**Increasing the employment and income of the bottom 50 percent, reducing inequality and generating growth**

**An Agenda for Tax Policy Reform**

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**Tax policy is in large part responsible for the low demand for labor, especially low-skill labor, in the developed world**. It also helps explain the stagnation and, in some countries like the US even significant decline, in the wages of low skill labor since the 1980s. It is behind rising income inequality across the OECD and emerging European economies, it goes a long way towards explaining the stagnation in aggregate demand and, in particular, in private consumption, that is at the core of the Great Recession. Shortcomings in tax policy also help explain insufficient public investment in many developing countries and rising income inequality in most countries in East Asia and, until recently, in Latin America. Conversely, tax policy is also at the heart of the solution of these critical developments –jointly with the need to dramatically accelerate our investment in education, especially of the bottom 50 percent of the population, and in R&D.

Over the past three decades, there has been a secular decrease in the demand for and returns to low-skill labor in the developed world jointly with an increase in profits and, in some cases, in the returns to highly skilled labor. This trend is reflected, for instance, in the decline in real wages for blue collar workers in the United States and the increase in unemployment among these workers in Europe. This trend is due to a combination of four factors: a shift toward technology substituting for low-skill labor and complementary to highly skilled labor, an expansion in trade with unskilled-labor abundant countries, the rapid increase in the immigration of low-skill labor to the developed world and the changing role of tax policy. In fact, the changing role of tax policy also helps explain some of the other factors, especially the change in technology.

**1. The shift away from income taxes –personal, especially of capital gains, and corporate—and towards consumption taxation diminishes the equity of the tax system and depresses consumption**. In the OECD, income taxes are the most important source of income re-distribution. Since the 1980s, however, rates for taxing personal and corporate income have become increasingly low and flat, eroding the progressivity of the tax. In addition, the rates for taxing capital gains –the income source of the wealthiest-- have been dramatically reduced. Currently, the rate for taxing capital income can be half the rate for taxing income from work. Simultaneously, VAT rates have escalated across the world to rates even above 20 percent with increasingly flat rates and a very broad base, hence affecting all consumption. The result is that the tax burden is largely borne by the working and middle classes. This trend is particularly acute in Latin America, where consumption taxes account for 60 percent of all tax revenues compared to 30 percent in Europe. Even in Europe, however, the share of household income paid through consumption taxes by the bottom income decile is three times as high as that paid by the top decile. Moreover, the endemic high rate of evasion of income taxation by small businesses and professionals means that taxes are mainly borne by salaried workers. The result of these changes in the tax system coupled with reductions in social assistance is the progressive erosion of the contribution of

fiscal policy to diminishing rising pre-tax-and-transfer income inequality. According to IMF estimates, from the mid-1980s to the mid-1990s, fiscal policy offset 73 percent of the 3 percentage point increase in pre-tax-and-transfer income inequality in the OECD while in the next decade this percentage had declined to 53 percent.

**Recommendations:**

**Equalize tax rates on personal income from work and from capital gains**

**Reduce consumption taxation and increase rates on personal and corporate income tax**

**2. Payroll taxes, which account for up to 40 percent of labor costs in the OECD, distort technological choice against labor and foster unemployment**. Payroll taxes are taxes on labor. As such, over time, they distort the choice of technology away from labor and in favor of labor-substituting capital. This is particularly the case when that labor is not very productive (because of receiving sub-par education) and relatively expensive while there are incentives for investing in capital such as accelerated depreciation allowances. Payroll taxes, often being single-rate, lack the progressivity of personal income taxation and, when capped at high income levels, can even be regressive. Moreover, payroll taxes are an important burden on entrepreneurs as, contrary to corporate income taxes, they need to be paid even when a business is making losses, fostering incentives to lay off workers. As such, the weight of payroll taxes, which constitute a particularly significant share of total labor costs for low-wage workers, is a critical reason for high unemployment rates in OECD countries. Finally, the artificial earmarking of payroll taxes to social security (or pension) benefits forces an arguably un-necessary and unfair debate on whether "social security (or the pension system) is fully-funded." Instead, social security, like military spending, could be funded from general budget sources based on social need and political preference.

