



# Tax Design for Inclusive Growth

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# “Tax policy to enhance equality while fostering growth”

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Aim of the workshop is to “Improve our understanding of how tax (and other) policies can be better designed to enhance equality while fostering growth”

1. “Tax design for inclusive growth” (OECD Taxation Working Paper, no. 26)

<http://www.oecd.org/ctp/tax-policy/tax-policy-working-papers.htm>

2. “Taxation of household savings” (forthcoming)

3. “Taxation and skills” (OECD Tax Policy Study, no. 24)

<http://www.oecd.org/tax/taxation-and-skills-9789264269385-en.htm>



## Channels through which tax policy affects inequality

### **Tax revenues finance expenditure which may reduce inequality**

- Most redistribution occurs through transfers

### **Taxes can reduce disposable income inequality**

- PIT progressivity is the key tool to narrow the distribution of disposable income

### **Taxes can reduce market income inequality**

- Taxes affect pre-tax opportunities and behaviours

### **The tax system can redistribute income across the lifecycle**

- Intra-personal as opposed to inter-personal redistribution, e.g. SSCs to finance future benefits



## “Tax policy to enhance equality while fostering growth”

- Equality in income or equality in wealth?
- Fostering “growth” or fostering “well-being”?
- “Equality” or “Horizontal Equity” and “Vertical Equity”?
- Differences in income as a result of **differences in effort or personal taste for leisure** are not necessarily undesirable (although tax systems ignore “effort”)
- Not only “**tax progressivity**” matters but also “**tax affordability**” (for both households and businesses)
- Narrow focus on “after-tax disposable income” versus focus on “**equality of opportunity**”
- “Inclusive Growth” puts emphasis on a more dynamic definition of equity, taking into account well-being over the life-cycle and across generations
- From a narrow country focus to the incorporation of country spill-over effects



# A systems approach to tax design for inclusive growth

## Design of individual taxes

### Tax system factors

- Tax administration and tax enforcement
- Tax remittance
- Behavioural responses to tax changes
- Tax planning and income shifting
- Tax incidence
- International tax rules

### Non-tax system factors

- Economic structure and challenges
- Interactions with benefit systems
- (Non-tax) drivers & characteristics of informality
- Social preferences for redistribution
- Existence of compensation mechanisms
- Time horizons

**Efficiency  
and equity  
implications  
of taxes**



## Examples of the “Tax Systems Approach”

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- Increasing top PIT rates may induce the self-employed to incorporate and earn capital instead of labour income
- Impact of introduction of mortgage interest relief differs from impact of the withdrawal of such tax relief (due to capitalisation in house prices)
- Distributional impact of recurrent taxes on immovable property depends on home ownership rates, distribution of housing values and whether the incidence of the tax lies on renters rather than owners.
- Reduced VAT rates for basic goods are poorly targeted but can be considered (only) if direct compensation of the poor is difficult
- Decreasing returns to tax rate reform (e.g. standard VAT rate increases)
- Progressivity should not be introduced on a tax-by-tax basis!
- Increase top PIT rates/ taxing super rich >< ensuring that remuneration of all workers increases
- Tax Admin capacity and enforcement possibilities are crucial – the move towards “Automatic Exchange of Financial Account Information for Tax Purposes” between tax administrations could be a tax policy game changer



