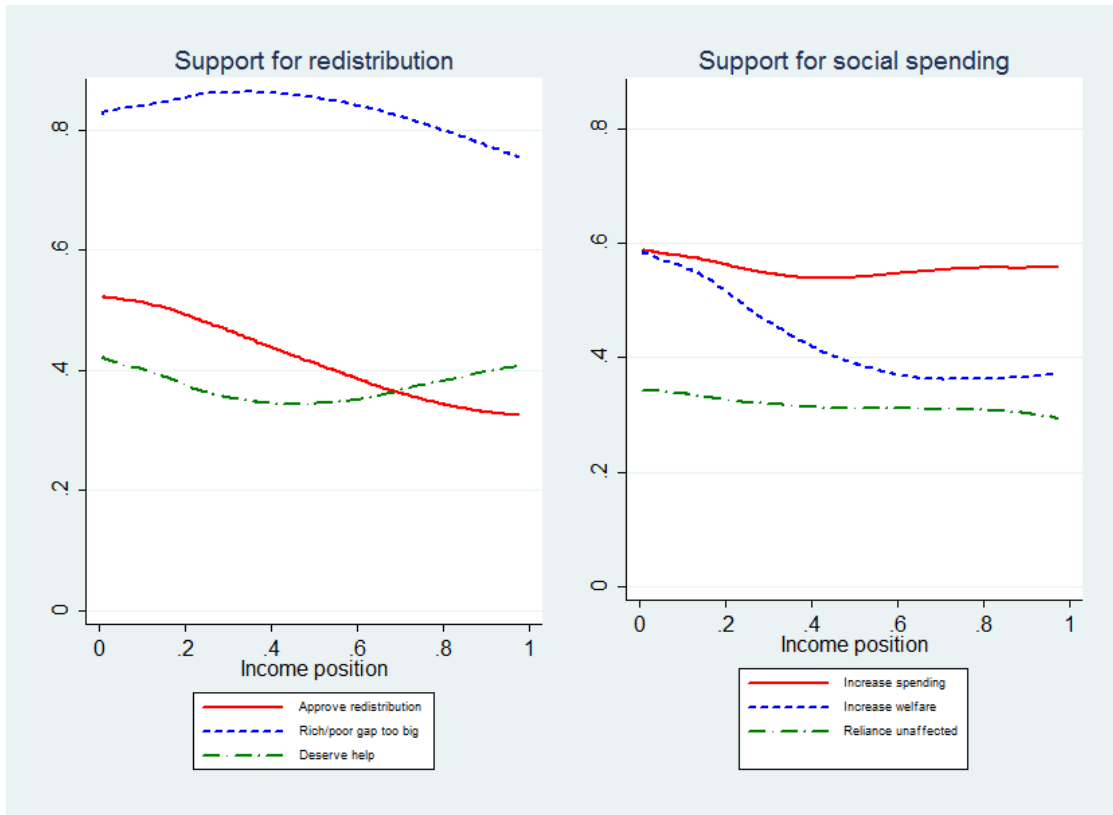
⁹ Responses to questions asked in one year of the survey about more specific items, with very precise tax consequences, have been analysed by Hall and Preston (2000) revealing similarly little evidence of strong income gradients.

¹⁰ Gimpelson and Triesman (2015) provide cross-country evidence of people's poor knowledge of income inequality and of their position within the distribution.

¹¹ If perceptions were accurate, given that the sample is representative, then the distribution would be uniform.

that not many individuals would rate themselves as having high income but that those who would were much more likely to see taxes on those with high incomes as excessive¹².

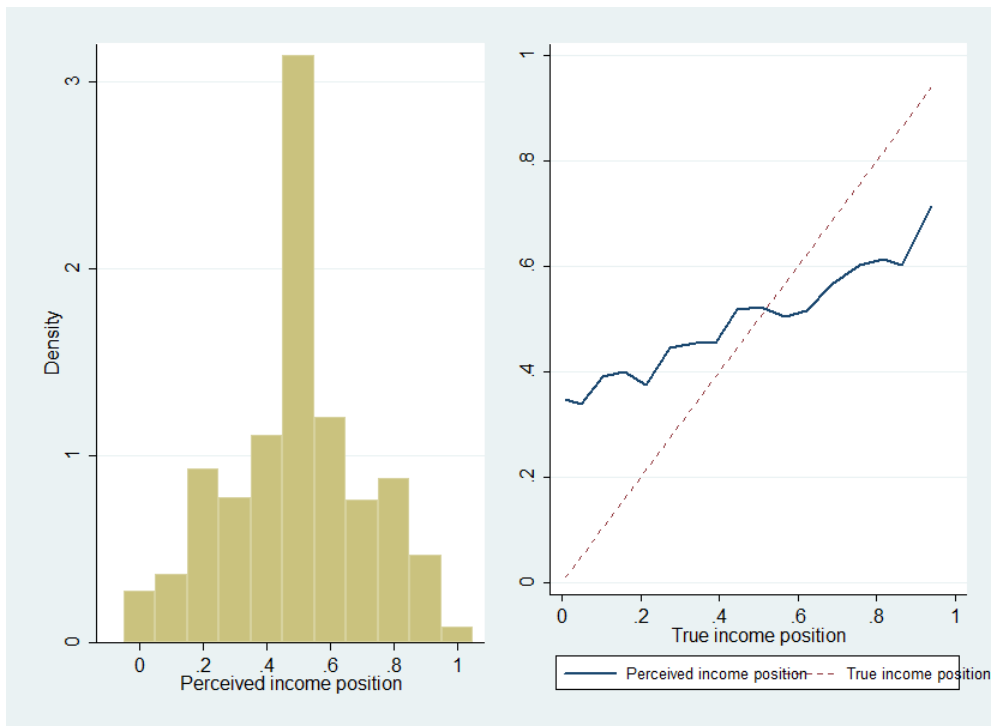
Figure 4 – Opinion by income 1986-2013



Author's calculations from British Social Attitudes data

Source:

Figure 5 – Perceptions of income distribution 2004



Source: Author's calculations from British Social Attitudes data

¹² Alt, Sibieta and Preston (2010) provide a longer discussion of this.

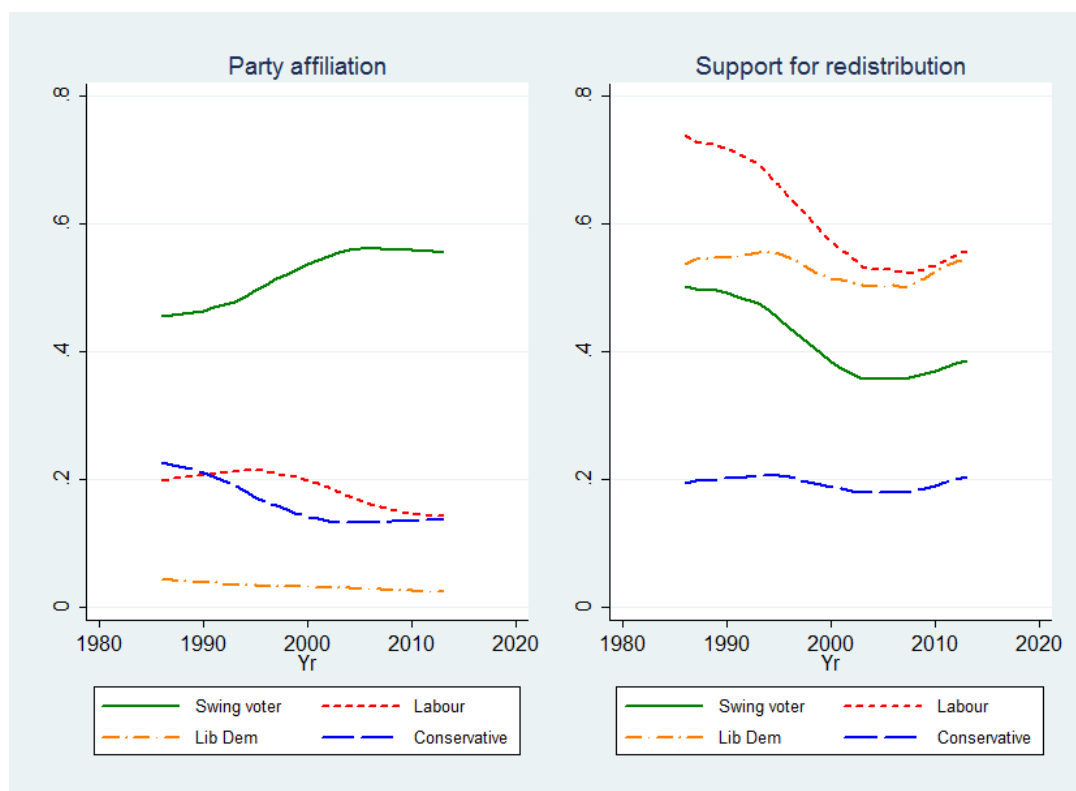
3.1.4. Electoral politics

The simple median voter model underlying the crudest models of electoral politics would make the strong assumptions on preferences necessary for the preferred tax rate of the median voter to be a Condorcet winner and suggest that this tax rate might at least act as an attractor for non-partisan two-party competition. This picture is too simple, however, in several ways¹³.

Elections in different countries occur according to a variety of systems, with the nature of the emergent party system dependent on the nature of electoral institutions. Constraints placed by the nature of resulting party competition can affect tax outcomes. A constituency-based majoritarian system like the UK gives decisive influence to swing voters in important constituencies. BSA asks for party affiliation and allows opinion to be tracked separately for those committed and those not. Figure 6 shows proportions identifying with the three major parties of the last thirty years¹⁴ and with none. Swing voters - those without declared attachment - increase considerably as a share of voters. In the second panel they are seen to have views on redistribution lying between Liberal Democrat and Labour supporters on the one side and Conservatives on the other. Greatest movement over time, and in the same direction, is seen in the opinions of swing voters and Labour supporters, both of whom become less keen on redistribution up until the financial crisis when the trend noticeably reverses.

It is not necessary to win the support of the median voter to implement reform under a majoritarian system with multiple constituencies since the geographical basis to voting favours parties whose support is geographically concentrated enough to win seats and not so geographically concentrated as to waste votes. Systematic electoral advantage on such a basis can give parties security to implement policies divergent from voter interests. Besley and Preston (2007) consider evidence from local government which suggests that electoral bias does indeed affect tax, spending and employment outcomes to the ideological advantage of incumbents.

Figure 6 – Opinion and party support 1986-2013



Source: Author's calculations from British Social Attitudes data

¹³ There is a large literature extending the model to accommodate its widely recognised deficiencies - see Alt, Sibieta and Preston (2010) for references.

¹⁴ Throughout this section, the Liberal Party, the SDP/Liberal Alliance and the Liberal Democrats are treated for simplicity as successive embodiments of the same electoral entity. In the 2015 election the Liberal Democrats suffered a sharp loss in vote share and were overtaken by the UK Independence Party.

Possibly the greatest weakness of a simple story of the politics of tax rate choice is neglect of the fact that tax decisions are multidimensional and elections address them together with other non-tax issues. Voter influence on tax-making decisions is mediated by parties representing particular points of view and seeking to build programmes capable of appealing to winning coalitions. Even if widening pretax inequality were to be associated with a movement of majority support towards greater redistribution considered in isolation, it could be associated with other trends which bring to power parties pursuing inegalitarian policies as part of a broader agenda.

Evolution of policies is also not straightforwardly electorally driven. An exercise in Alt, Sibieta and Preston (2010) tracked party positions on tax rates by close reading of party manifestos at elections since 1979. The exercise is updated in Table 1 where we see the actual basic and top tax rates at the time of elections, the manifesto offers of each party¹⁵, the vote share won by each party and the apparent vote-weighted median position. The median electoral offer is typically close to the current actual tax rate - basic or top - but, because of the nature of the electoral system, is far from always being that of the electorally victorious party. As tax rates drift downwards between elections, subsequent manifesto positions follow.

Table 1 – Party manifesto positions on tax rates 1979-2015

Year	Actual		Labour			Lib/Alliance/Lib Dem			Conservative			Median	
	Basic rate	Top rate	Vote	Basic rate	Top rate	Vote	Basic rate	Top rate	Vote	Basic rate	Top rate	Basic rate	Top rate
1979	33	83	(36.9)	33*	83*	(13.8)	<33	50	(43.9)	<33	<83	<33	<83
1983	30	60	(27.6)	30*	>60	(25.4)	30*	>60	(42.4)	<30	<60	30	>60
1987	27	60	(30.8)	29	>60	(22.6)	27*	60*	(42.2)	25	<60	27	60
1992	25	40	(34.4)	25	50	(17.8)	>25	>40	(41.4)	20	40*	25	>40
1997	23	40	(43.2)	23	40	(16.8)	24	50	(30.7)	20	40	23	40
2001	22	40	(40.7)	22	40	(18.3)	23	50	(30.7)	<22	<40	22	40
2005	22	40	(35.3)	22	40	(22.1)	22	50	(32.3)	22*	40*	22	40
2010	20	50	(29.0)	20*	50	(23.0)	20*	50*	(36.1)	20*	50*	20	50
2015	20	45	(30.4)	20	50	(7.9)	20*	45*	(36.9)	20*	45*	20	45

Source: Party manifestos 1979-2015

3.1.5. Conclusion

Growing pretax inequality over the last thirty years in the UK has coincided with a drift down in the headline rate of income tax and a stable overall effective tax rate and tax burden, contrary to what optimal income tax models would suggest as an appropriate response or to what a naive political economy model would predict. Over most of that period average public opinion has moved against redistribution and public spending, both on average across the whole population, within cohorts and across generations. This has been particularly true of less politically committed voters who have become more numerous.

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¹⁵ Starred values are those set by default at the actual rate given that the party proposes no change.

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3.2. MAKING FUNDAMENTAL TAX REFORMS HAPPEN

by Bert Brys*

Countries often succeed in implementing fundamental tax reforms. Sometimes, however, tax reform proposals never leave the drawing boards of studies departments or ministries of finance. In other cases, the tax reforms that are implemented have been revised to such an extent during the reform process that they only partially – or even no longer – serve the original tax reform objectives. It also happens that the initial reform objectives are scaled down 'pre-emptively', as policy makers anticipate the obstacles that will have to be overcome and conclude that the cost would be too high or the prospects for success too uncertain to justify risking their political capital.

In order to make fundamental tax reforms happen, policy makers must try to balance the different goals that tax systems aim to achieve and have to take into account the major political economy challenges they are likely to face before, during and after the tax reform process. This implies a need to make difficult trade-offs. This note reviews the political economy obstacles and challenges for tax reform and presents a number of strategies which may allow policymakers to overcome those challenges and make fundamental tax reform actually happen.

3.2.1. Political economy obstacles and challenges for tax reform

The democratic political process is such that a number of its characteristics might create obstacles to the implementation of tax reforms (see also Olofsgard, 2003); some of the most important obstacles are briefly reviewed in this section.

Political cycles and the visibility of tax-policy decisions matters

Politicians have an incentive to implement tax reforms that benefit large numbers of voters. However, they may not need to give equal weight to the interests of all voters, preferring instead to focus on attracting “swing voters”, who are more likely to change their votes in response to a reform that favours them (Profeta, 2003). Tax reforms that benefit swing voters, though, are not necessarily in the general interest.

Policy makers may create or use reform opportunities to signal to particular groups of voters that they care about taxpayers' welfare. This might give rise to a sequence of incremental tax reforms that target specific groups and try to create winners without making losers. However, if piecemeal reforms are undertaken for the sake of reform and without any strategic vision to guide them, policy makers will not necessarily take into account the long-term implications of these measures. The visibility of tax policy changes may be highly asymmetrical: politicians may find it easy to adopt tax breaks that bring significant, visible benefits to specific groups (who are thus aware of the change and will support it) but result in an increase in the overall tax burden on other groups that is so small as to pass unnoticed. This asymmetry contributes to the incentives to increase tax expenditures and thus the complexity of the tax system overall.