**Recommendations:**

**Progressively eliminate payroll taxes and substitute with revenue from higher personal and corporate income taxation**

**Fund social security out of general budget resources**

**3. The tax system has not kept up with changes in the economy and overtaxes the manufacturing sector while under-taxing the financial and agricultural sectors**. In OECD countries, agriculture receives myriad forms of support, from tax advantages to direct subsidies. The financial sector, which has so greatly contributed to the outbreak of the Great Recession, is under-regulated and under-taxed (e.g. VAT is still not imposed on many financial transactions). This violation of the neutrality of the tax system places the manufacturing sector at a disadvantage. This is particularly harmful as the sector is most exposed to the pressures of global competition, including from increasingly competitive low-wage

countries. The combination of distortive labor taxation through payroll taxes with the over-taxation of manufacturing helps explain the excessive growth of the service sector –less exposed to the pressures of world trade— and the ongoing decline of labor intensive manufacturing in the OECD. Similarly, the favorable treatment of agriculture puts manufacturing at a competitive disadvantage in both developed and developing countries while subsidies in developed countries are particularly harmful to the economies of the developing world.

**Recommendations**

**Carry out a thorough review of the financial sector and ensure it is taxed on par with manufacturing**

**Continue reducing subsidies to the agricultural sector, especially in OECD countries**

**4. Despite their distortionary and de-stabilizing effect, short-term capital flows are not properly taxed**. Contrary to long-term capital flows, short-term capital flows are highly de-stabilizing as we are witnessing in the current crisis and can arguably be conceived of as a negative externality to the world economy. International cooperation should allow for the taxation of such cross-border short-term capital flows. This taxation would also generate much-needed resources.

**Recommendation**

**Introduce a Tobin tax on short-term capital flows**

**5. The banking system's costly bailouts are paid for by the average taxpayer**. The banking system is largely responsible for the Great Recession. In many countries, it has required enormous bailout packages whose bills are footed through our increasingly regressive tax systems despite the large benefits reeked by this sector over the years. There is no good reason why the public funds used for the bailouts should not be progressively paid back to the public Treasury. This would also go a long way towards restoring the legitimacy of fiscal policy in the eyes of the average citizen.

**Recommendation**

**The banking system should pay back public bailout funds progressively through a special tax on profits**

**6. Tax havens are a global hazard.** The existence of countries where income taxation is very low or non-existent threatens income tax receipts everywhere. The wealthiest people in the world take advantage of tax havens to avoid paying the taxes they owe to their home countries. This practice not only erodes the tax intake of governments, it is also a blow to the credibility of global tax practices undermining citizens' trust and voluntary compliance. The international community has so far tolerated this practice

through the weak regulation of tax havens including its current definition of a tax haven simply in terms of transparency requirements.

> **Recommendation**
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> **Include minimum income tax rates in the definition of tax haven and use OECD leverage on tax havens**

**7. Real estate property is often over-taxed**. Real estate taxes have been the mainstay of local taxation. However, in countries where they are set at high levels, like the US, they create important distortions. First, they weigh heavily on small and medium-sized businesses, depress the retail sector and favor outsourcing. Property taxes, jointly with the exemption of consumption taxation of e-sales in some countries like the US, help explain the crisis of retail in favor of e-commerce (e.g. the disappearance of bookstores and the takeover of Amazon). Second, when they fund essential services like education, they create high levels of inequality as rich local governments run excellent schools and poor local governments run poor schools. Third, they lead to economic segregation. High levels of property taxes mean that families of different income levels simply cannot co-exist in one area as the poor cannot afford the property taxes of the wealthier. This helps explain the high level of economic segregation in US cities.