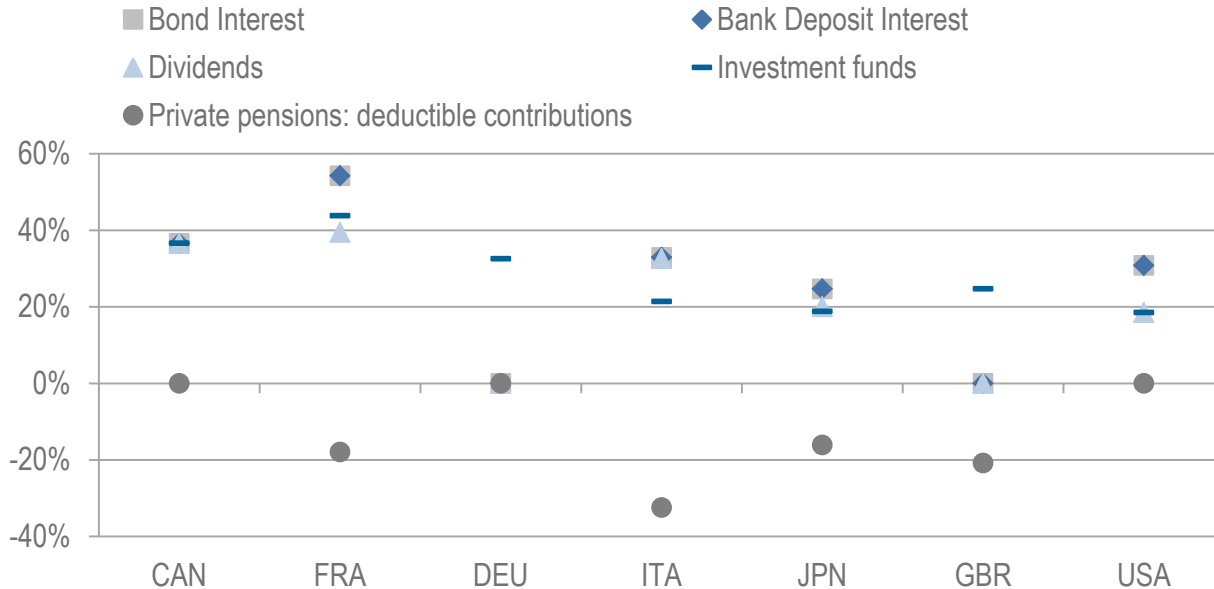
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# Taxation of household savings



# Strengthening capital taxation

## Effective tax rates on savings by asset types



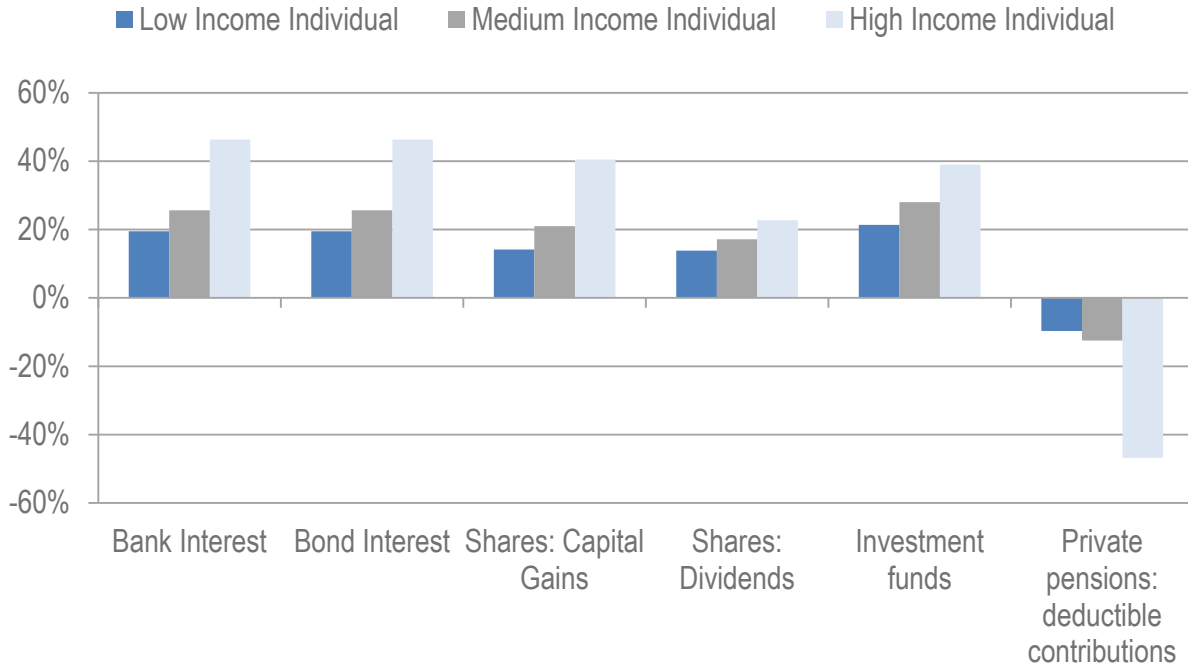
- Capital income is more likely to be earned by those on higher incomes.
- Taxing capital at higher rates can increase the overall progressivity of the tax system.
- Bank deposits that are a common form of savings vehicle for those with low incomes are comparatively heavily taxed.
- Private pension savings are often subsidised.