In general, politicians face an incentive to enact reforms whose gains are visible at the time of the next election – and, if possible, whose costs are not. If the gains from tax reform are visible when the election takes place, politicians will maximise the probability of being rewarded for having undertaken them. This is, of course, on the assumption that individuals – regular as well as swing voters – will associate the politician(s) responsible with the benefits of the reform. Because fundamental tax reforms usually take longer to realise than incremental changes to the tax laws and are sometimes so complex as to leave voters uncertain of how to evaluate them, politicians operating with electoral time horizons in mind might prefer highly visible ad hoc measures to more fundamental reforms, especially when the next election is relatively close.

Tax reform visibility has other implications as well. If politicians view voters as strongly averse to increased taxation, they might want to choose forms of taxation that are less visible to the decisive (swing) voters. This

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partly explains why recurrent taxes on immovable property, which are highly visible, are rarely increased by politicians (Alt, Preston and Sibieta, 2008).

Uncertainty may impede tax policy reform

There can be considerable uncertainty about who will win and who will lose from a tax reform and whether (and how) voters will change their voting behaviour in response. In the presence of high levels of tax reform outcome uncertainty – i.e. uncertainty of the impact of the tax reform on agents' behaviour, the income distribution, tax revenues, etc. – policy makers might become more careful in taking a decision to engage in tax reform.

In fact, risk-averse taxpayers might vote against tax reform even if they knew that a majority would gain from the reform (Fernandez and Rodrik, 1991). This status quo bias reflects the fact that, while some of those who stand to gain or lose from the reform may be easily identifiable, the median or swing voter may not know ex ante whether he/she will join the winners, because the tax reform benefits will become clear only in the future.

Other types of electoral uncertainty can hinder the implementation of fundamental tax reforms. Policy makers face uncertainty about who will be in power after the elections and whether the new government can reverse or stop a tax reform that was started before the election. Tax policy annulations or reversals might have an impact on who actually wins and loses from the tax reform.

Policy makers may also be uncertain about the quality of information available concerning the likely impact of reform. The greater the uncertainty about information quality and the greater the divergence between the information obtained through different channels, the harder it will be for politicians to draw conclusions and to make decisions regarding the actual implementation of the tax reform.

Uncertainty about the divergent impact of tax reform on different parties in the governing coalition (or different groups within the ruling party) might create an obstacle to the implementation of fundamental tax reforms, especially if the constituents of one of the coalition parties bear most of the costs.

Special interests may be very effective at influencing tax policy

An alternative political economy approach focuses on the political influence of tax reform losers who may attempt to block the implementation of the tax reform. They might exert influence either directly, through their ability to block enactment of reforms within the parliament, or indirectly, by persuading politicians to opt for the status quo instead of launching a tax reform (Olofsgard, 2003). Indeed, potential beneficiaries of tax reform are often silent in contrast to the taxpayers who are (or perceive to be) losers of the reform.

Politicians might be more willing to listen to particular special interest groups if they receive direct or indirect campaign contributions from these groups or if these special interest groups consist of swing voters that have an influence on the outcome of the next election (Olofsgard, 2003). Different groups of taxpayers might also face different transaction (lobbying) costs (Holcombe, 1998). As a result, tax policy reform will be biased towards reforms that are favoured by influential lobby groups, which then might create an obstacle to the implementation of tax reforms that would be welfare-enhancing overall.

Alt, Preston and Sibieta (2008) note that policy makers should be aware that the enactment of new tax expenditures and the introduction of special tax treatment for particular groups of taxpayers might create new special interest groups. The removal of the special tax treatment might then turn out to be very difficult and might give rise to additional or extended special tax treatment provisions over time. Ashworth and Heyndels (2001) see tax expenditures, in particular, as a tool to serve swing voters and special interest groups. The underlying rationale for this is linked to the fact that, as noted above, the benefits from tax expenditures can be targeted while the costs – the reduction in overall tax revenue – can be spread over all taxpayers.

3.2.2. Political economy strategies to make fundamental tax reform happen

Tax reform strategies that enable policymakers to reconcile tax policy objectives and successfully carry out

fundamental reforms do exist. Some of the key strategies are reviewed below. For a more in depth discussion, see Brys (2011).

Tax reform design should be guided by a clear strategic vision and backed up by solid analysis

Policymakers may want to formulate and communicate a clear strategic vision and tax reform objectives. Since tax reform is likely to be a lengthy and complex process, articulating broad aspirational goals can help to clarify the meaning of reform for taxpayers and voters, while also making it easier to resist special interest lobbies. This may allow implementing reforms with a longer time horizon and creates incentives to continue the reform and prevent that reforms stop, are changed or reversed. Once the broader tax reform objectives have been set, governments can then start evaluating specific reform proposals and studying the degree to which these proposals achieve the desired objectives.

Framing tax-policy debates broadly is crucial

The framing of tax reform debates broadly is critical: by considering the tax system as a whole, rather than focusing on isolated elements, policy makers can better communicate the issues involved, as well as address issues of efficiency and equity. Lobby groups might have an interest to frame particular tax policy reforms narrowly, for instance by focusing on each tax in isolation, but this approach is unlikely to be in the interest of the general public.

Advancing tax reform may require acceptance of ex-ante constraints

Accepting certain reform constraints up front might help governments to build support for tax reform. A government could, for example, commit to implementing only reforms that were judged to be redistribution-neutral or decide upfront not to include a particular tax in the reform package. However, explicitly accepting some upfront constraints regarding key tax objectives might imply ruling out some Pareto-improving reforms. That said, accepting constraints on the reform process might also make it easier to implement reform. The more negotiable are the tax reform details, the greater is the likelihood of reform delay (Alesina and Drazen, 1991).

Ex-post evaluation may help strengthen the case for tax policy change

Ex-post evaluation of tax-policy changes will provide valuable insights and offer an opportunity to learn from tax reforms that have been implemented in the past, thereby increasing the probability of better reforms in the future. Countries might also learn from other countries' best practices. International organisations like the EU and the OECD play an important role in offering a platform for sharing experiences and discussing international best practices.

The proper timing of tax reform is important

Good reform proposals that are put forward at the wrong moment may be blocked. Policy makers will have to decide when to bring the tax reform proposals to the attention of the broader public, when to explain the impact of the reform and when to implement it. New governments that have campaigned for election on a platform of tax reform can use their electoral mandates to make rapid progress. Other issues of reform timing, however, may depend more on the state of public finances than the political conjuncture. Experience shows that it might be easier to implement fundamental tax reform when a country is running budget surpluses that could absorb possible revenue losses or could be used to partly compensate the losers from the tax reform.

There are strong arguments for "bundling" tax reforms into comprehensive packages...

In devising an approach to tax reform, policy makers face a difficult choice between "bundling" and "sequencing" – that is, between attempting to adopt a comprehensive tax reform more or less at once, in what is sometimes referred to as a "big bang" approach and pursuing a more incremental strategy. Both offer advantages and disadvantages, and the question of which is to be preferred depends not only on the institutional and political context, but on the goals of the reform and the obstacles that might be foreseen.

In general, however, the literature suggests that comprehensive reform is preferable, at least when it is possible. Policymakers should treat the tax system as a system of interacting taxes (Perret et al., 2016), rather than to consider each tax in isolation. Disconnected tax debates may be counterproductive. Bundling reforms may make it easier to address distributional issues and to compensate the losers of tax reform. It may allow finding sufficient political support and is preferred if the full tax reform package is necessary to realise the long run tax reform benefits. It might allow spreading costs and benefits over the population at large, and allows mitigating the costs of reforms for groups that might otherwise be hard hit by the reform.

...But incremental approaches may nevertheless be preferred in some circumstances

There are occasions, however, when incremental reform approaches may work best. It might just take too long to implement a comprehensive tax reform given the electoral cycle. Incremental tax reforms might also help to overcome the status quo bias by unbundling reforms that do not harm the same voters (Dewatripont and Roland, 1992). In essence, the strategy of sequencing aims to bring the taxpayers on board who would otherwise object to the fundamental reform if it were undertaken all at once. Incremental reform might also be more efficient if the tax reform outcome is uncertain, as it allows minimising tax reform “reversal costs” (Dewatripont and Roland, 1995). An incremental tax reform approach also makes fewer demands on scarce policy-making and administrative resources and may therefore be more likely to succeed (Bird, 2004).

A proper design of the different phases of the tax reform – which type of tax reform will be implemented when, and what are the conditions for tax reform deferral – is therefore crucial. Thus, a sequenced approach to tax reform would still benefit from the kind of overall strategic reform vision discussed above. Otherwise, there is a risk that policy will become increasingly ad hoc and inconsistent. Finally, also comprehensive tax reform might require a sequence of incremental “fine-tuning” reforms.

Transitional tax arrangements may help make tax reform happen

Governments may make tax reform happen by introducing “grandfathering rules” that allow the old tax rules to continue to apply to some existing situations while the new tax rules will apply to all future situations. This strategy might be considered if agents no longer have the opportunity to adjust their behaviour in response to the new tax rules because they are, for example, already retired and therefore no longer have the opportunity to adjust their labour-market behaviour. However, those rules will reduce the tax reform gains and will increase the complexity of the tax code. Gradually phasing in and the use of temporary tax measures might help to make reform happen as well, although temporary tax measures have the tendency to become permanent. The use of sunset clauses is therefore a best practice.

Good quality institutions that design and implement tax reform are at the centre of tax reform

Tax reform proposals have to be underpinned by solid research and analysis. An evidence-based and analytically sound case for reform serves both to improve the quality of policy and to enhance prospects for reform adoption. If reform advocates can build a broad consensus on the merits of a reform, they will be in a stronger position when dealing with its opponents. There is often a role for independent bodies charged with assessing the likely impact of proposed reforms on taxpayer behaviour, revenues, equity and ease of administration; the role of the tax administration, in particular, is often critical.

The transparency of the tax reform process and design is often a crucial factor

The way that taxation and public spending are perceived by the public or reported by the media may be decisive in winning public support for a particular tax reform. A proper tax-reform communication strategy and a dialogue with business, unions and other social partners, special interest groups, academics and the broader public may help to overcome the obstacles to the implementation of fundamental tax reform. Transparency is also a key element of government accountability. Some countries, however, have been able to implement tax reform because of a lack of transparency, but those reform processes are not considered to be best practices.

Policy makers may also want to be transparent about the inequities of the current tax system and the status quo. This may persuade voters that tax reform is necessary. Here, too, the quality of information available to

politicians and the public may be critical to prospects for “selling” the reform. Detailed reporting of the cost of tax expenditures, for example, may strengthen the case, on equity and other grounds, for reforms aimed at simplifying income taxation, in particular.

That said, talk can be cheap (Olofsgard, 2003), and one-line slogans typically catch the public’s attention but are not necessarily a reflection of the truth. Tax-reform discussions are complicated and cannot always be summarised in short, pithy statements. Governments that want to introduce complicated tax reforms will therefore have to adapt to the modern media landscape which seems to provide less opportunity for deep analysis and discussions. Tax-reform discussions within parliaments are therefore important. Dialogue on the substantial tax reform measures with business, unions, etc. also helps to signal the quality of the reform and the reform intentions of the policy makers involved and to build broad tax reform support.

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3.3. POLITICAL SUPPORT FOR TAX REFORMS IN ITALY

*by Paola Profeta**

Tax systems are a major part of our economic systems. How to design and implement tax reforms is at the core of economic policy. Tax systems and tax reforms are also a highly debated topic worldwide and one where political aspects become crucial (Profeta and Scabrosetti, 2010). On one side, the political process shapes tax design, the main features of the tax systems and the direction of reforms. On the other side, in democracies, tax reforms need the support of voters in order to be implemented. Policymakers try to design a tax system and to propose tax reforms to attract and please as many voters as possible. Thus, tax reforms can be seen as a response to political constraints (see Winer et al., 2013 for a comprehensive bibliography on the topic of political economy of taxation).

The debate on tax design and tax reforms includes issues such as complexity (Galli and Profeta, 2009), progressivity, efficiency and the level of the top rates, the optimal tax mix and possible shifts from labour income to consumption taxes (see Arnold et al., 2011). One crucial issue is the optimal versus actual tax design and reforms: why is there often a gap between the efficiency and fairness prescriptions based on standard economic theory and actual tax systems? Political constraints may account for a large part of this gap.

In Italy, the political debate around issues of taxation is particularly strong. According to Eurostat, the Italian total fiscal pressure is around 43%, versus the EU-28 average of 39%, and total tax receipts are 30% versus EU-28 average of 26.5%. In times of zero growth, the debate on how to incentivise labour supply and investments, and what is the potential role of taxes in this final goal becomes a central one.

This short article presents some evidence on the action of political constraints in shaping tax reforms with a particular focus on the Italian case. After presenting a few general lessons drawn from a broad analysis on European labour taxes (section 2), we introduce a simple framework, which helps understand how political constraints may shape the equilibrium in taxation (section 3). In section 4, we present a case study focused on a personal income tax reform in Italy, together with some other examples drawn from the Italian case on the role of political constraints in shaping tax reforms. Section 5 concludes.

3.3.1. Political constraints and tax reforms: Lessons from Europe

The analysis of past reforms implemented in different European countries provides general lessons on how political constraints influence tax reforms, and thus which reforms can be implemented. The analysis related to labour taxes is particularly meaningful, as these taxes are the most visible to citizens and voters, and they have a crucial impact on individuals' well-being. Using LABREF, a database on labour tax reforms in the EU27 for the years 2000-2007, Castanheira et al. (2012) check which political or economic conditions increase the probability of observing a reform of labour taxes. They find that political variables have more explanatory power than economic factors in explaining the probability that a reform in labour taxation occurs in a given European country and a given year. High unemployment or a more negative output gap - for instance - are not conducive to more reforms. In contrast, political variables do have a systematic impact on the probability to reform. For instance, coalition governments appear to reform more, the broader the coalition is. Interestingly, most reforms are targeted, i.e. they concern a specific group of individuals/taxpayers. The authors argue that policymakers have an incentive to introduce targeted reforms, even when broad reforms may be more efficient from an economic point of view, because of the political feasibility of these reforms. These reforms, in fact, are used by all parties (right or left equally) to win the support of specific voter groups. Moreover, when the probability of targeted reforms is considered, economic variables turn out to be no longer significant, suggesting that, unlike general reforms that necessitate broad political support, targeted reforms might be political acts targeting specific constituencies. There is also evidence of reform gradualism combined with targeting: targeting different groups

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at different times allows overcoming some of the oppositions to reform and thus it represents a good strategy to introduce reforms.

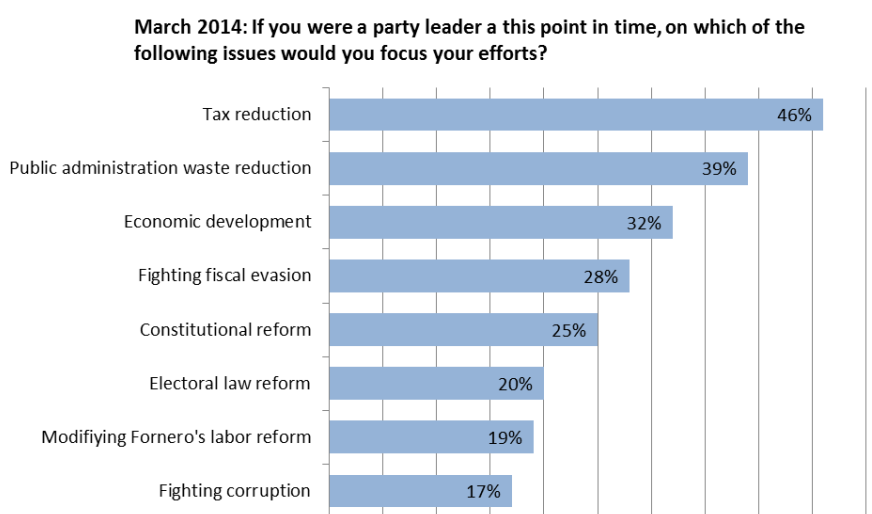
3.3.2. A simple framework

Probabilistic voting models have been used to explain the role of political influence in complex tax systems and tax reforms (Profeta, 2007). This framework seems appropriate to predict why political factors play a role in explaining the dominance of targeting reforms. This approach assumes that voters choose between parties on the basis of the policies proposed by the parties, while parties propose their platforms without knowing with certainty how voters will vote, but maximizing their expected number of votes. As a result, the expected number of votes received by each party becomes a smooth function of the proposed tax rates. In other words, a small change in a policy platform does not lead to a total change of the support from the incumbent to the opposition (or vice versa, according to which party proposes a more favourable outcome), like it happens in deterministic voting, but it only leads to a change in the probability of support. Therefore, an equilibrium exists even if the tax system is multidimensional. The equilibrium is a balance of opposing interests in the electorate, with some interests being more political influential than others. To maximise vote share, party offers are more generous to more influential groups. This influence depends on the size of the group (number of votes) and its political mobility (which depends on the reaction to the offers by the party). Mobile voters, who are ready to reward with their votes the party, which offers them the most favourable policy platform, are called 'swing voters'. Targeting swing voters is a good strategy for politicians.