> **Recommendation**
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> **Keep taxation on real estate at moderate levels**

8. **Wealth, especially financial wealth, is under-taxed**. Inequality is high and rising, increasingly undermining our market system and democratic institutions. The IMF estimates that, in the US, the share of market income captured by the richest 10 percent rose from 30 to 48 percent between 1980 and 2008 while the shares of the richest 1 percent increased from 8 to 18 percent and the share of the richest 0.1 percent increased fourfold, from 2.6 to 10.4 percent. A free market system delivers the best outcomes for a society when it ensures competition. Similarly, democracy delivers good governance for its citizens when economic and political power is not excessively concentrated. The rising concentration in wealth we have witnessed in the past few decades is increasingly leading to oligopolistic markets (whether it is in American farming or in the banking and energy sectors across the world). Industry concentration is mirrored in growing concentration of wealth in an increasingly smaller number of individuals whose greatest source of wealth are financial assets.

This concentration of economic wealth is beginning to impair media freedom (with the wealthiest controlling large communications networks) and influence policy choices through its clout on campaign financing, especially in the United States. Preserving the proper functioning of the free market system as well as of our democratic institutions requires ensuring the proper taxation of wealth and wealth

redistribution across generations. Despite the fact that financial assets are the main source of wealth of the richest, they are under-taxed. Nowadays, technology and cooperation across governments should allow for the proper taxation of financial wealth.

**Recommendations:**

**Expand taxation on financial wealth and enact progressive wealth taxation, especially on high-wealth individuals**

**Ensure adequately high levels of succession taxes**

9. **Environmental damage by natural resource extraction and manufacturing may not be sufficiently compensated by their tax payments**. Natural resource extraction –whether it is through mining or oil and gas extraction—is causing enormous damage to our planet. The same is true of environmental disasters such as oil spills and the damage caused by highly polluting industries. It is unclear that the current taxation system sufficiently compensates for these negative externalities by placing the burden of the clean up on the polluting or environment-damaging firms. Moreover, oil and mining firms operating in developing countries often use asymmetric information and weakness of governance structures in these countries to extract unfairly favorable deals for themselves short-changing natural-resource rich countries in the process and generating or consolidating state capture by local elites.

**Recommendations**

**Ensure environmental pollution taxation fully compensates for the negative externalities generated by economic activities**

**Supervise tax deals of OECD firms in developing countries to ensure fair revenue arrangements to supplement EITI**

10. **Service fees on education health and transportation have been increasing**. The degree of subsidization of public goods and government services generating important positive externalities has been decreasing and, as a result, fees to be paid by users have been increasing. This is the case for critical sectors like education, health and transport. Such services, in particular in the European Union, are considered crucial to the role of the state in the economy, underpinning universal and virtually free access to quality education and healthcare. In developing countries, access to education and health are arguably the most fundamental foundation of sustainable development and high user fees are a barrier to service access for the poor. Similarly, quality, widely available and affordable public transport is a hallmark of the role of the state in European economies and an important contribution to individual and social welfare anywhere in the world. Sufficient revenue-enhancement per the above recommendations should help reduce fees on these basic services thereby contributing to shifting the tax burden away from the working and middle classes.

**Recommendation**

**Keep education, health and transport fees as moderate as possible**

11. **Tax exemptions are a great source of revenue losses, inequity and governance problems**. Tax exemptions are, by definition, inequitable as they grant lower tax rates to one sector or one firm than another. In addition, they tend to benefit the wealthiest and more politically connected social groups. This alone justifies their elimination. However, as it tends to be the case with inequitable policies, they are also ineffective. Firm surveys have consistently shown that the overall investment climate jointly with political stability is the key determinant of investment decisions rather than tax exemptions. Despite this, governments keep on trying to attract investment through tax exemptions. Moreover, the system for granting tax exemptions is often far from transparent and highly questionable from a good governance perspective, especially in developing countries. Finally, a tax system with myriad tax incentives becomes impossible to administer properly, fosters tax avoidance and undermines the legitimacy of the tax system and of government as a whole. Governments would be well-served in keeping tax exemptions to a minimum and, wherever possible, enacting legislation outlawing them based on the premise that differential treatment of taxpayers violates the basic principle of equality before the law.