# Making capital taxation more progressive

Effective tax rates on savings by asset type and income level, G7 averages

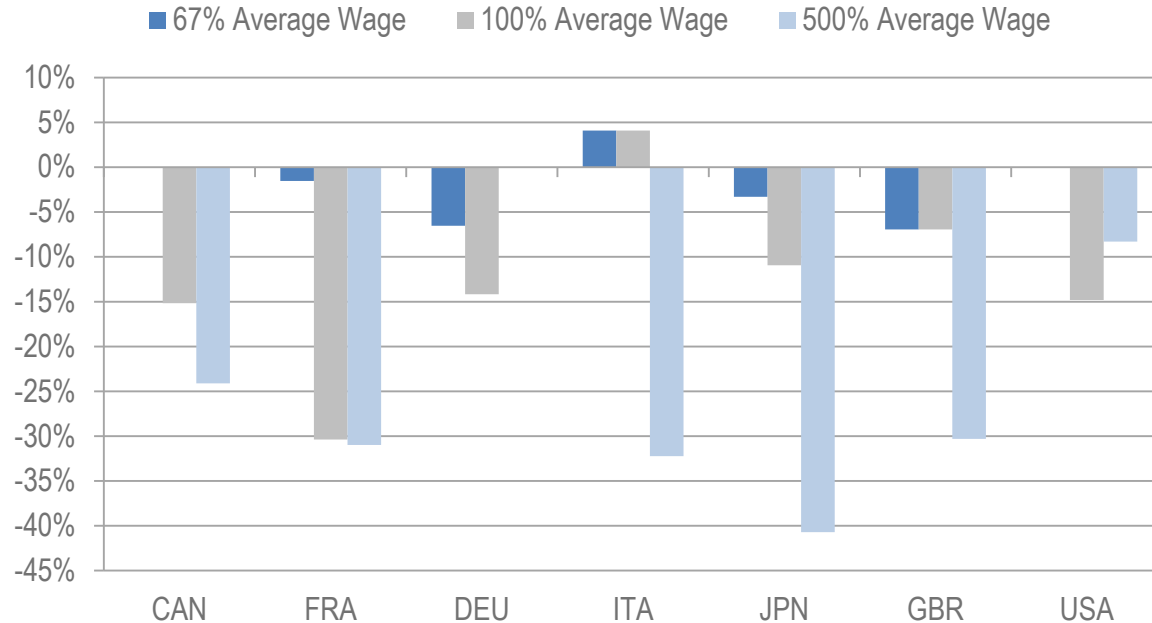


- The taxation of savings is broadly progressive, except for private pensions.
- Tax rates are nonetheless usually below those for labour income (though CIT is not included).