3.3.3. The political economy of tax reforms: an Italian example

Italy represents a good country where to investigate the role of political constraints and, in particular of political influence, in the context of taxation. The issue of taxation is central in the Italian debate and in determining voters' choices. It is also responsible for much of the discontent of voters and their uncertainty. Figure 1 shows that, according to a survey conducted by SWG in March 2014, 46% of Italians say that 'tax reduction' is the issue they would focus their efforts on, if they were a party leader at this point in time. In July 2015, 87% of the interviewees say that 'drastically reduce taxes' is the most important thing to do to guarantee the country's development. Moreover, it is a well-known feature, both for the past and the current situation, that in Italy many voters are uncertain about the elections, i.e. they are swing voters. This is particularly true for those who claim to be at the centre of the political spectrum. Finally, taxes are a good candidate as a policy platform able to capture the uncertain voters. Every time there is an election, to capture the vote of the uncertain voters is decisive to win and the government knows that it can try to do this through the tax reform.

Figure 1: Tax reforms and politics



Source: SWG

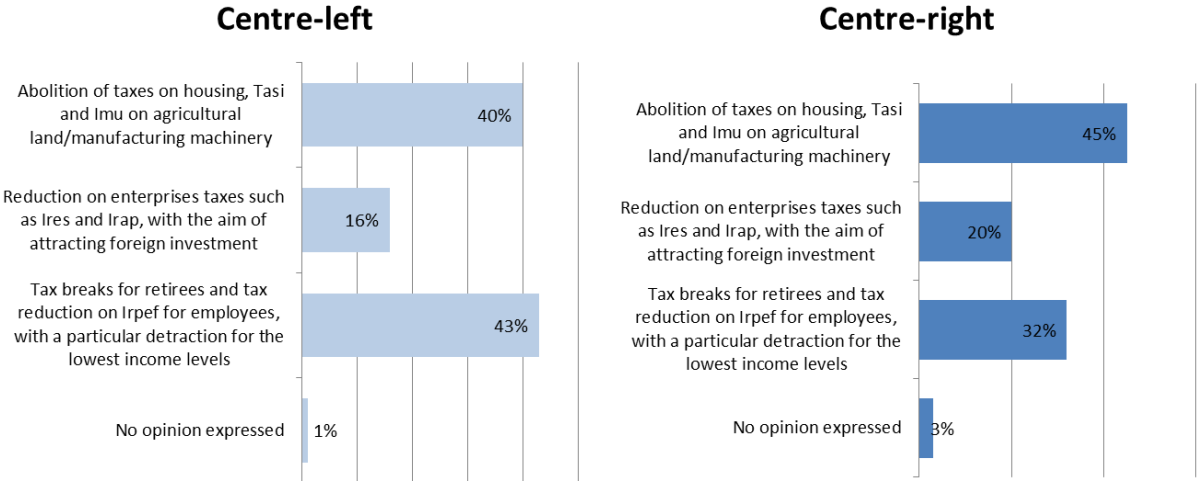
Note: Multiple answers allowed; CAWI survey on a national representative sample of 1000 adults

Analysing the personal income tax reform in 2006, Profeta (2007) shows that the reform reduces the total level of revenues (it reduces taxes for all income groups) and it targets both the poor and the rich group, while leaving the middle-income levels almost unaffected. May political electoral reasons explain this strategy of the reform? A multi-logit regression based on individual survey data where individuals declare their intentions to vote (centre-right, centre-left, uncertain) confirms that attracting the uncertain voters is decisive to win the election: centre-right has a predicted probability of 0.448, centre-left of 0.404 and the remaining is going to the uncertain. However, when we move to the analysis of the uncertain voters, we see that the only variables important to determine who are the uncertain voters are the following: political orientation (individuals declaring themselves at the centre of the political spectrum are more likely to be uncertain), age (old are less uncertain), education (voters with a university degree are less uncertain) and union participation (voters belonging to a union are less likely to be uncertain). Income is not significant in predicting the uncertain outcome. In other words, the identity of the uncertain-swing voters does not seem to depend on their income. Thus, while a general cut of taxes is politically feasible, the specific redistribution which favours low and high-income individuals does not seem to lead to a politically feasible outcome.

Another crucial item of taxation, which has recently attracted a lot of attention, is the local property tax. Figure 2 shows that, in July 2015, according to a survey conducted by Piepoli, 40% of the centre-left voters and 45% of the centre-right ones put the abolition of taxes on housing (local taxes) at the top of the tax reduction plan announced by the government for the next five years. Thus, the local property tax has a high salience. Analysing the Italian municipality tax on property, *Imposta Comunale sugli Immobili* (ICI), in the period 1998-2008, which represents the 33% of municipality fiscal revenue, Bracco et al. (2013) show that when there is more political competition (the distance between the elected mayor and her opponent is small) the per capita tax revenue from ICI drops, while other sources of local revenues increase. They argue that, when political competition is tight and elected politicians can rely on more tax instruments, they will substitute salient taxes with less salient ones, which are not necessarily preferable. When instead competition is low, since the incumbent does not face a real threat to loose elections, she decides the mix of taxes irrespective of their degree of salience.

Figure 2: Tax reforms and politics

Among the following 3 intervention areas, which is the one you would mostly like to be implemented? (According to political orientation)



Source: Piepoli, July 2015

3.3.4. Conclusions

We have presented some evidence drawn from Italy that supports the view that political factors play an important role in tax reforms, a major issue under debate. Due to political factors, tax reforms, which are mainly targeted reforms, are used as an attempt to attract votes, and they respond to political incentives (political competition, for example). The approach we suggest is certainly limited and preliminary. However, linking individuals' political orientation and, related to this, the strength of the political competition to the design of specific tax policies seems to be a promising avenue to explain many cases of tax reforms worldwide.

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3.4. POLITICAL CHALLENGES TO REFORM TAXATION IN GREECE

by Nikolaos Tatsos*

Prior to the economic crisis, the Greek economy seemed to be performing fairly well, having from 2000 to 2008 an average GDP growth of 4%, almost double the size of GDP growth in the euro area. However, in 2009 the public deficit and the public debt jumped to approximately 15% and 140% of GDP respectively and the country started losing credibility. In conjunction with the global financial crisis, Greek spreads increased enormously, access to financial markets was in practice closed and a solution was desperately needed.

In May 2010, the country embarked upon an EU/ECB/IMF ('troika') economic adjustment programme, i.e. a programme implemented under the supervision, the technical assistance and the financial support of the 'troika' with the results being at first impressive as primary deficit was reduced in 2010 by almost 5% of GDP, which is of no precedence in the EU or in the OECD. However, it seems that the instigators of the programme failed to realize that the conditions prevailing in Greece and in the global economy were not similar to those experienced in the past. In addition, as was recognized later (¹⁶), they made a mistake in the size of the multiplier.

Thus, the strong fiscal contraction and the other austerity measures reduced domestic demand more than expected, output started to decline and the unemployment rate to increase. Confidence was reduced as markets and an ever increasing number of people doubted the ability of the programme to deliver sustainable fiscal consolidation which, together with fiscal austerity and the inability of the banking sector to provide adequate liquidity created conditions for negative growth spiral. Since then, Greece has been in recession with both sides, having a share in the failure. The Greek side for not fully implementing the programme and the 'troika' side for proposing an ambitious programme resulting in a recession much deeper than expected.

3.4.1. Main areas of tax reform

Many countries have implemented tax measures to alleviate the impact of the economic crisis. Despite the differences in the specific conditions prevailing within each country and in the tax measures taken, the aim of all measures was to stimulate spending and support private sector liquidity. Policy makers in Greece, facing huge fiscal imbalances and having no access to international capital markets, were forced to do the opposite.

Table 1: Tax receipts from main categories of taxes (million €)

Taxes	2008	2014*	Change (%)
I. Direct taxes	20,863	21,396	2,6
Personal income tax	10,816	8,224	-24,0
Corporate income tax	4,211	2,806	-33,4
Property taxes	486	3,432	606,2
Other direct taxes	5,350	6,934	29,6
II Indirect taxes	30,222	24,228	-19,8
Value added tax	18,243	13,892	-23,9
Excise tax on energy	2,299	2,276	-1,0
Other indirect taxes	9,680	8,060	-16,7
Total tax revenue (I+II)	51,085	45,624	-10,7

Note:* Budget estimates

Source: State Budget

The significant fiscal consolidation needed in Greece was attempted through across-the board tax increases with detrimental effects on economic activity, growth and finally on tax revenues (Table 1). In addition, the measures taken and their short run benefits did not provide a long lasting solution. They prevented policy makers from taking the necessary measures for enhancing the efficiency of the tax system and had harmful effects on social and equity grounds.

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¹⁶ IMF (2013a) and <http://www.thetoc.gr/eng/politics>.

3.4.1.1 Personal income tax

Personal income tax in Greece is clearly underperforming due to tax evasion, tax privileges and exemptions (¹⁷).

A major step, aimed at broadening the tax base and curbing tax evasion, was made in 2010 by associating the basic tax allowance with the receipts collected by taxpayers for their purchases. However, when first introduced, the measure was too generous and although it became successively less generous, there are doubts as to its net final effect on tax evasion. This is because the taxpayers have been used to associate remarkable tax benefits by requesting receipts for their purchases. When the method became less generous they started using the requests for receipts as a tool for negotiating better prices. Thus, while before the introduction of the measure the offer of two prices – one with and another (lower) without the issuance of the relevant receipt – was made from the part of the sellers, after the reduction of the refund a relevant request is also made from the part of the buyers, who are much more in number than the sellers.

Another step towards the rationalization of the tax was the introduction in 2010 of a single rate scale applicable to all main sources of income, instead of the two rate scales that had been applied until then. However, in 2013 a change was made in the opposite direction and the number of the rate scales increased to three, while it has been announced that they will be reduced again in 2016. This instability has been further accentuated by the fact that since 2008 the structure of rate scale(s) changes almost every year.

Lack of stability also characterizes the 'extraordinary levy' which when imposed was deemed to be temporary in nature. The levy was introduced (retroactively) in 2009 to incomes exceeding €60,000. The threshold level increased to €100,000 in 2010 and then reduced drastically to €12,000 in 2011. Its rates were also increased retroactively in July 2015 and finally, as requested by the 'troika', the levy will be incorporated in the income tax scale(s) in 2016. Another notable measure in personal income tax is the abolition of almost all tax allowances (including child allowances).

The instability of income taxation is also reflected in the treatment of capital gains. A capital gains tax was imposed in 2008, was abolished in 2010, reintroduced in 2012 and postponed in 2014.

The above rather abrupt and unsystematic changes in income taxation show that there has been no sound plan for reform and that the changes made were aiming solely at increasing revenues. However, by exerting additional recessionary pressures on the economy, they failed to attain their target (Table 1) and made more uneven the distribution of the tax burden (Giannitsis and Zografakis, 2015).

3.4.1.2 The taxation of profits

The taxation of profits has also experienced noticeable volatility over time, as it has been changed (sometimes retroactively) almost every year, exerting in this way harmful effects on investment decisions at times when the boosting of the economy was desperately needed. An extraordinary levy on profits was imposed in 2009; a levy on economic activity was imposed in 2011, increased then retroactively in 2013; the corporate income tax rate was increased in 2013 from 20% to 26% (EU average 20.5%) and then again to 29% in 2015; the withholding tax on profits was amended a few times, etc. That is, in order to attain the set fiscal targets, Greece adopted recessionary measures at times of recession. As in the case of the personal income tax, the above changes do not reflect a plan for reform but are changes aimed at fulfilling short term needs and balances.

3.4.1.3 Real property tax

The first reform in real property taxation was implemented in 2008 when the up to then progressive tax was replaced by a flat rate tax on all real properties. In 2010, this tax was abolished and a progressive tax on large real properties was introduced, while in 2011 a new area-based property tax was introduced on buildings

¹⁷ In 2009, the tax free allowance in Greece (€12,000) as a fraction of a 'typical' annual wage was 65.5%. The relevant percentage was only 17.3% in France, 14.5% in Belgium and 35.7% in Austria, while a number of countries have no tax free allowance at all (OECD, 2010b).

connected to electricity. In 2013, the last two taxes were replaced by a unified property tax. In addition, a progressive surcharge on property holdings over €300,000 was imposed.

As with the previous taxes, the almost yearly changes in the structure of the real property tax do not constitute a part of a plan for reform but are tax increases disguised as 'tax reforms'. However, apart from the absence of a reform plan, there are also other reasons that have made the imposition of the real property tax difficult and unpopular in Greece.

First, in Greece, there is no official record of real property holdings that would provide all necessary information for imposing efficiently a property tax. Thus, the imposition of the tax was based on self-assessments, with all legal problems and other difficulties such a procedure may have. Second, in order to provide high tax revenues, the tax was imposed on 2007 real property values. Since real properties have been devalued during the economic crisis by over 40%, there is over-taxation. Third, real property taxes increased by over 600% in a period of drastic income reductions, other tax increases, mass vacancies of buildings, considerable falls in real property values, freezing in real property transactions, rapid increase in unemployment rates, etc. making income and liquidity restrictions of taxpayers much more apparent in fulfilling their property tax obligations. So, the argument that the property tax is a 'tax everyone loves to hate' (Rosengard, 2012) could not be more justified than in the case of Greece.

3.4.1.4 Indirect taxes

To fulfil fiscal consolidation targets, VAT rates were raised three times from March 2010 to January 2011. The standard rate was raised from 19% to 23% (EU average 21.5%), the reduced rate from 9% to 13% and the super-reduced rates to 6.5%. The VAT tax base was also broadened to cover legal and notarial services, previously exempt, while a number of products and services were transferred from the reduced rate to the standard rate. Despite these measures VAT revenues have decreased by almost 24% due to the economic recession and the effect of rate increases on tax evasion. However, the third Memorandum of Understanding agreed in July 2015 between Greece and its creditors provides for further VAT increases. Excise tax rates have also been increased up to 1,471%, with negative effect on tax revenues (Table 1).

3.4.1.5 Tax debt

While statutory tax rates in Greece have been higher than in other countries (OECD, 2011), the effective tax rate was up to 2012 well below the OECD average, due to high tax debt and widespread tax evasion.

While the tax administration was improved lately, the government, in attempting to implement the economic adjustment programme has been involved in a 'tax collection trap'. That is, by being pressed to fulfil revenue targets and restore fiscal balances within tight time limits, apart from increasing taxes, the government has been offering ever more generous tax deferrals and tax amnesty programmes aiming at decrease tax debt. However, these measures make it more difficult to collect current accruals, shifting in effect the growing problem of inadequate tax collection to the next administrations. And as the economic crisis and the prolonged austerity programmes are making the number of taxpayers who are unable to meet their obligations continuously to increase, the situation is becoming year by year worse. So, while the amount of tax debt was €33 billion at the end of 2009, it increased to over €80 billion in 2015, showing that Greece has been involved in a self-reinforcing condition of persistent and increasing under-collection of tax revenues. That is, an ever increasing amount of the assessed taxes is not collected, shifting the burden to the taxpayers that are still able to fulfil their tax obligations, with the latter being in number constantly reduced.