**Recommendations**:

**Reduce fiscal incentives to a minimum and consider outlawing them as violating the basic democratic right of equality before the law**

**Publish tax exemptions as an annex to the annual budget**

12. **E-commerce has developed recently and is not always properly taxed, causing unfair competition to the traditional trade sector**. For instance, small and medium-sized businesses in the retail sector are increasingly coming under pressure from the competition of large retailers and e-commerce firms. Small and medium-sized businesses are great contributors to the wellbeing of consumers. Whether they be family farms, small and medium-size manufacturing firms, retail stores, or non-chain restaurants, these businesses ensure product and outlet diversity and availability as well as providing a more humane and pleasant environment for the production and exchange of goods and services. They are also frequently producers of higher quality goods and services and essential to maintaining competition in the market system. Nevertheless, instead of being supported, they face the unfair competition emerging from the granting of tax incentives to large firms as well as the rising threat from e-commerce. E-commerce should be taxed at the same rate as any other economic transaction. Unfortunately, it is often not. In the US, for instance, e-sales across state borders are simply not taxed, placing non-e-commerce firms at a great competitive disadvantage.

**Recommendation**:

**Ensure e-commerce is taxed at the same rate as any other economic activity**

**13. Tax intake in most developing countries is insufficient to fund development needs.** In most developing countries, the combined impact of reduced trade taxes (especially import tariffs), declining income tax rates, growing tax exemptions, insufficient returns on natural resource exploitation, weak voluntary compliance and poor tax administration result in a sub-optimal tax effort. This critically impairs the state's capacity to fund the education, health care, physical infrastructure and social safety nets needed to engineer sustainable development. It also limits the capacity of the tax-and-transfer system to mitigate income inequality. In Latin America, a low and regressive tax effort means that the poor and middle classes pay a higher share of their income in taxes than rich households. One study estimates that, in Argentina, the the Gini coefficient is 7 points higher after than before taxes due to the regressive effect of the tax system. Moreover, a low tax effort arguably enhances donor dependence, fosters middle class opt-out of public services, and lowers a government's accountability to its citizens.

**Recommendation**:

**Increase the tax effort and the progressivity of the tax system in developing countries**

**14. The nature of fiscal adjustment is of great import to income inequality and economic growth.** According to IMF research, fiscal adjustment tends to increase income inequality because, by reducing output, it increases unemployment and leads to a declining wage share in GDP. The Fund also points out that the level and composition of tax and spending adjustments greatly affect income inequality—the more fiscal adjustment relies on increasing regressive taxes (such as consumption taxes) or on reductions in progressive spending (such as social assistance), the larger the impact on income inequality. Moreover, in the ongoing Great Recession, given its hallmark reduction in personal consumption caused by the ongoing decline in the income of the bottom half of the population, regressive fiscal adjustment further depresses aggregate demand and the capacity of the economy to grow out of its funk. In the current circumstances, raising progressive taxes such as top rates in corporate and personal income taxes, wealth, financial sector and financial transaction taxation and reducing consumption and payroll taxation would have a positive impact on employment, consumption and therefore economic growth.

**Recommendation:**

**Ensure that, on the tax policy side, fiscal adjustment is effected by increasing taxes on those who are under-taxed and have the greatest capacity to contribute**

**15. The enactment of many of the above policy changes would be greatly facilitated by international cooperation within the European Union and in the context of the OECD**.

| **Recommendations for the EU**: |
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| **Minimum floors for personal and corporate income and succession taxes** |
| **Coordinated taxation of financial assets, financial transactions and e-commerce** |
| **Strict limits on tax exemptions based on common market competition** |
| **Grant the EU a share of income taxation from member countries** |
| **Recommendations for the OECD:** |
| **Re-define and place concerted pressure tax havens** |
| **Introduce a Tobin tax on short-term capital flows** |