# Reforming regressive tax expenditures

## Effective tax rates on savings with tax-deductible private pension contributions

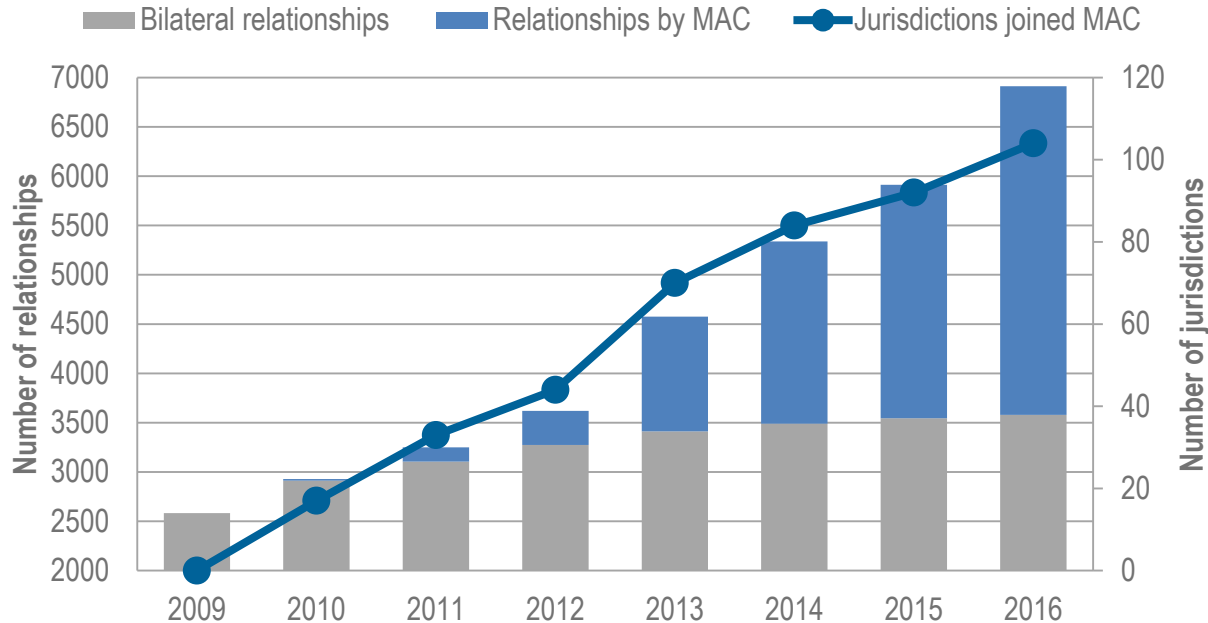


- Tax expenditures for pensions often result in ETRs that are negative, and regressive.
- Capping these provisions could be an inclusive growth oriented policy measure



# Expanding the exchange of information

## Bilateral Relationships and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MAC)



- EOI should reduce the extent to which individuals and companies are able to use offshore structures to avoid and evade tax.
- Needs a continued focus on the peer-review process and also the development of the network of EOI agreements



## AEOI allows countries to revisit the way they tax capital income at the individual level

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- Information exchange agreements will reduce opportunities for evasion of tax on capital income
- Trend towards lower statutory CIT rates, but EOI allows shifting the capital income tax burden from the corporate towards the individual level
- Rethink Savings Tax Expenditures
- Dual Progressive Income Tax
- Strengthening inheritance and gift taxes can support inclusive growth
- Use household wealth more effectively in income tax design (e.g. income and wealth testing of benefits)

OECD ongoing work on the Effective Taxation of Household Savings in all OECD member countries



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# Taxation and Skills



## Taxation, Skills and Market Income Inequality

- Investment in skills lowers market income inequality
- The tax system has an impact on the incentives to invest in skills
- Huge literature on **Tax** and physical capital but limited focus on **Human Capital**?
- Are we getting the mix right between physical and human capital?
- Are we over-subsidising physical capital through the tax system and under-subsidising human capital?
- Does it pay for students to invest in skills? What is the impact of age?
- What is the effect of tax progressivity, direct costs including tuition fees, scholarship income and skills tax expenditures on the financial incentives to invest in skills?
- How much of government spending on education and training is returned to the government in the form of future tax revenue?
- If the government decides to raise tuition fees, can it use the tax code to compensate workers' incentives to upskill?
- **OECD Tax Policy Study on "Taxation and Skills"** aims at starting this discussion.