3.4.1.6 Tax evasion

Tax evasion has been an endemic problem in Greece (18) and despite the measures taken during the implementation of the economic adjustment programme, there is no evidence suggesting that it has been reduced.

¹⁸ Tatsos, N. (2001), Schneider (2009)

However, since all taxpayers are not willing or able to evade taxes, the combination in Greece of high statutory tax rates and low effective tax rates implies that a part of the population is paying less taxes than should be paying and another part is being overtaxed. This, in turn, suggests that the tax reform measures needed in Greece in order to bring the effective tax rate in line with the OECD average (¹⁹) should aim at eliminating the impact of some factors on tax evasion and at reducing nominal tax rates and not the other way round. Despite the fact that, during the implementation of the adjustment programme, a number of important measures have been taken to curtail tax evasion (better access to bank accounts, third party information, indirect methods for estimating taxable income, better international cooperation, crosschecking of statistical information, etc.), it seems that there are issues that have been underestimated or neglected.

According to the theory, people will always try to evade taxes if they are given the chance and the only thing that is preventing them from doing so is the threat of being caught and fined (Allingham and Sandmo, 1972). That is, tax evasion is driven by costs and benefits and rational individuals weigh the benefits they expect to have from evading taxes against the prospect of being caught and punished and act accordingly.

As to the benefit side, the higher the tax rates, the higher the benefits from not paying taxes and the higher the incentive for tax evasion. Tax rates in Greece have been considered by the OECD (2011) and the IMF (2013a) as being high and standing at the top among OECD member countries. The tax wedge of salaried employees in Greece is 43% as compared with an OECD average of 26%, while the corporate income tax rate and the VAT rates are placing Greece among the countries with the highest taxation. Thus, the tax rate increases implemented in Greece in order to attain fiscal consolidation have amplified the expected benefits from tax evasion and have induced taxpayers to join the underground economy. Furthermore, the economic recession and the tough austerity measures that were taken during the implementation of the economic adjustment programme have made the economic situation of most businesses and individuals very difficult, putting on them additional pressure to evade taxes in order to survive.

As to the cost side of tax evasion, the main determinants are the probability of being caught and the penalties imposed. Penalties have been already high in Greece and there are risks to increasing them further at times of deep recession. Moreover, a prerequisite for having very severe penalties is the tax code to be clear and fair, and with easily understood and undisputable rules, which certainly is not the case in Greece. On the contrary, Greece has an extremely complicated tax system, with myriads of tax regulations scattered among thousands of laws, often not well harmonised (if not in conflict). And the plethora of changes in the tax laws made after the outbreak of the economic crisis, designed and implemented in haste and often rescinded has made the imposition of more severe penalties much more risky.

Increasing the enforcement of tax laws is not an easy option for Greece either. First, because this takes time and the time limits set in the economic adjustment programme for attaining fiscal consolidation were too tight. Also, although some very useful measures have been taken that facilitate the enforcement of the tax laws, some other measures are contradictory and have undermined the attainment of the set targets. For instance, increasing the enforcement of the tax laws requires the expansion of the tax administration and the provision of incentives to tax auditors. However, as has been noted by the IMF, while in other countries the remuneration of the tax auditors varies between 134% and 340% of per capita GDP, depending on their scale, tax auditors in Greece are paid significantly less — at less than 50% of GDP per capita, something that does not create sufficient incentives for the staff to perform complex tasks (IMF, 2013b). However, the Economic Adjustment Programme provided for the abolishment of bonuses to tax auditors and for the decrease in their total remunerations by almost 50%. In addition, as was noted also by the IMF, more than 50% of the tax revenue staff in Greece is more than 50 years of age, which means that the yearly rate of retirement is high. In addition, after the reduction in their remuneration levels and fearing that if they retire later they will qualify for reduced pensions, a great number of tax officials close to the retirement age have chosen early retirement, amplifying the drainage rate of the most experienced personnel. And since there is a non-replacement clause in the agreed Memorandum of Understanding, these tax officers have not been replaced. Thus, while the curtailment of tax evasion has been a

¹⁹ In 2007, the effective tax rate in Greece was 30.9% and the OECD average 34.2%. In 2012, the effective tax rate in Greece was in line with the OECD average (33.7%).

top priority in the economic adjustment programme the Greek tax authorities are facing the challenging situation of being expected to increase the enforcement of tax laws with much less staff, with less experienced staff and with remunerations levels almost halved, something that appears to undermine the attainment of the set objective.

Furthermore, the frequent use of amnesty schemes asking taxpayers to pay an additional tax liability in exchange for not having the tax authorities auditing their tax returns creates self-fulfilling expectations of more generous schemes in the future being another example of measures undermining tax compliance and efficiency in the collection of taxes.

3.4.2. The lost opportunity for reform

Although economic crises are expected to open political windows for substantial reforms, it seems that in the case of Greece the economic crisis has not been a sufficient condition for tax reform and that there are other political and institutional factors that have influenced the result.

It is worth pointing out in the first place the severe asymmetry between the factors that caused fiscal destabilisation in Greece and their contribution to the restoration of fiscal balances. That is, while roughly 77% of the fiscal deterioration in Greece prior to the economic crisis ⁽²⁰⁾ was due to primary current expenditure (Giannitsis and Zografakis, 2015), which indicates that the adjustment should be focused on the expenditure side of the budget, the adjustment attempted was the other way round. That is, more than 72% of the decline of the deficit as a percentage of GDP from 2009 to 2013 was achieved on the revenue side. Moreover, the distributional effects of this asymmetry were not counterbalanced by other adjustments in the tax system. On the contrary, they were reinforced, since the changes made were bare tax increases in a rather 'flat' way having adverse distributional effects. Thus, the lower income taxpayers had an increase in the tax burden by 337.7% while those in high income classes an increase of only 9%. Or, the share of the lower income groups to the tax-led adjustment increased from 2.5% to 9.4%, while that of the higher income groups decreased from 97.5% to 90.6%. (Giannitsis and Zografakis, 2015).

The focus of the economic adjustment programme to be placed on the revenue side was obviously a political decision based on the fact that increases in nominal tax rates, abolishment of tax exemptions and imposition of new taxes were considered to be easier than the curtailment of public expenditures. And something that probably counted most, increases in taxation could be made much faster than expenditure cuts, demonstrating to all internal and external actors that fiscal consolidation was on track. However, not all tax changes constitute a tax reform. Moreover a tax reform in order to be successful must fulfil certain conditions (Tompson and Price, 2009).

First, a good tax reform takes time. Successful reforms need over two years to be prepared and adopted while the least successful reforms are those attempted in haste, often in response to immediate pressure. The excessive haste with which the reform was attempted in Greece created problems and in many cases the end result was the opposite of what was expected. As shown above, the policy makers, irrespectively on whether the ownership of the relevant decisions belongs to internal or external actors, in order to restore fiscal balances were introducing successive 'reforms' aimed at securing extra tax revenues in a rather 'fast track' way. Under these conditions, the outcome could not be satisfactory. One tax law succeeded the other, some tax laws were amended before or shortly after their implementation, etc. Or, they were bare tax increases without any social or redistributive element on them. Thus, at the end 'tax reform' was conceived by the public as having a negative connotation, with all the detrimental effects on the acceptance of the measures and on any tax reform in the future.

Second, tax reforms need a favourable reform momentum and although crises are deemed to facilitate reforms, in the case of Greece the economic crisis has made tax reform very difficult to implement. Not only because the reform was attempted under conditions of extreme haste, but also because of the effects the economic crisis had on taxpayers and on the economy. That is, it is easier for a government to implement a tax reform when there are

²⁰ Increase in fiscal deficit as a percentage of GDP between 2006 and 2009.

budget surpluses that can be used to absorb revenue losses or to compensate the losers of the tax reform, which certainly was not the case in Greece. Also, it is not easy for the taxpayers to respond positively to tax changes in a country having high unemployment rates, huge wage and pension reductions, substantial devaluation of property assets etc., especially if the proposed tax changes are aimed at increasing tax revenues.

Third, an essential requirement for a successful tax reform is a strong will for reform. This can be facilitated if among the taxpayers/voters are both winners and losers as a result of the reform and if the proposed measures are socially acceptable. Also, voters are more willing to accept a tax reform if there are offsetting benefits through reforms in other policy areas. The situation in Greece was not favourable in this respect either. The tax measures imposed had losers only, because they were bare tax increases. They were also not accompanied by offsetting measures in other policy areas and the measures in the tax system were considered from the outset to be unfair. Actually, those who were hit most by other policy measures (income policy, labour market regulations etc.) were those who were asked to bear most of the additional tax burden.

Fourth, the outcome of a reform is highly affected by the cohesion of the government with regard to the specific reform. If the messages received by the public show that the government is not united regarding the reform proposal, the reform will not be supported and its opponents will exploit the situation in order to reap political benefits.

This factor has not been favourable for tax reform in Greece either. The weak cohesion of the government with regard to the reform proposals is reflected in the fact that since 2009 there have been seven successive governments and ten Ministers of Finance. Another factor affecting the cohesion of the government is also that the measures proposed were externally driven. That is, they were dictated, recommended or approved by the 'troika', something that neither all political parties nor all the members of the political parties were equally ready to accept. And since the reforms : (a) were all restrictive in nature, (b) covered a very wide spectrum of policy areas, and (c) affected within a very limited time period the everyday life and the standards of living of the population, they acted cumulatively on the cohesion of the government. It is worth noticing in this respect that the attempted reforms have been responsible for the splitting of all political parties that have participated in the government since 2009.

Fifth, a successful reform requires persistence. However, as mentioned above, the tax amendments attempted during the implementation of the economic adjustment programme were not made to the same direction. Moreover, due to the very limited time allowed for the economic adjustment program to be implemented, the amendments made in the tax system were neither well designed nor well implemented, which necessitated unprecedented 'corrective interventions' at later stage. And certainly the successive changes of political parties in power and of Ministers of Finance have not facilitated the condition of persistence for a successful tax reform either.

Finally, in order to be successful, reforms need an electoral mandate for reform or visible benefits very rapidly. The measures agreed with the 'troika' in 2010 had no previous electorate mandate for reform. The voters realised shortly that they were caught up in a vicious circle of successive income reductions and tax increases without any pay-offs. They punished all the political parties that have been in power since then and had agreed the 'reforms' by not re-electing them. In fact in all successive elections thereafter they voted for the parties that promised to take no further reforms.

Thus, none of the conditions for successful reform existed in Greece and if reform means '*the improvement or amendment of what is wrong, corrupt, unsatisfactory, etc.*' (Wikipedia) the tax amendments made in Greece during the implementation of the economic adjustment programme can hardly be considered as constituting a tax reform either.

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4. SESSION II – FOCUS ON POLITICAL ECONOMY DIMENSIONS OF SPECIFIC TAX AREAS

4.1. RESISTANCE TO REFORMING PROPERTY TAXES²¹

by *André Masson**

This paper focusses on resistance to taxes on immovable property and wealth. First, it looks into the current economic arguments as regards taxation of immovable property, wealth and wealth transfers, while emphasizing the propositions of reforms advanced by *some* French authors. It also gives specific attention to the social and economic implications of increasing longevity and ‘patrimonialisation’ (growing weight of wealth) in our societies. To mitigate resistance to tax reforms, it finally advocates solidarity ‘deals’, which offer various compensations for tax hikes.

4.1.1. Current economic arguments on wealth taxation

Let us first recall standard views that will be labelled ‘current economic arguments’. The focus is on redistribution against the rise of inequality in (pre-tax) income and wealth since 1980, and also on growth- and employment-friendly taxes to cope with the slowdown of growth, most often associated with massive (youth) unemployment. Wealth taxation is limited by globalisation and internationally mobile capital. The economic crisis makes some issues more pregnant, such as the sustainability of public debt, the adequate level of household indebtedness, and the further need for tax revenue.

Tax analysis is framed in the usual efficiency-equity trade-off, while adding simplicity, compliance, and especially political feasibility. Simplicity should reduce administrative costs and increase transparency of tax design to taxpayers. Lack of compliance, usually measured by the tax gap between tax owed and tax effectively collected, is an indicator of people resistance (see European Commission, 2015a). Political feasibility notably means that tax reforms welcome from a theoretical standpoint may not be realistic or politically feasible (see *e.g.* Profeta *et al.*, 2014, on wealth transfer taxation).

Empirical analysis usually relies on cross-country comparisons, often in a historical perspective. It leans on ‘benchmarking’ – to the EU average or to the best country-performers according to the relevant tax policy indicator – to identify scope for improvement in countries with poor performances (European Commission, 2015a, b). Prior theoretical considerations, concerning *e.g.* the growth-friendly ranking of different taxes (Arnold *et al.*, 2011) or the reasons of decline and gloomy future of wealth transfer taxation (Profeta *et al.*, 2014), are typically tested using cross-country regressions over a period of time (with country dummies).

Current economic arguments lead to quite strong implications concerning fiscal policy. The first one advocates a shift away from labour income taxation in favour of other, more growth- and employment-friendly taxes, the tax cut in personal income (and social security contributions) being especially targeted to low-income households. This general move is likely to reach a consensus among economists, but this is *not* the case of the two growth-friendly taxes highlighted in the OECD paper of Arnold *et al.* (2011), namely taxes on immovable property and consumption taxes, such as VAT. Moreover, current economic arguments lead to the following conclusions concerning the practical relevance of (household) wealth taxes:

- An annual tax on total net wealth, in Piketty (2014) line, is seen as too utopian due to the international mobility of capital: the tax would be operative only under automatic exchange of information, which is just

²¹ Some developments of the text lean heavily on the papers of Piketty, Saez and Zucman (2013) and Allègre, Plane and Timbeau (2012). I am further grateful to these colleagues for friendly and fruitful discussions. Thanks also to the ECFIN division for sending me its relevant work on housing taxation. The usual disclaimer especially applies here: I am solely responsible for the ideas and proposals presented in this paper.

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beginning (Bradbury, 2015). Moreover, it is rare in Europe (only in France, Norway and Switzerland) and has been repelled in a number of countries during the 2000s (Sweden, Italy, Austria and Germany). Therefore, it should not be given a high priority in the agenda of tax reforms. This is all the more the case of Piketty's proposal of a one-time capital levy that would help to reduce public debt – see Keen (2015) for criticism.

- The decline in taxation of capital income appears a more or less inescapable change (due to capital mobility). The 'fuzzy frontier between capital and labour income' (Zucman and Piketty, 2015) is not considered as a compelling argument for the harmonisation of labour and capital income tax rates: the reduction of the top personal income tax rates is even welcome as a way to 'encourage entrepreneurship and investment in education' (Arnold *et al.*, 2011). Unrealised capital gains being difficult to tax, recurrent property tax is an indirect way to tax latent housing capital gains, provided that properties are periodically reassessed to proper market values. Finally, current economic arguments seem to pay only limited attention to the taxation of realised capital gains, or to the one of capital gains on death or wealth transmission.
- Wealth transfer taxation should be part of an ideal tax system, at least for equity reasons, but proponents of current economic arguments place limited hope in the contribution of these taxes: they are too unpopular, and their revenue is modest and declining (in % of GDP) in a majority of OECD countries (Masson, 2015a). Moreover, Profeta *et al.* (2014) cast doubt on their political feasibility, which is likely to become even more problematic in the future owing to population aging and the resistance of older voters to taxes on bequests (see below).
- But current economic arguments highly recommend a shift away from housing transaction taxes towards higher recurrent property taxes on immovable property, especially on residential housing, while limiting tax relief on mortgage (interest) payments to avoid excessive household debt – see European Commission (2015a,b).

To sum up, the first and main priority of current economic arguments (somewhat caricatured) is a strong increase in recurrent property tax. Otherwise, they may 'perhaps' recommend hikes in wealth transfers and capital gains taxation.

France as an interesting case study

According to the tax criteria put forward by current economic arguments, France is a rather 'good performer' in Europe as regards wealth taxation: it is so for recurrent taxes on immovable property; it has an annual net wealth tax – an exception; tax revenues on capital gains are largely above average (despite numerous loopholes); and it is second, after Belgium, for the revenue (in % of GDP) of wealth transfer taxation. Interestingly enough, some French economists do not share this positive view about wealth taxation in France: Piketty (2014) and Piketty *et al.* (2013); and at OFCE (*Observatoire français des conjonctures économiques*), Allègre *et al.* (2012) and Sterdyniak (2015). These authors share common views that are quite different to those underlying current economic arguments:

- Remedies to globalisation and capital mobility (automatic exchange of information and international tax cooperation), should be taken more seriously: the difficulty of the task is not an excuse to concentrate on recurrent property tax and other taxes (*e.g.* VAT) that do not suffer from capital mobility. And tax innovations and experiments conducted in a sole country may be useful.
- Household excessive indebtedness is not such a major issue.

- In the resistance to tax reforms, more attention should be paid to the lobbying of the rich, as in Piketty (2014) or Stiglitz (2012).²²

4.1.2. Taxes on immovable property (especially on residential housing)

Current economic arguments advocate a shift away from housing transaction tax to recurrent property tax, with limited or no tax relief on mortgage payments if imputed rent is untaxed: in many countries, owner-occupation appears undertaxed compared to other private investments, more conducive to growth. In France, recurrent property tax, relative to GDP, is high (the second highest in the EU after the UK); tax relief on mortgage payment for owner-occupation has been cancelled (for homes acquired after October 2011); yet, transaction taxes on housing remain important, but lower than in the UK (see European Commission, 2015a).

The reduction of transaction taxes is likely to reach a consensus among economists. It should lead to a more dynamic housing market and a drop in housing prices, and also facilitate labour mobility. It reinforces, however, the bias in households' investment in favour of housing, and represents a revenue shortfall for the government. More importantly, the measure will face strong resistance from (rich) local governments in countries where they directly receive the transaction taxes. This resistance can only be overcome by substantial reform of local taxation and by innovative national tax cooperation.

According to current economic arguments, tax relief on mortgage interest should be abolished if the imputed rent is not taxed. Granting a tax relief for expenses without taxing the related income is unfair, benefits more to highest incomes, entails a revenue cost, and may lead to excessive indebtedness. Together with other tax breaks aimed at promoting homeownership, it may even translate into higher housing prices (when supply is rigid) and curb instead ownership attainment, notably for younger and poorer households (European Commission, 2015b).

Recurrent property taxes (land, real property and housing tax), being the most growth-friendly and the least sensitive to capital mobility, should be increased in EU countries where they are relatively low. They would compensate for the revenue loss on transaction taxes, lead to lower housing prices and reorient savings away from housing towards more risky and productive investments. Provided that periodic reassessment of property to market values is feasible, recurrent property taxes seem an ideal tax according to current economic arguments: hence, the focus on the resistance to these taxes, attributed to their 'visibility' (people hate to pay taxes using their checking accounts), the secular desire to own one's home, or the security brought by home ownership against the rising longevity risk and the uncertain future of the welfare state.

4.1.2.1 France: a good performer on recurrent property tax? French objections

Current economic arguments' positive views on this part of the French tax system are not shared in France by professional and academic circles, who complain that recurrent tax is both too high and unfair. Piketty *et al.* (2013) would thus prefer a more comprehensive wealth tax than a tax on housing only and, furthermore, a tax on *net* wealth rather than a tax on gross property which favours older homeowners. Above all, regular reassessment of homes to their market values proves to be difficult, requiring elaborate national cooperation and adequate treatment of capital losses (inducing property tax rebates?). In France, that revaluation was thus planned every 5 years but not really enforced (Allègre *et al.*, 2012). Outdated property values lead to strong inequalities and injustices: low tax in the centre of big towns, high tax in suburbs. No wonder that Sterdyniak (2015) deems French recurrent property tax to be an archaic tax, which makes "*rich people pay little in rich communities and poor people pay a lot in poor communities*". And recent sudden hikes on land tax in France have revolted taxpayers.

Updating property values to market prices is indeed likely to create a little revolution in France, as it would induce a number of heavy losers. In nice quarters of Paris, recurrent property tax might be multiplied by three or

²² Not all French economists entertain such views. Aghion and co-authors, in their quest for a more 'inclusive' Schumpeterian growth, are thus more favourable to current economic arguments: claiming that capital is overtaxed in France, they advocate a higher consumption tax and a limited flat rate on capital income (see Aghion *et al.*, 2014).

four – or even more if the tax is made progressive for equity reasons... – for homeowners who already face increased maintenance costs. If they do not plan to sell, it will be an important loss to them – and that for an unchanged housing service. If not designed properly, the measure would indeed imply that only the rich can now afford living in posh quarters of big towns. The young households who plan to become homeowners in these quarters would have no guaranty that transaction taxes decrease enough to compensate for the increase of recurrent property taxes.

Updating property values will encounter serious resistance not only from (high income) homeowners but also from local governments, who are not sure to benefit *directly* from the additional recurrent tax – if ever they do, inequality will increase between rich and poor communities. *National* tax cooperation between the State and local governments is again essential here, but it may prove as problematic to enforce as international tax coordination, especially in times of austerity. There must be an adequate fiscal redistribution between communities to be sure that the tax reforms advocated by current economic arguments create a sufficient number of winners among present or future homeowners, and do not exacerbate regional inequalities. Sure, the first move would be the most difficult one, since property values have not been updated for many years: subsequent revaluations would be much easier to perform.

4.1.2.2 *The case of imputed rent for homeowners*

In most developed countries during the period 1910-1980, the tax base for the personal income tax was, according to Piketty *et al.* (2013), “*defined in very comprehensive manner, particularly for capital income: for instance, imputed rent was usually part of the tax base*” – a proposal welcomed by current economic arguments. The main rationale for this comprehensive tax base was presumably ability-to-pay, implying that all forms of ‘income’, including imputed rent, should be treated alike. But today, taxing imputed rent (especially for the main dwelling) is rare, existing only in the Netherlands and Luxembourg, and appears not easy at all to implement.

According to Allègre *et al.* (2012), comparable ability to pay for full or indebted owners and renters implies that imputed rent, *net* of mortgage interest payments, should be taxed: taxation of imputed rent should be coupled with a tax relief on mortgage payments. Two major difficulties concern the adequate evaluation of imputed rent and the strong political resistance faced by the tax, due to the number of (heavy) losers. That is why Allègre *et al.* (2012) propose instead to *deduct* from taxation rents for renters and mortgage interest payments for indebted owners, the shortfall in tax revenue being compensated by a general increase of the income tax. The reform would ensure horizontal equity while being redistributive, since rent-to-income ratios are higher for low income households; it would be easier to enforce because declared rents are known; and it would be easier to defend in public debate.

4.1.3. Other schemes of lifetime wealth taxation

As indicated in the introduction, I will be brief on other lifetime wealth taxes despite their potential importance, giving only some insights of Piketty *et al.* (2013) and Allègre *et al.* (2012) views on these topics.

4.1.3.1 *Back to a comprehensive and progressive income tax?*

Piketty *et al.* (2013) emphasise the existence, during the period 1910-1980, of a sort of consensus among developed countries for a 'comprehensive-income-tax-cum-inheritance-tax', with a progressive schedule applied to the sum of labour and capital income and a large tax base, particularly for capital income (see above). Still in the 1960-1970, the top marginal tax rates were higher for capital income than labour income, especially in the US and the UK. The comprehensive income tax (*i.e.* treating labour and capital income flows 'alike') and its progressivity were then justified by ability-to-pay considerations. In the view of Piketty *et al.* (2013), “*the simplest and most compelling rationale*” for such an income tax is the existence of a “*fuzzy frontier between capital and labour income*”, especially at the top of the income ladder (self-employed, business owners, corporate executives).

Piketty *et al.* (2013) attribute the vanishing tax base and the decline in taxation of capital income (and high bequests) since 1980 to several factors: a change in the nature of wealth, with a relative rise of life-cycle wealth and a compression of wealth inequality; financial globalisation and international tax competition, to which small European countries, including Sweden, have been particularly receptive; and a change in the balance of political power in favour of richer households. In any case, Piketty *et al.* (2013)'s proposal would lead again to sizeable top marginal tax rates for capital income; for that reason, it faces today strong opposition from those economists who fear that such rates will be detrimental to innovations, productive investment and risky savings, including proponents of current economic arguments and Aghion *et al.* (2015) on innovations and top income inequality. The debate is not easy to settle as it goes far beyond empirical issues.

4.1.3.2 *Capital gains*

Compared to other capital taxes, capital gains taxation has a number of advantages: it mitigates the double taxation issue, to the extent that capital gains are due to luck; it takes into account the high heterogeneity of rates of return to wealth and the existence of capital losses. Ideally, it should concern *real* capital gains (net of inflation and capital depreciation).

An interesting thought experiment performed by Allègre *et al.* (2012) gives an order of magnitude of the sums involved in the case of France, where there have been massive capital gains on housing. Define 'augmented' capital income while adding to standard capital income real capital gains (realised and latent) and imputed rent: the latter represent on average 12% of household income over the period 1998-2010. A large part of this supplementary income is not taxed: if it had been taxed, the additional tax revenue would have been near EUR 50 billion per year, representing an increase of some 70% of the tax revenue on capital income.

Admittedly, direct taxation of latent capital gains raises many difficulties. But realised capital gains could be taxed on a larger scale. Those on owner-occupied housing are thus tax exempted in France as in many countries: Allègre *et al.* (2012) proposal is to tax housing capital gains (at the standard 30% rate) for the part not reinvested in owner-occupied housing.

Also, taxation of (real) capital gains when wealth is *transmitted*, notably on death, would allow to avoid 'erasing' of latent capital gains through tax allowances on wealth transfers. This tax exists in Canada. It is clearly distinct from an inheritance tax: the two taxes pursue different goals and may in principle coexist (see Boadway *et al.*, 2010).

4.1.3.3 *Annual wealth tax: the French experience*

Piketty *et al.* (2013) and Piketty (2014) advocate an annual progressive tax on individual total net wealth at its market value, imposed on European millionaires. The tax base should be as large as possible, with pre-filled wealth declarations and international tax coordination. The tax revenue could reach 2% of GDP. This tax is justified by the difficulty to define consumption and income flows of the rich, and by the non-income benefits of high wealth, such as power, prestige and influence (Keen, 2015). It is a better option than taxing (equivalently) the variation of wealth, which is too volatile. Progressivity is justified by rising rates of return with the size of wealth. The tax could hopefully prompt rich households to take more risk in their portfolio in the hope of higher returns.

Objections to the wealth tax are well known. It does not distinguish between rent-wealth and productive investment, neither between inherited and self-accumulated wealth. Capital gains taxation is more adapted to the high heterogeneity of rates of return between assets and capital sectors – a wealth tax may be confiscatory – and to the existence of capital losses. Moreover, it would require an unrealistically high degree of tax cooperation at European level: capital mobility is indeed one reason for the repeal of the wealth tax in several countries during the 2000s. The other one, pointed out by Piketty *et al.* (2013), is (was) an ill-defined tax base, with very high tax rates applied to fiscal values well below market values.

The French experience makes an interesting contribution to the debate. The wealth tax, now named *Impôt de solidarité sur la fortune* (ISF), is paid by the 2% top wealth holders. It was first introduced in 1982, abolished between 1987 and 1989 and re-established since 1989 (see Trannoy, 2015, for details). Three points are worth mentioning. Firstly, despite all its flaws (narrow tax base, high tax rates, fiscal emigration to Switzerland and Belgium), the ISF does not work so badly: due to a rising tax base, its revenue is steadily growing, posting over EUR 5 billion today. Secondly, the ISF should have brought up invaluable information on the rich over some 30 years, including on intra-cohort mobility in that group; but a lot of tax files have been lost or damaged, particularly among old tapes... Thirdly, the ISF is popular in France, in fact the most popular tax in opinion polls (where inheritance taxation is the most unpopular). People tax resistance goes *in reverse* here: it will be difficult – if the Right comes back in power – to cancel the ISF. Tax resistance may thus be *country specific*: presumably, the wealth tax has never been so popular in Germany or Sweden.

4.1.4. Wealth transfer taxation

According to the theory of optimal capital taxation, wealth transfer tax is *a priori* an ideal tax: Cremer and Pestieau (2012) thus claim that if “*our basic goal is to finance government services with a tax that is as efficient, fair and painless as possible, [then] on all counts, it is difficult to imagine a better tax than the estate tax*”; and Piketty *et al.* (2013) add that “*there are strong meritocratic reasons why we should tax inherited wealth [an unearned income] more than earned income or self-made wealth*”. Note however that the tax schedule will depend a lot on both the nature and the strength on the bequest motive, which are difficult to assess empirically and are likely to vary along the social ladder²³. In any case, the predictions of the standard theory of optimal capital taxation are at odds with the limited revenue of the tax (below 0.5% of GDP) and the strong collective preference in all OECD countries for 'lifetime' wealth or capital taxation. Moreover, opinions polls in the UK, the US and in France reveal very unpopular wealth transfer taxes compared to other taxes (Masson, 2015a).

Objections to wealth transfer taxation, that could explain such a discrepancy between theory and evidence, include various forms of tax illusion, including (i) overestimated propensity to bequeath – see Piketty and Saez (2013)'s optimal tax formulas; (ii) the fact that inheritance taxation comes too late, when rates of return to wealth are highly uncertain and uninsurable over the long run; (iii) horizontal inequity and (iv) the ability of the rich to escape the tax. Also, the tax is deemed to hurt family values and intergenerational links, being a 'virtue tax' against parental altruism (notably in the case of gifts) and a tax on family home or family business. And inheritance taxation is labelled a 'death tax', generating a double loss.

From a political economy standpoint, resistance to the wealth transfer tax is usually attributed to the power of the coalition of the rich with family-oriented members of the middle classes. But that does not explain the *specific and growing aversion* to the wealth transfer tax, whose revenue has strongly declined (in % of total tax receipts or GDP) since 1960 in most countries. This is *not* the case of lifetime wealth or capital taxation: ratios of tax revenue to GDP or total tax receipts are generally higher in 2007 than in 1995 – lightened tax schedules have been compensated, and beyond, by a higher wealth tax base (Masson, 2015a).

In other words, tax resistance is all the more tricky to understand that it may change over time. Indeed, the wealth transfer tax was quite popular in the US in the 1930s, and remained so until the late 1960s (Beckert, 2012). Explaining this historical change in attitudes is a basic requirement for a suitable and successful reform of the wealth transfer tax.

4.1.4.1 How to explain the specific and growing resistance to the wealth transfer tax?

A possible answer lies in the increasing strength of family values and intergenerational links, when the family appears to be the only true safe haven against the vagaries of globalised markets and the uncertain future of the welfare state (Masson, 2015b). This claim needs much further theoretical and empirical qualification, coming also from other sciences than economics (see Beckert, 2012).

²³ See Kopczuk (2013) for the US, Arrondel and Masson (2013) and Masson (2015b) for France.

Another route is to concentrate on two crucial puzzles (Fennel, 2003): (i) Why is the tax also unpopular – and apparently more and more so – among less well-off people who should reasonably expect to leave only few bequests? (ii) Why do richer people do not use *inter vivos* giving on a larger scale in order to reduce wealth transfer taxation?

Piketty *et al.* (2013)'s tentative answer to (i) is a change in “*perceptions and beliefs about expected wealth mobility*”, which raises political science issues. It is related to Beckett (2012), who claims that wealth, no matter its origin, is more and more the dominant sign of ‘success’, fuelling further the dream to become rich one day. Profeta *et al.* (2014) focus on (ii), following Kopczuk (2013). The limited use of estate planning to reduce tax obligations is justified by the desire of the wealthy to maintain control over their wealth when old. Moreover, people do estate planning only later in life: the older they are, the more single-minded they become about leaving bequests. We should then expect “*growing resistance to wealth transfer taxes as the population generally ages*”. Cross-country regressions over the period 1965-2009 and simulated projections seem to support this stimulating view, questioning the political feasibility of increasing or even maintaining the tax on wealth transfers. Yet, population aging cannot really be the only source of the growing unpopularity of inheritance taxation.