# The tax system apportions the costs and returns of skills investments between governments and individuals

| Type of costs           | Government  | Student  |
|-------------------------|---|--|
| <b>Costs (Direct)</b>   | <ul style="list-style-type: none"><li>• Direct EDU Spending</li><li>• Scholarship Spending</li></ul>  | <ul style="list-style-type: none"><li>• Tuition Fees</li><li>• Books, Materials</li></ul>                  |
| <b>Costs (Indirect)</b> | <ul style="list-style-type: none"><li>• Foregone Tax Revenue</li><li>• Cost of Skills Tax Expenditures (STEs)</li><li>• Cost of student loans</li></ul> | <ul style="list-style-type: none"><li>• Foregone After-Tax Income</li><li>• Net of value of STEs</li></ul> |
| <b>Returns</b>          | <ul style="list-style-type: none"><li>• Higher Tax Receipts Post-Education</li></ul>  | <ul style="list-style-type: none"><li>• Higher After-Tax Income</li></ul>                                  |

**New indicators**

**returns to costs ratios**

**BEI – METR - AETR**



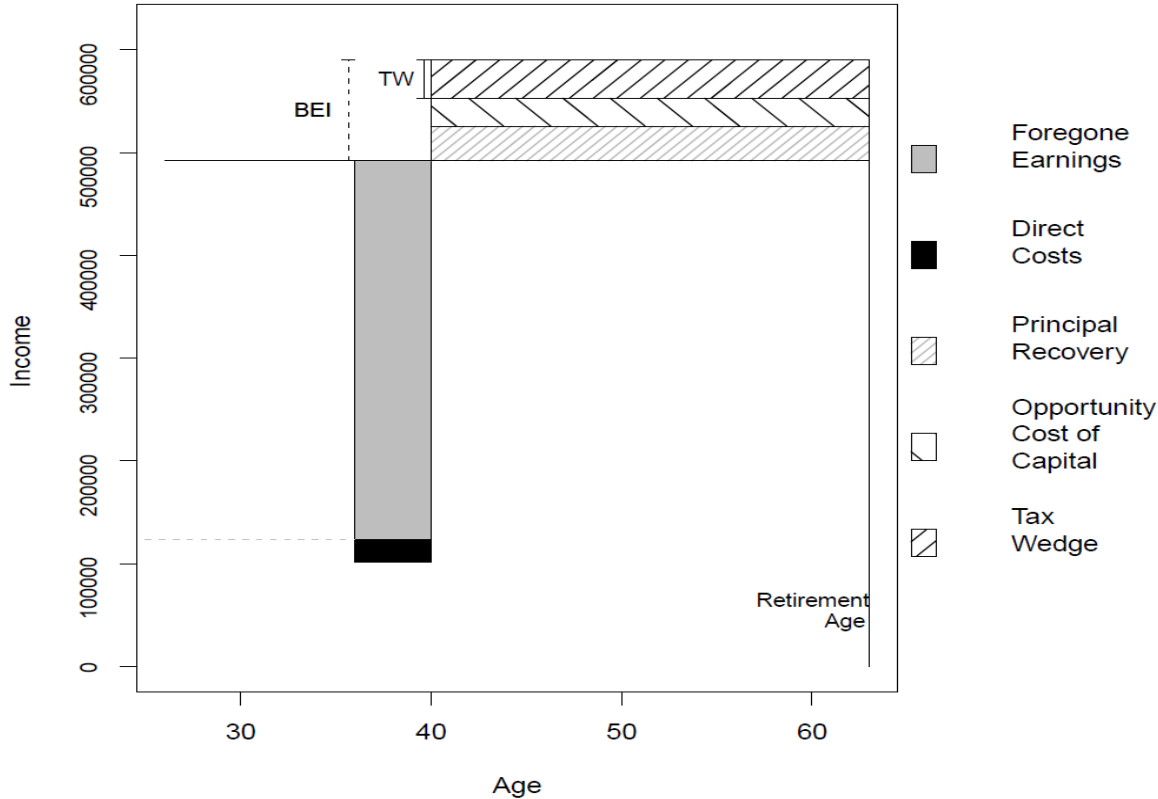
## Skills tax provisions in Taxing Wages