Fennel (2003) explores rational as well as behavioural reasons (such as optimism, loss aversion, overconfidence...) for (i) and (ii). She recommends the following reforms of the US estate tax: reframing the tax as a 'gain-reducer' (gain is received bequest), instead of a 'loss-creator'; earmarking its revenue for specific opportunity-enhancing programs for the young and allowing to pre-pay the tax on major illiquid assets. These proposals are worth considering but will not save the wealth transfer tax: more structural reform is needed.²⁴

4.1.5. Underestimated changes: increased longevity and 'patrimonialisation'?

This overview of the various forms of household wealth taxation does not lead to very encouraging conclusions, at least for anyone opposed to a drastic reduction in tax revenues. The reason for that impasse could be that current economic arguments focus only on the remedies to increasing income inequality and growth slowdown. But these changes interact with two other factors whose dramatic effects appear somewhat underestimated.

A first factor, the rise in life expectancy, puts pressure on the financial sustainability of our welfare state through population aging and the rising mass of transfers to the elderly (pensions, health expenses and long-term care). Projected pension spending until 2060 by the *Ageing Working Group* (European Commission) may well be favourable to France, showing even a decline of the ratio of pensions to GDP. But the scenario for growth and unemployment is optimistic, the average age of retirement is postponed for four years by 2035, and the *relative* purchasing power of retirees is projected to decline over the long term by 20% at least. And people will have difficulty to understand or accept basic economic statements such as: a (projected) longer life expectancy in younger cohorts means that they will have to work longer – at which wage? – to get the same pension as their elders; or actuarial fairness implies that an expected longer life in retirement will 'compensate' for a lower pension. Also, from a political economy angle, the first baby-boomers (born before 1960), who form a well-identified generational group with a high rate of voters, will be soon all in retirement and are likely to try hard to maintain their relative purchasing power (pensions indexed on wages) whenever inflation or growth become higher than today.

In countries with strong inheritance rights for the surviving spouse, rising longevity also means that children will inherit family wealth, in *full* ownership, at an average age of 60 today (in France), when that age was only 40 in the 1960s. Moreover, homeownership will be more and more viewed as an essential insurance against the increasing risk of longevity (including the financial costs of long term care).

The second factor, that will be named 'patrimonialisation', covers a multi-faceted process taking place since the late 1970s. A first component concerns the growing weight and inequality of wealth and capital in our societies

²⁴ Arrondel and Masson (2013) and Masson (2015b) examine provocative reform proposals, such as Meade's or Rawls' social inheritance, or a differential tax treatment applied to inherited vs. self-accumulated bequests (Rignano, Fisher or Nozick): to the author's knowledge, these reforms have never been successfully implemented.

(Piketty, 2014): wealth-income and capital-output ratios rising to unprecedented levels since 1914, albeit due in part to (latent) capital gains on housing; increasing wealth concentration at the top (1% and 0.1%), with a potential danger of plutocracy. The second one is the growing weight of inheritance and often of the share of inherited wealth in total accumulation: the annual flow of bequests which has increased more rapidly than GDP in a number of countries (Piketty, 2014), but also more rapidly than wealth itself in France²⁵, forms an ideal tax base. The third one concerns the age-distribution of wealth: in France, there has been an 'excessive' and rising concentration of wealth in the hands of the elderly, who seem to 'over-save' for their old age and whose savings mainly represent a low-risk store of value, driven first by precautionary motives, retirement needs and the risk of longevity (Masson, 2015a). On the other hand, young households face liquidity and credit constraints in their accumulation projects, before they inherit at 60 – far too late: increasing downward mobility of wealth is thus welcome.

Most countries do not have historical data as rich as France, so that their exact degree of 'patrimonialisation' is difficult to assess. National accounts and individual data from the HFCS (Household Finance and Consumption Survey), collected in 2010 by euro area central banks, do indeed reveal important heterogeneities between countries. But they also show that French wealth statistics are by far the closest to averages in the euro area, be it median or mean of wealth, wealth inequality or concentration (share of top wealth-holders), diffusion of assets or structure of portfolios (by age, size of wealth, etc.).²⁶

4.1.6. Solidarity deals

Social debt and promises of the welfare state that may be unsustainable, to the detriment of future retirees, on the one hand; 'patrimonialisation' of our societies, creating tensions between generations and curbing long-term and risky investments, on the other: these two changes are quantitatively important²⁷ and constitute major obstacles to growth. The most growth-friendly reforms of wealth taxation are those which allow removing these obstacles. To cope with tax resistance, they should be framed as 'solidarity deals', trading tax hikes against compensations or ways out beneficial to society or national solidarity.

4.1.6.1 *Taxfinh (Tax family inheritance) as an improved wealth transfer tax*

The *Taxfinh* program combines two inseparable components (see Masson, 2015a&b). The first one is a heavier and more progressive taxation of 'family inheritances' only: the relative tax advantage of *inter vivos* gifts or charitable transfers comes from a disincentive to *post-mortem* bequests to one's offspring. The second one, which makes *Taxfinh* a solidarity deal, aims at providing more numerous and easier means to sidestep this new tax, such as:

- Giving part of one's wealth to children sufficiently early before death (e.g. 10 years before, to avoid gifts being reintegrated into the estate), or making charitable gifts and bequests;
- Investing more in long-term and risky assets, conducive to growth (benefitting from tax exemptions on death);
- Exploiting new or increased possibilities to run down and consume wealth at retirement: adapted immediate life annuity, long-term care insurance and chiefly, for home owners remaining in their home until death, new forms of reverse mortgage²⁸ or 'viager'.²⁹

²⁵ This is not the case in the US: the ratio of the flow of bequest to wealth has decreased significantly between 1989 and 2007, due to the rapid rate of new wealth creation (see Masson, 2015b, and references).

²⁶ See Arrondel and Masson (2014).

²⁷ The "Ricardian" circuit of social upwards transfers and private downwards transfers between generations has thus *doubled* in importance, in % of GDP, over the period (1980-2010) in France.

²⁸ The standard reverse mortgage is not to be encouraged; but the 'long-term care reverse mortgage', attributed only in case of confirmed dependency, will allow for much lower interest rates and constitute a welcome substitute to LTC insurance (see Masson, 2015a).

²⁹ The viager pays a sum of capital and often a life annuity to the seller who remains in his home until death. The seller loses bare ownership but keeps the usufruct: the longer he lives, the more he gains. The traditional viager, where the buyer is a private individual, suffers

The suggested ways to avoid the inheritance surtax would reduce disincentive effects and tax resistance (such as tax emigration). The *Taxfinh* programme would be a relevant answer to many objections raised against standard inheritance tax (see above section): the surtax would not apply to transfers most driven by parental or social altruism and the threat of the surtax would encourage early estate planning. In that respect, *Taxfinh* penalises the type of ‘joy of having’ behaviour described by Kopczuk (2013) and Profeta *et al.* (2014), making the decision to maintain control over wealth until late in life more costly; and rightly so, since it can be shown, at least on French data, that early wealth transfers free the beneficiaries from liquidity constraints and boost their wealth projects, whether that involves buying a house, creating a business or taking over a business outside the family (see Arrondel *et al.*, 2014).

Moreover, the *Taxfinh* measure would be fairer – and hopefully less unpopular – than a standard wealth transfer tax, insofar as the surtax will essentially affect well-off households that ‘deserve it’ because of their short-sightedness and/or selfishness. And above all, it would remedy the current unfavourable wealth situation in France and in the euro area. Indeed, the *Taxfinh* measure would have been far less justified in the wealth situation of the 1950s or 1960s, when longevity and ‘patrimonialisation’ were much more limited.

Another way to mitigate resistance to *Taxfinh* would be to earmark its revenue either for long-term care expenses or opportunity-enhancing programmes for the young: there are good reasons in favour of each option but it would likely be better to choose one or the other.

4.1.7. Conclusions

People and political resistance offers limited room for standard reforms of household wealth taxation and may create perverse distributional and other effects. Higher recurrent property taxes would generate many heavy losers and require elaborating tax cooperation at national level, between local and central governments. Hikes in capital income and annual wealth taxes are hindered by the lack of international exchange of information and tax coordination and are not consensual among economists. Wealth transfer taxation suffers from growing unpopularity and hurts rising family values.

To overcome tax resistance, this paper proposed ‘solidarity deals’ that provide compensations or ways out for tax hikes and favour growth. These solidarity deals remedy two major obstacles to growth generated by rising longevity and ‘patrimonialisation’: (i) the questionable sustainability of social debt due to the growing weight of social transfers to the elderly and (ii) the increasingly negative wealth situation in a number of countries, with a mass of rather inert wealth concentrated in the hands of the elderly. The paper developed one example of solidarity deals, the *Taxfinh* programme. The general objective of other deals could be to use the mass of wealth held by the elderly to help financing social transfers, *e.g.* by the building of a retirement or social fund fuelled by progressive taxations of capital or capital income: the longer retirement life of middle and upper classes would be made a bit more difficult (being more taxed, working longer) but would be secured, with maintained replacement rates instead of just a basic safety net. Another deal would concern top-wealth holders, dividing them between (less taxed) ‘good rich, and ‘bad rich’. The separation should not been made according to the origin of their wealth (see the endless debate between the alleged ‘bad’ Carlos Slim and ‘good’ Steve Jobs), but according to its current *use* – an idea already put forward by St Thomas d’Aquin.

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justifiably from a poor reputation. A better adapted “pooled viager” is now proposed, where the buyer is an institution subject to certain rules and social imperatives, which can pool the risks on both sides – on the survival of the seller and on the value of housing at his death.

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4.2. POLITICAL ECONOMY OF TAX EXPENDITURES

*by Athena Kalyva**

Tax expenditures are reductions in government revenue through preferential tax treatment. EU Member States make ample use of tax expenditures with a wide variety of aims including employment creation, income redistribution, innovation, education, entrepreneurship and home ownership. While tax expenditures may be motivated by relevant economic or social goals, they are not necessarily the most cost-efficient instrument and may, in some cases, lead to severe economic distortions.

Tax expenditures allow certain groups of taxpayers to reduce their tax burden and, therefore, could be regarded as revenue losses attributable to derogatory tax provisions. Against the background of recovering growth and remaining fiscal consolidation needs, reforming tax expenditures may offer a promising avenue to raise revenue and, at the same time, improve the efficiency of tax systems. However, not all tax expenditures are equal in terms of revenue forgone and economic effects. Hence, it is important to understand the political economy characteristics of tax expenditures, what makes some tax expenditures successful and what lessons could be learned.

4.2.1. General policy issues

The concept of tax expenditures is rather complicated in the context of taxation as the logical choice of the benchmark tax system remains unclear. From a public finance perspective, tax expenditures entail costs in terms of foregone revenue compared to a benchmark tax system. A precise quantification of such losses is not straightforward, notably because of behavioural responses, interactions with other tax bases and other methodological issues. Since the definition of the benchmark tax system varies across countries, the very same identification of what precisely constitutes tax expenditure will differ. In the absence of a commonly agreed definition of the concept of tax expenditures, cross-country comparisons are difficult to perform. Moreover the case for transparent reporting of tax expenditures is even stronger.

The economic relevance of tax expenditures could be assessed against a small number of criteria. Identifying the proper criteria is also an issue when assessing the tax expenditures. A first group of criteria could cover various facets of the microeconomic efficiency (internalising externalities, minimising distortions generated by taxation and remaining compatible with a sound functioning of the single market). The second group of criteria could reflect the capacity to meet social or strategic objectives defined by the government with the best instruments, which are not necessarily tax expenditures. The last group of criteria relates to the efficient functioning of fiscal policy, which would include keeping the tax system simple and stable and ensuring transparency and accountability. A thorough assessment of tax expenditures includes an evaluation of their impact on these three dimensions.

First, tax expenditures might cause severe microeconomic distortions and encourage rent seeking behaviour. Tax expenditures can cause severe distortions and encourage rent seeking behaviour, while also requiring an increase in statutory tax rates by narrowing tax bases and thereby generating welfare losses. An evaluation of the efficiency of tax expenditures requires a case by case analysis for different policy areas of how tax expenditures could – or not – help meet given economic objectives in these areas.

Second, a thorough assessment of tax expenditures also includes an evaluation of their impact on social equity. This involves discussing their potential benefits and limitations in comparison, where possible, with the alternative available tools, not necessarily related to tax policy.

Third, tax expenditures might also impact the fiscal framework. Caution is needed when deciding on whether to apply tax expenditures, as they increase the complexity and instability of the tax system, risk overburdening tax

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administrations and might lead to welfare losses. Simultaneously, they are subject to less control and scrutiny by national parliament, as well as more vulnerable to influential lobbies, compared to direct spending.

4.2.2. Political economy dynamics

Generally, the introduction of tax expenditures narrows tax bases, which often results in higher tax rates. They affect the behaviour of economic agents and can distort the allocation of resources. Tax expenditures are also vulnerable to lobbying, and to rent seeking behaviour. Tax expenditures are sometimes not transparent and are not always included in the budget process. Lack of co-ordination with related spending programs and control may increase the risk of abuse. Even more tax expenditures have strong political appeal: governments risk using tax expenditures to reduce the overall tax pressure or to provide preferential tax treatment to specific groups without increasing expenditures.

Tax expenditures are often quite persistent, even when their *raison d' être* has disappeared, due to: i) a lack of transparency, ii) the economic rents captured by a specific group of taxpayers, which is more important for them than the wide spread cost of financing by all taxpayers, iii) the electoral cycle, and iv) often less bureaucracy in implementation than with direct spending programs.

When evaluating and rationalizing tax expenditures governments need to look at: i) the need to meet given economic objectives ii) the impact on social equity iii) the impact on competitiveness, iv) the need to foster entrepreneurship and growth, v) the need to complement non-tax policy solutions, and vi) the administrative and enforcement costs. This evaluation may result in rationalizing tax expenditures in order to: i) internalise externalities (this could refer to positive externality, like for instance those generated by R&D and innovation, ii) minimise distortions generated by taxation, iii) remain compatible with a sound functioning of the single market (especially in corporate taxation), iv) improve social equity and v) to strengthen the simplicity and stability of the tax system (reducing its complexity will positively affect the compliance costs for firms and citizens and the collection costs for public administrations).

Overall there is a need to create a culture of evaluation and transparency. Ideally case-by-case analysis with a focus on specific groups or categories of tax expenditures associated with specific economic issues (bottom up or thematic approach). Hence, there is strong need for stringent monitoring, effective evaluations and transparent communication on the application of tax expenditures in Member States. While some well-designed expenditures can enhance positive spill overs and welfare, it is important to ensure that they do not cause economic distortions and that they are the most cost-efficient means of achieving economic and social policy goals. That is why the potentially harmful characteristics of these instruments deserve more attention.

4.2.3. Transparency and reporting

The European Commission and other international organisations regularly emphasise the need to report on and review tax expenditures as part of national budget management. Governments should describe clearly the use of tax expenditures in their tax systems, and provide an explanation of the main policies in place. This should include defining the benchmark situation (from which the tax expenditure is a deviation), the estimated cost of the measure in lost revenue and its coverage. In addition to reporting tax expenditures in the budget, regular evaluations of the tax expenditures in place should be carried out. The evaluations may be conducted by independent bodies or commissions, if this is thought more appropriate, and should assess the efficiency and cost effectiveness of current tax expenditures. More extensive evaluations may be carried out on a less frequent basis (i.e. less than once a year).

Under the EU Directive on requirements for budgetary frameworks (2011/85/EU), Member States have been required since 1 January 2014 to publish detailed information on the effect of tax expenditures on revenue (Article 14(2)). The Directive does not specify a standardised procedure for evaluating tax expenditures.