- Tax and skills provisions build into the OECD Taxing Wages models
- OECD data on costs of tuition and direct costs of education for government
- Use of actual average college premiums earned in labour market
- Debt (i.e. tax implications when students borrow) and equity -financed investment in skills
- Calculation of:
  - Break even earnings increment, METRs, AETRs (BEI = cost of human capital)
  - Marginal and average returns to costs Ratios (Tobin's Q)
- Different scenarios modelled: 17-year student who follows 4-year degree/ 32- year worker who follows a short training course/ 27 year worker who does a one-year master degree/ 50 year old worker who retrain during 1 year
- **King and Fullerton & Devereux and Griffith methods but for Human Capital**





# Break-Even Earnings Increment and METR on Skills

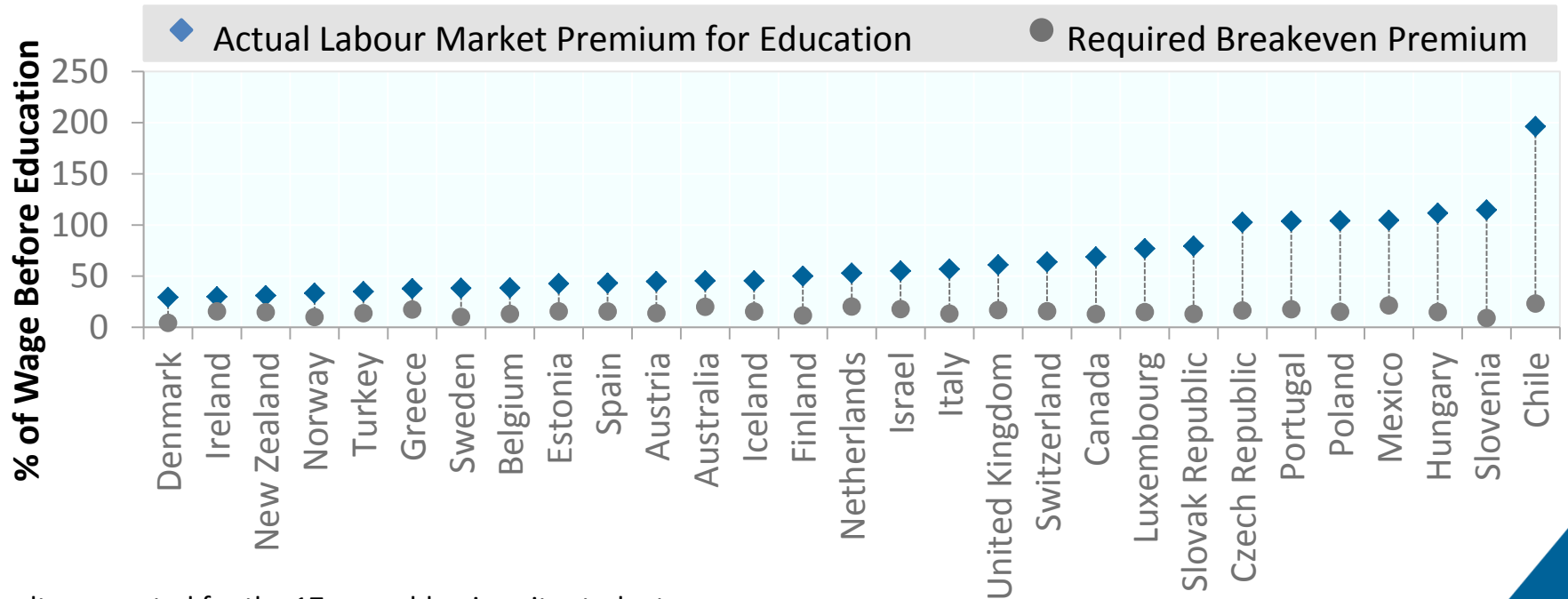


- “If a worker decides to get a Master’s degree, how much will she need to earn to recoup the costs?”
- “How much of the extra earnings needed to breakeven on a skills investment is because of taxation?”



# For a 17-year old student, education pays for itself

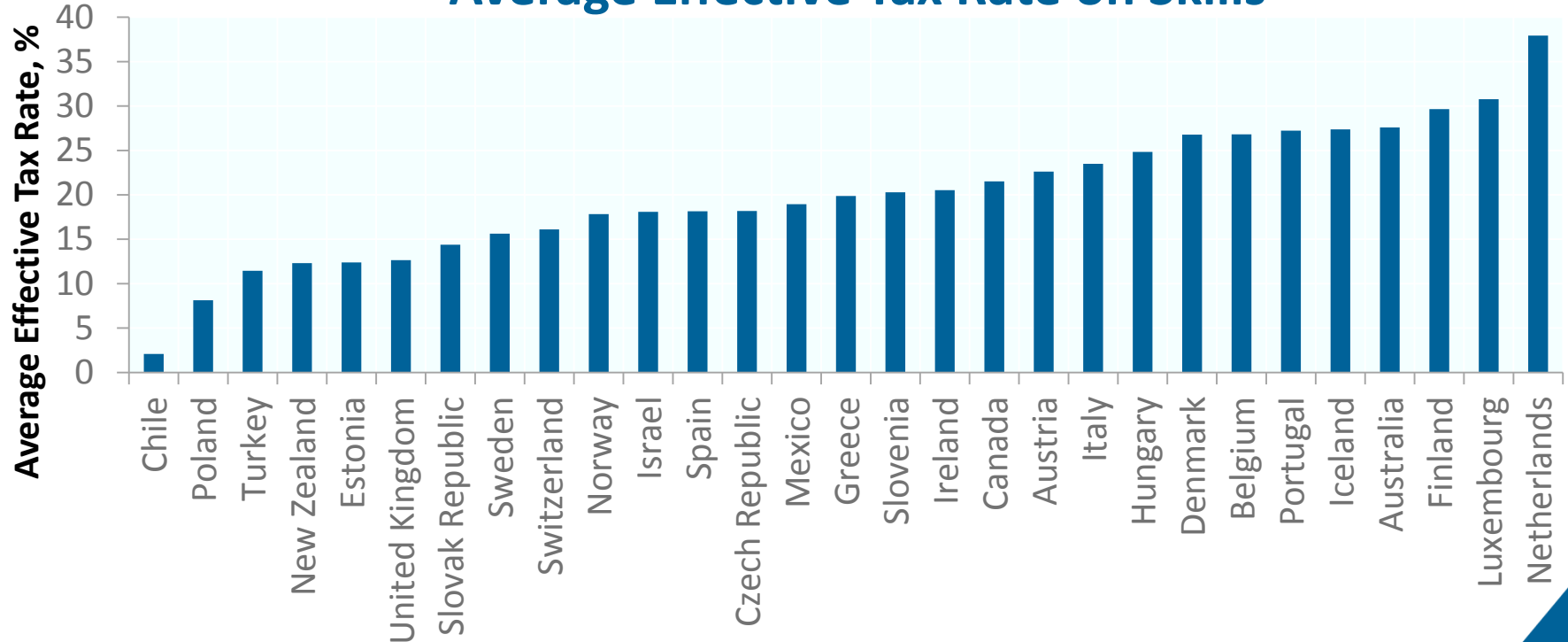
## Gap between actual return on investment and breakeven return