ESA 2010 introduces explicit new rules on how tax credits are to be recorded in national accounts. This is a significant change from the method previously used under ESA 95. Tax credits that constitute non-contingent government liabilities are now treated as expenditure instead of as a reduction in tax revenue, and are recorded at the moment when a government recognises the obligation to pay. The new system of recording on a gross (rather than a net) basis leads to an increase in total revenue and in total expenditure, compared to the approach used in the past.

Table 1 presents an overview of the current reporting requirements on tax expenditures in EU Member States, based on the information given in the 2015 Tax reforms report (European Commission, 2015). The information provided shows that 19 Member States now regularly report on tax expenditures, two more than in 2013. Reporting practices do, however, vary widely across countries, and the reports produced therefore also vary, in terms of their presentation, depth and coverage. In 2014, a national legal requirement to report on tax expenditures was in place in 14 of the 19 Member States that report regularly, a significant increase from the 9 Member States that had such requirements in 2013.

The reports generally use the ‘revenue forgone’ method for calculating tax expenditures, but there are significant differences in methodology, for example, whether revenue is estimated on a cash or accruals basis. The time period covered by the reports and the categorisation of tax expenditures used varies greatly. Similarly, some countries’ reporting is backward-looking and others’ forward-looking.

Overall, information on the tax expenditures in force or planned in Member States is still often incomplete, and the data provided are not fully comparable across countries and over time. This makes it more difficult to identify possible improvements to fiscal and tax arrangements, and can thus make fiscal policymaking less effective and efficient. This can, in turn, affect the strength of countries’ national budgetary frameworks as — more or less hidden — losses of revenue may weaken the positive effect to be gained from new measures increasing transparency on the expenditure side.

Table 1: Reporting of tax expenditures

Member State	Legal requirement	Regular (annual)
BE	X	X
BG	X	X
CZ	X	X
DK	X	X
DE	X	X
EE		X
IE		
EL	X	X
ES	X	X
FR	X	X
IT	X	X
LU	X	
NL	X	X
AT	X	X
PT	X	X
SK	X	X
FI		X
LV		X
HU	X	X
PL		X
SE	X	X
UK		X

Source: European Commission (2015)

4.2.4. Evaluation

A careful evaluation of the efficiency of tax expenditures requires identifying different policy areas and examining how tax expenditures could – or not – help meet given economic objectives in these areas. Tax expenditures could be justified but should be based on a clear analysis of costs and benefits. Developing such policy options for strategic and prudent management of individual tax expenditure items is a difficult task. The economic relevance of tax expenditures could be assessed against a small number of criteria. A first group of

criteria covers various facets of the microeconomic efficiency. The second group of criteria reflects the capacity to meet social or strategic objectives defined by the government with the best instruments, which are not necessarily tax expenditures. The last group of criteria relates to the efficient functioning of fiscal policy.

Based on these criteria, one could identify: i) possible risks attached to their use and ii) dimensions to watch so as to ensure the economic efficiency, alongside with arguments in favour of specific tax expenditure items. Such an evaluation will help limit the use of tax expenditures to cases where considerable market failures exist and where obvious administrative advantages over comparable spending programs can be identified (see Kalyva et al., 2014).

4.2.5. Recent analysis

Recent work provides an analysis of the effects of work related tax expenditures (Barrios et al., 2014) and on housing and pensions-related tax expenditures (Barrios et al., 2015), by analysing tax expenditures with EUROMOD microsimulation model. The model is based on EU-SILC data and harmonised for the EU-28.

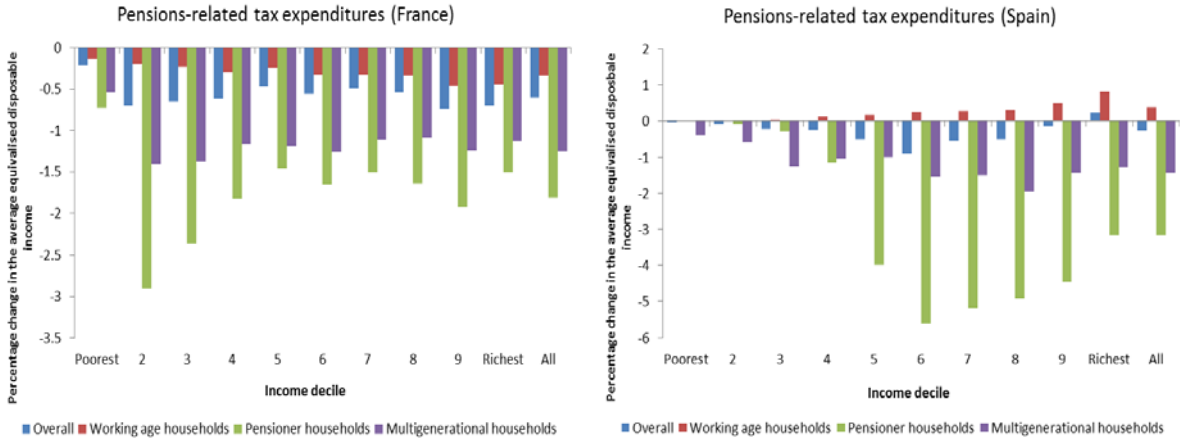
Graph 1: Budgetary impact of tax expenditures (in % of tax expenditures in baseline scenario, July 2013)



Note: For Spain the calculations do not yet reflect the wide-ranging measures that have been introduced in recent years to reduce tax expenditures. Source: Barrios et al., 2015

Quantification of the revenue impact and distributional effects has to be done by comparing the baseline scenario, of no tax expenditures, with the actual tax regimes currently in place in selected Member States. Graph 1 shows the budgetary effect of pensions-related (left-hand side) and housing-related (right-hand side) tax expenditures for several Member States.

Graph 2: Distributional effects of tax expenditures in selected EU Member States; three types of households: working age, pensioners, and multigenerational households



Source: Barrios et al., 2015

The work gives also an overview of the distributional effects by income decile of pensions-related and housing-related tax expenditures in France, Spain, Belgium and Italy. Graph 2 provides an overview of the distributional effect (by income decile) for France (left-hand side) and for Spain (right-hand side) of pensions-related tax expenditures. In brief, pensions-related tax expenditures are found to tend to be regressive. Removing tax expenditures would reduce tax revenue in some country cases as a result of currently negative tax expenditures arising to the pension contributions being partially deductible from taxable income in the current tax system and becoming fully deductible after the removal of tax expenditures in the benchmark scenario (lower taxable income). For France the effect of removing pensions-related tax expenditures on disposable income is strongest for pensioners in the second and third –lowest income deciles of the distribution. This indicates the strong redistributive nature of pensions-related tax expenditures. For Spain the removal of tax expenditures would affect in particular the disposable income of pensioners in middle and top income deciles. Pensions-related tax expenditures tend to be regressive.

4.2.6. Conclusions

A careful assessment of the efficiency of tax expenditures requires identifying different policy areas and examining how tax expenditures could – or not – help meet given economic and policy objectives in these areas. While some well-designed expenditures can enhance positive spill-overs and welfare, it is important to ensure that tax expenditures do not cause economic distortions and that they are the most cost-efficient means of achieving economic and social policy goals. Such an assessment will help the efficient application of tax expenditures to cases where considerable market failures exist and where administrative advantages over comparable spending programs can be identified. Overall there is a need to create a culture of evaluation and transparency, which may help address political economy aspects.

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4.3 TAX TRANSPARENCY AND TAX CO-ORDINATION: A NEW ERA FOR TAX REFORMS IN A GLOBALISED WORLD

by Michael Devereux*

The international corporate tax system is in need of a fundamental reform. The compromise for the allocation of profit between countries, first agreed in the 1920s, is not suitable for taxing modern multinational companies as it attempts to tax similar forms of income in different ways and in different places. As a consequence, it is open to manipulation by companies seeking to reduce their worldwide tax liabilities. In addition, the system incentivises tax competition between governments, which over time has led to reductions in both tax rates and bases.

Currently, there are a number of ongoing initiatives by the European Commission and the OECD to tackle those issues. However, the majority of the proposed measures do not target the fundamental problems. A stable international system must remove the incentives for governments to undermine it. If governments reach an agreement to preserve the basics of the existing system, while tightening anti-avoidance rules, there will still be an incentive for future governments to undermine that system, as their predecessors have done in the past.

4.3.1 Problems of the international corporate tax system

When commercial activity moves beyond a purely domestic setting, many countries can potentially claim jurisdiction to tax the income. In principle this could lead to multiple taxation of income. To prevent this, the League of Nations and its successors the United Nations and the OECD developed a series of model treaties on which the majority of bilateral double tax treaties are based. The treaties are in principle a compromise between source and residence taxation.

In general, the residence country is the country where a person who has the right to receive the profits of an activity resides, while the source country is the country where the economic activity takes place. Source countries are allocated primary taxing rights to the active income of the business, and residence countries the primary taxing rights to passive income, such as dividends, royalties and interest. These principles are reflected in the OECD Model Treaty. Article 7 of the Treaty allocates the right to tax business profits to the country of source if the 'permanent establishment' threshold is met; whilst articles 10, 11 and 12 allocate the right to tax dividends, interest and royalties to the recipient's country of residence, subject to the source country's circumscribed right to impose a withholding tax on dividends and interest.

Moreover, taxation of transfers are governed by the 'arm's length principle'³⁰. Under this principle, affiliated entities of multinational companies are treated as if they were unrelated, independent entities. This implies that intra-group prices should be equal to prices charged by independent parties.

These principles of international corporate taxation lead to three main issues:

- Source vs residence country: the distinction between source and residence dates back to the 1920s, but is now applied to affiliates of multinational companies. The question is whether residence taxation is a good way to tax e.g. royalty income. According to the OECD and the European Commission, it is not if there is no activity of economic substance in the residence country. The basic principles of international corporate taxation should therefore be revisited.
- Active vs passive income: the distinction between active and passive income may no longer be reasonable if it is easy for companies to manipulate different forms of income. For example, a different tax treatment of corporate debt and equity incentivises tax planning. One may question whether there is any good reason to treat them differently. The OECD proposal in the Base Erosion and Profit Shifting (BEPS) project to

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³⁰ See OECD (2010) The Arm's Length principle <http://dx.doi.org/10.1787/tpg-2010-4-en>

restrict interest relief to a proportion of earnings may therefore not be an appropriate response. This proposal essentially seeks to close a loophole rather than to re-examine the fundamental source of the problem.

- Treating affiliated entities as independent: the principle of treating affiliates of a multinational as independent may no longer be appropriate, as it gives rise to several issues. For example, is it possible to allocate risk between affiliates? Risk is often an influential factor in establishing the price between unrelated companies. In the case of a subsidiary engaging a parent company, risk will not be borne by the subsidiary. Ultimately risk is borne by the shareholders of the company, as risk cannot be passed on or shared with subsidiaries. Moreover, can a tax haven affiliate really finance activity elsewhere under a Cost Contribution Agreement³¹ (CCA). CCAs are required to be consistent with the arm's length principle. The problem is that even compliant CCAs provide a relatively simple mechanism to shift profits amongst affiliates.

4.3.2 Main reforms and reform proposals

4.3.2.1 European Commission

In June 2015, the European Commission adopted an Action Plan for a Fair and Efficient Corporate Tax System in the European Union³². The Action Plan sets out to reform the corporate tax framework in the EU, in order to tackle tax abuse, ensure sustainable revenues and support a better business environment in the Single Market. The European Commission has identified five key areas for action: (1) re-launching the Common Consolidated Corporate Tax Base (CCCTB)³³, (2) ensuring fair taxation where profits are generated, (3) creating a better business environment, (4) increasing transparency and (5) improving EU coordination.

The CCCTB would completely replace the existing system within the EU. It includes a single tax base for any company, a single calculation for EU wide profit and revenues allocated to countries by a formula based on location of capital, employment and sales. Under the CCCTB, each country can still tax its share at its own rate. Such a system would require an EU wide agreement on the principles. In general, it is harder to achieve an agreement on these elements than on increased transparency with exchange of information between countries.

4.3.2.2 OECD

The OECD BEPS Project is a two year programme intending to curb tax avoidance by multinational enterprises. It was completed in October 2015, containing 15 action points covering many aspects of international tax planning. In general, the BEPS Project essentially aims to close 'loopholes' in the existing corporate income tax system rather than re-examine the fundamental structure of the system. Although the BEPS Project does not change the current allocation of taxing rights, to some extent it departs from it. This is done by adding a qualification to the current allocation rules where abuse is perceived, requiring 'substantial activity' for any preferential regime. However, it is not completely clear what 'economic substance' is. If 'economic substance' is meant as a new and additional principle, it is not clear how it relates to existing basic principles of taxation of income derived from multinationals. If it is not meant as a new principle and if taxing rights are aligned and linked only to 'economic substance' in some cases but not in others, it could create further distortions or opportunities for tax planning.

4.3.3 Transparency

In March 2015, the European Commission launched a Tax Transparency Package, including a number of initiatives to advance the tax transparency agenda in the EU, such as (1) introducing the automatic exchange of

³¹ The OECD's Transfer Pricing Guidelines define a CCA as "a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights."

³² http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/fairer_corporate_taxation/com_2015_302_en.pdf

³³ See http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm

information between Member States on their tax rulings, (2) assessing possible new transparency requirements for multinationals, (3) reviewing the Code of Conduct on business taxation, (4) quantifying the scale of tax evasion and avoidance and (5) repealing the savings directive.

4.3.3.1 Transparency on tax rulings

In 2014, the European Commission investigated a possible infringement of state aid rules in several Member States, including Ireland, the Netherlands and Luxembourg. In that same year, information about 548 Luxembourg rulings leaked ('Luxleaks'), some of which resulted in very low effective tax rates. As a reaction, EU Member States unanimously agreed on an automatic exchange of information on cross-border tax rulings on October 6 2015.

An exchange of tax rulings will provide information to tax authorities in other Member States and to the European Commission. This may identify areas of concern and bring forth audits. Moreover, it may identify possible infringement of state aid rules. However, there are limits to the action the recipient tax authority can take to possible infringement as measures must be compatible with EU law. For example, Controlled Foreign Corporation (CFC) rules can only be applied if the arrangement in another Member State is 'wholly artificial' (Cadbury case). A revision of the Parent Subsidiary Directive would be required to make it easier to tax a dividend received from an EU affiliate that pays little tax.

4.3.3.2 Further corporate tax transparency

In September 2015, the European Commission concluded a public consultation on further corporate tax transparency, with the aim to "move to a system on the basis of which the country where a business' profits are generated is also the country of taxation". The suggested tax transparency measures would expose enterprises "to more intense scrutiny on the part of the authorities or different stakeholders", although it is questionable whether this would contribute to reaching the overall objective. In this context, the consultation suggests implementing OECD Action Plan 13 at EU level, i.e. introducing country-by-country reporting. This implies that companies will need to disclose basic information on revenues, profit, employees, tax and other factors on a consistent basis across countries.

In general, it is unclear what the value of country-by-country reporting will be. If the information is disclosed only to tax authorities, it is uncertain whether it can really contribute to profits being taxed in the country where they are generated. If the information is also disclosed to the general public, it would be useful in statistical work, for example in identifying the scale of BEPS. However, it would not be very useful in identifying whether a specific country has paid the right amount of tax.

Increased transparency would make companies an easier target for governments, the European Commission, the OECD and NGOs. However, transparency will not address the fundamental problems of the international corporate tax system. It may help to combat avoidance within the participating countries, but it would not change the incentive for shifting profits to countries outside the EU.

4.3.4 Co-ordination vs competition

Tax competition between governments typically aims at attracting real economic activity, benefitting domestic companies, and increasing tax revenue. Such competition – especially the first two elements – has resulted in falling tax rates over time. However, tax competition has gradually taken other forms, such as the introduction of patent boxes and limitations to anti-avoidance rules.