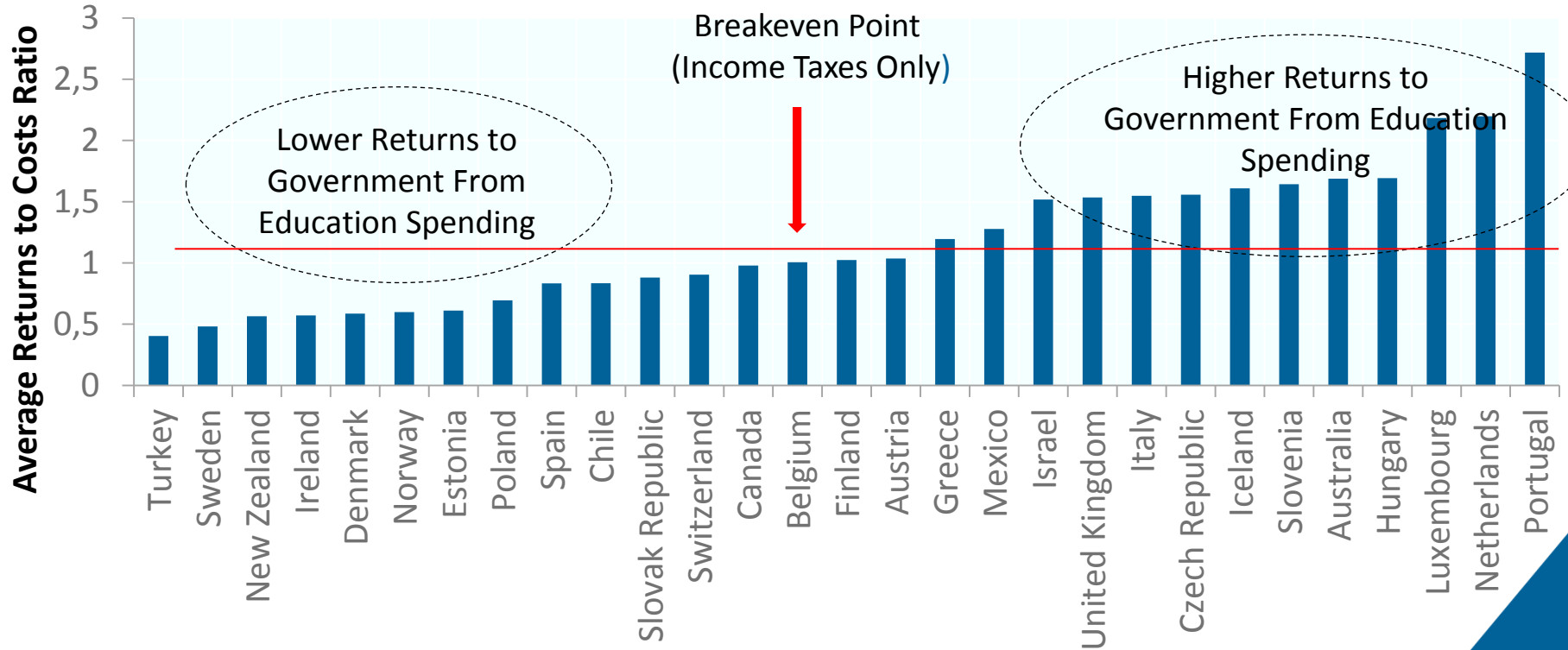
# AETRs on skills investments

## Average Effective Tax Rate on Skills





# Average Returns to Costs for governments





## Tax and Skills Policy Insights (I)

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- While progressivity taxes away the returns to skill investments, investment in skills pay a healthy return to the individual on average.....
- ....but not for students who earn a small return in the labour market
- There is a need to provide information to students on the financial returns to skills which they can expect in the labour market.....
- .....as Government is a stakeholder in the investment of skills, so it may want to ensure it earns a healthy return on its investment in skills as well
- Effect of tuition fees is small on incentives to invest in skills
- Tax support for skills is generally modest
- Tax support is often provided only for training related to the worker's current job (in an attempt not to subsidise skills spending as consumption)
- Skills Tax Expenditures (STEs) are often regressive: higher incomes gain more



## Tax and Skills Policy Insights (II)

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- Older workers face higher BEI which makes up-skilling less (or not) financially worthwhile
- Early retirement leads to lower incentives to skills which leads to early retirement
- Idem for other situations where labour market attachment is weak!
- Skills **Development** and Skills **Activation** are complementary
- Policies to reduce credit constraints and reduce market failures potentially most effective, e.g. training funds & accounts, and **income-contingent loans**
- Higher skills = higher productivity so you can support higher tax wedge on labour income
  - Higher tax wedge on labour is particularly challenging when skill levels are low
  - Impact globalisation
- Do not include firm training provisions as taxable income for PIT purposes



# Contact Details

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