In 2010, the UK government announced a Corporate Tax Roadmap, explaining how the government planned to make the UK corporate tax system more competitive. Since then, the corporate income tax rate has been reduced from 28% to 20%, and is to be further reduced to 18% by 1 April 2020. The UK government introduced a patent box with a 10% tax rate for profits from development and exploitation of patents. In addition, there have been changes in the design and generosity of both the UK's R&D relief schemes and the CFC rules. Moreover, the

UK has introduced a generous treatment of interest deductibility and introduced a Diverted Profits Tax. All of these reforms may be seen as forms of tax competition, with the UK governments' objective to make the UK an attractive place for companies to locate their headquarters and to provide domestic companies with a competitive advantage.

Although rarely defined, harmful tax competition is usually thought of as special treatment of specific groups of taxpayers and can upset 'the level playing field' for competition between countries. In general, all forms of tax competition aim to benefit one country at the expense of others, in terms of revenue, investment etc. The taxpayer might benefit from such competition between countries, but society overall will be the loser.

4.3.5 Conclusion

The international tax system can only be stable in the long run if there is no incentive for countries to compete with, and thus, impose externalities on others. Competition over rates or other factors that affect the location of activity, profit or revenue will affect other countries. Problems arise because governments try to tax income on locations where it is most mobile, and fungible. In principle governments should attempt to levy taxes on less mobile income and activities. This suggests basing taxation on the residence of, or consumption by, individuals.

In general, it will be easier to reach an agreement between Member States when the possible costs are low. Thus, the OECD and the European Commission focus on transparency because the extent of losses for Member States will be low. A real reform of the tax system, such as the CCCTB and the Financial Transaction Tax proposals may generate significant gainers and losers amongst Member States, and will therefore be much more difficult to implement.

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5. CLOSING SESSION

5.1. KEYNOTE ADDRESS – POLITICAL ECONOMY OF TAX REFORMS

*by Pierre Moscovici**

Ladies and Gentlemen,

It is my pleasure to join you today and to contribute to your discussions on the political economy of tax reforms. As today's presentations and discussions have shown, tax reforms face a significant number of political obstacles, which require specific strategies to be overcome.

I would like to outline challenges governments are faced with in implementing tax reforms, to stress the importance of balancing efficiency and fairness considerations and also to underline the role the European Commission can play in helping Member States designing and implementing their reforms.

Challenges faced in implementing reforms

As part of a successful reform strategy, the potential political obstacles of planned tax measures should be assessed early on, alongside their economic and redistributive features. Therefore, I am pleased to see that leading tax economists focus exactly on the political economy dimension of tax reforms in today's discussion.

As you know I was Finance Minister of France for two years when the fiscal system of my country was substantially modified. As a matter of fact I know pretty well the gap between tax reform on paper and tax reform in real life.

I believe that the following aspects are important in this context:

Given the limited amount of political capital, governments are often not able to implement all those reforms that might be considered ideal or desirable from an economic perspective, and they must invest their capital wisely.

Along the same line, governments need to consider whether a 'big bang' or a step-wise implementation of reforms would be the best strategy. I am aware that there are many arguments in favour of packaging reforms. In practice, however, when such a 'big bang' seems unfeasible, sequencing initiatives can help to build support and address the concerns of those most affected by the different measures. This is to a large extent, by the way, the strategy that was adopted in France when I was Minister of Finance.

Sometimes, the aim of increased efficiency may be in opposition to what is politically feasible. The most desirable economic feature of a reform may not be the one that can be implemented easily from a political point of view.

I am convinced that it is important to hold on to the reforms taken and to ensure that they are not reversed. Even if one may not agree 100% with reforms undertaken by one's predecessors, credibility, predictability, and continuity of policy are crucial for a country's investment climate and confidence. This argument is particularly valid in the area of taxation.

Balancing efficiency and fairness

Let me turn to a point that I consider to be very important:

As already expressed, to successfully implement tax reforms, governments need to seek a balance between efficiency, fairness and political feasibility.

* Pierre Moscovici is EU Commissioner for Economic and Financial affairs, Taxation and Customs.

Efficiency is sometimes at odds with the desire for greater fairness. Whereas efficiency calls for a neutral tax system, equity may call for more redistributive elements in the tax system or for specific instruments to address the needs of vulnerable groups.

Take the example of a tax shift from labour to consumption. Such tax shifts can under some circumstances be shown to be beneficial for growth and employment and for society as a whole.

Tax shifts can – from the start – be targeted at low-income earners or low-skilled unemployed. As Minister for the Economy and Finance in France from 2012 to 2014, I was confronted with the crucial challenge of increasing employment, in particular of low-skilled workers. With the Ayrault government, we introduced the credit d'impôt compétitivité emploi – CICE, which became a key measure of the pacte de compétitivité. This corporate tax credit aimed to significantly reduce the cost of low-skilled labour, as it is calculated on the payroll of low-income earners. While this measure was partially financed by an increase of consumption taxes, it was from the beginning focused on the least well-off, balancing efficiency and fairness considerations.

Last: one important point I am sure you are very familiar with: the importance of data and simulation. It is fine to think theoretically on how to target reforms, but if you do not know who is going to be affected by a cut or a hike, you do tax reform under high uncertainty of the results – and political economy is vain. The government I was part of had some experience of that.

Precise knowledge is key. So stage one of tax reform is to give access to (anonymous) data to academics and experts so that they can compete in designing smart tax reforms well in advance.

As Finance Minister I modified the Tax Code to enable academics to work on tax data and France has now an open-licence online simulation engine able to perfectly simulate all components of our tax and benefits system – Openfisca.fr.

Now what is the role of the Commission in national tax reforms?

As Commissioner for Economic and Financial Affairs, Taxation and Customs, I have a different perspective on the tax reform efforts by Member States. Our analysis shows that several Member States ensured stable public finances and boosted growth by changing their tax structures and improving the efficiency of their systems.

What we see as well is that measures taken by Member States, for example when reducing labour taxation, often go in the right direction but are of limited ambition, given the size of the challenge faced.

In recent years, the Commission has actively supported Member States in the area of taxation, while recognising their competence for national tax policy.

We use several channels to do so:

The European Semester, the cycle of economic policy coordination leading to country-specific recommendations, is the most prominent one. Based on in-depth analysis, we identify which reforms could best help Member States boost growth, increase employment and achieve sustainable public finances. Tax reforms naturally have an important role to play. But again, with taxes, the devil lies in the details – and the details are for national governments to decide.

To focus attention on the most important reforms and to invest in them political capital, recommendations have been streamlined.

Another way in which the Commission supports tax reforms is through its ongoing dialogues with Member States, which includes the ECOFIN Council, where Finance Ministers meet on a regular basis. This dialogue allows Member States to share best practices among themselves and helps to identify 'do's' and 'don'ts'.

A good example is the area of labour taxation. The European Commission recommended that the Eurogroup organises thematic discussions on structural reforms with potentially large spillovers between Member States.

The Eurogroup has discussed the issue of labour taxation several times, establishing it as a reform priority, agreeing to common reform principles, and setting a benchmark to track progress.

But where our added value is the most important is probably in helping member states regain tax sovereignty in fighting efficiently against evasion and avoidance.

An EU dimension to tax policy

Clearly some tax policy challenges are more difficult for Member States to address in isolation. Think of tax evasion and tax avoidance. Uncoordinated national measures are being exploited by some companies to escape taxation in the EU, leading to significant revenue loss for Member States and a heavier tax burden for citizens.

The OECD has sought to address this issue through the Base Erosion and Profit Shifting project. But EU action is needed, in addition to action at global level, as the EU has unique characteristics, such as the Treaty Freedoms and an internal market with 28 different tax systems. This means we have our own priorities and objectives that need to be considered.

The crisis gave momentum for reforms at EU level, which would not have been possible before. Who would have thought that Member States would agree to exchange information on savings?

In June 2015, the Commission adopted the communication "A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action". The initiatives included in the Action Plan aim at tackling tax avoidance while securing sustainable revenues for Member States and strengthening the Single Market. While taking into account the necessity to reinforce the efficiency of the tax environment for businesses in the internal market, the key objective of this Action Plan is to ensure that companies are taxed where their profits are generated and cannot avoid paying their fair share of tax through aggressive tax planning.

The plan identifies five key areas for action: re-launching the Common Consolidated Corporate Tax Base initiative (or CCCTB), ensuring fair taxation where profits are generated, creating a better business environment, increasing transparency, and improving EU coordination.

Key to the action plan is the re-launch of the CCCTB, which would harmonise the tax base for multinationals operating across borders in the EU and – as a second step - allow businesses to consolidate their taxable profits across Member States. The CCCTB is a key building block in the agenda for fairness, transparency and a truly single fiscal market I mentioned earlier. It would make the internal market more competitive, as business would need to comply with just one set of tax rules and would allow them to offset profits in one Member State with losses in others. But it would also limit the opportunities for these companies to manipulate their tax position, thereby providing a holistic approach to combatting evasion within the EU.

Conclusions

Ladies and gentlemen, distinguished guests,

Today's presentations and discussions highlighted the political obstacles that tax reforms face and the specific strategies that can be used to overcome those obstacles. What is needed now is a large measure of political will – indeed political courage – to make tax reforms happen.

Thank you.

5.2. CLOSING PANEL DISCUSSION

Chair: *Lucio Pench (DG ECFIN)*

Panel: Andreas Strub (Council of the EU, GSC³⁴), Valère Moutarlier, Paola Profeta, Michael Devereux and Thomas Neubig

The panel discussion was opened by Lucio Pench, who highlighted that the workshop tackled the political economy of tax reforms from different perspectives. The panellists offered further elements for reflection, presenting, among other interventions, both the Council's and the Commission's perspective on EU-wide initiatives in the area of taxation.

In the Council, discussions about the revenue side of budgets have gained in importance in the context of the large consolidation needs after the crisis. This has resulted in a sort of 'renaissance' for tax policy discussions at the EU level. The way to approach tax issues has changed. In the past, putting in place legislation preventing double taxation was a key priority. In recent years, the question how to avoid double non-taxation has become equally important. The low taxation of some multinationals has attracted public interest and the question was raised how best to ensure that 'all pay their fair share of taxes'. Some concrete achievements by the Council in meeting these challenges could be made during the Italian and Luxembourg Presidency: The Parent-subsidiary directive has been revised and a directive allowing for automatic exchange of rulings has been adopted. Given the Treaty requirement to reach unanimity in the Council to adopt EU legislation in the tax area, 'Tax Coordination' (i.e. informal cooperation between Member States in the Council, without legislation) has continued to be an important avenue for making progress. An example in this field is the work carried out by the Council Code of Conduct Working Party. It allows for a collective examination at EU level of potentially harmful tax measures in the area of business taxation. Discussions on the proposal for a Financial Transaction Tax have also brought about some novelties in dealing with tax issues in the Council. Once this tax would be adopted, it would apply to a smaller group of EU Member States, willing to introduce such a tax ('enhanced cooperation' procedure). Another novelty is that this proposal has been put forward as a direct response to the challenges arising from the financial crisis. There also seems to be a clear trend towards moving from a 'dialogue' on taxation between the EU level and Member States, to a broader and more comprehensive 'trialogue' involving third countries and actors (such as the OECD, G20). All in all, it is likely that fairness and tax competition will remain politically important themes for the Council in the years to come. The EU will have the opportunity to use a variety of instruments at its disposal to meet expectations: further EU tax legislation, informal tax coordination in the Council and consolidating cooperation with third countries and actors on tax related matters.

Against this background, the importance of seizing the momentum was underlined for the success of the Commission agenda. This implies that pan-EU initiatives are likely to be put on the table while other tax reforms are being implemented at the national level. In this respect, benefitting from the reform momentum, they might be more likely to succeed in the negotiations at the political level. The need for momentum must anyway be balanced with other considerations on the timeliness of reforms, particularly when it comes to short versus long term objectives. In practice, political feasibility would suggest that a gradual approach might be preferable than implementing fundamental tax reforms in one go. A clear example is the C(C)CTB, which, while requiring a long preparatory process, has recently accelerated after a step-by-step approach has been decided. This proposal is also emblematic of the Commission's approach in the field of taxation, which is (and more and more needs to be) informed by evidence of what is needed as policy action, rather than motivated by the ex-ante judgements on the likelihood of success of potential proposals.

The linkages between the national and the international aspects were also discussed. In this respect, the clear presence of common trends was highlighted when it comes to increased activism in implementing tax reform. Basically everywhere policy action has been taken having regard to the efficiency and equity aspects of the reforms, and clearly accounting for the well-known political constraints. While this appears to be common to many Member States, there are however also country-specific factors which possibly involve also different

³⁴ Contributing in his personal capacity.

levels of government. Each of these possible stages raises its own political economy issues. On one hand, soft recommendations and binding legislative initiatives at the EU level provide both incentives and constraints on national governments to take action, not only in the domain of taxation (an example is pension systems). On the other hand, at the local level there might be more policy 'experiments' on different types of taxes, in order also to circumvent status quo bias in reforms. All in all, this depicts a situation where common and diverging trends in reforms coexist at different levels of government. An important aspect is also linked to the learning opportunities that a period where so many tax reforms are taking place offers to countries, which might ultimately lead to the establishment of commonly recognised best practices.

A final important point which emerged in the discussion with the audience concerns the availability of information for empirical policy analysis. This is essential not only to gain support from the public opinion on policy initiatives, but also for the adequate knowledge of rapidly evolving phenomena, particularly in the field of international tax issues. It was agreed that the willingness of governments to provide under strict confidentiality rules access to certain taxpayer information to qualified academics for purposes of tax policy and tax administration research is a promising first step in this area. This was one of the recommendations in the OECD-G20 BEPS Action 11 report. Ultimately, insights from objective empirical analysis of reliable data are a prerequisite for effective policy action.



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"Political economy of tax reforms"

- 08:30-09:00** **Registration and welcome coffee**
- 09:00-09:10 **Introduction** – *Servaas Deroose (DG ECFIN)**
- 09:10-09:30 **Kick-off presentation – Challenges for tax reforms in EU Member States:** main lessons from the 2015 "Tax Reforms Report" - *Florian Wöhlbier (DG ECFIN)*
- 09:30-12:45** **Session I – Obstacles and strategies for tax reforms**
Chair: *Lucio Pench (DG ECFIN)*
- 09:30-10:00 **Political economy of taxation: needs and drivers for tax reforms** - *Ian Preston (University College London)*
- 10:00-10:30 **Making fundamental tax reforms happen** – *Bert Brys (OECD)*
- 10:30-11:00 ☕ Coffee break
- 11:00-11:30 **Political support for tax reforms in Italy** – *Paola Profeta (Bocconi University)*
- 11:30-12:00 **Political challenges to reform taxation in Greece** – *Nikolaos Tatsos (Panteion University Athens)*
- 12:00-12:45 **General discussion** – *introductory comments by Karel Lannoo (Centre for European Policy Studies)*
- 12:45-14:00** 🍽️ **Lunch break**
- 14:00-15:40** **Session II – Focus on political economy dimensions of specific tax areas**
Chair: *Valère Moutarlier (DG TAXUD)*
- 14:00-14:30 **Resistance to reforming property taxes** – *André Masson (Paris School of Economics)*
- 14:30-14:50 **Political economy of tax expenditures** – *Athena Kalyva (DG ECFIN)*
- 14:50-15:20 **Tax transparency and tax co-ordination: a new era for tax reforms in a globalised world** – *Michael Devereux (University of Oxford)*
- 15:20-15:40 Discussant: *Thomas Neubig (OECD)*
- 15:40-16:00** ☕ Coffee break
- 16:00-17:00** **Closing session**
Chair: *Lucio Pench (DG ECFIN)*
- 16:00-16:15 **Keynote address – Political economy of tax reforms** - *Pierre Moscovici (EU Commissioner, Economic and Financial affairs, Taxation and Customs)*
- 16:15-17:00 **Closing panel discussion**
Chair: *Lucio Pench (DG ECFIN)* – Panel: *Andreas Strub (Council of the European Union), Valère Moutarlier, Paola Profeta, Michael Devereux and Thomas Neubig*

* Replaced by Lucio Pench

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