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Tax design in Turkey and other middle income countries: lessons from the Mirrlees Review

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The report and this presentation

- The Mirrlees Review
  - What is it?
  - What are the key principles?
- The implications of the Review for Middle Income Countries
  - Features of middle income countries
  - Direct personal taxation
  - Indirect taxation
  - Corporation tax
  - Cross-cutting issues: efficient redistribution, and avoiding distortions
- A guide for further research?
  - Micro-simulation of the effects of policy changes
  - Responsiveness of individuals and firms to tax policy
  - The role of contributory social insurance systems

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The Mirrlees Review: what it is

- Comprehensive review of the entire tax system drawing on
  - New evidence and new applied theory
  - Changes in the economic environment and technology

- View the tax system as a whole
  - Savings and capital
  - Earnings and direct taxation
  - Indirect taxation
  - Corporate taxation

- For developed open economies, with focus on UK

- But principles and lessons applicable to middle income countries (like Turkey and many in Latin America) and transition countries (like Hungary)

The Mirrlees Review: the existing situation

- There is ample scope for improvement to make tax systems
  - Simpler
  - More equitable
  - Better for welfare, economic efficiency and output
- There are reasons why systems may not be achieving this
  - Politics and the policy making process
  - Lack of public understanding
  - Straightforward policy mistakes
- They all contribute to a system that is complex, inequitable and inefficient
  - Review aims to provide input that can help overcome some of these issues

The Mirrlees Review: key principles for tax design

A progressive neutral tax system: each part of this is important

- Progressive
  - Trade-off between redistribution and efficiency is key in tax design
  - Redistribute in a way that minimises efficiency costs
- Neutral
  - Do not discriminate between different activities unless good reason to (e.g. different types of goods, different forms of remuneration)
  - Non-neutralities often lead to inefficiency, complexity and opportunities for tax evasion
- System
  - Important to think how system works as a whole (and with benefits)
  - Consider role of each tax – e.g. not all need to be progressive

The Mirrlees Review: key principles for tax design

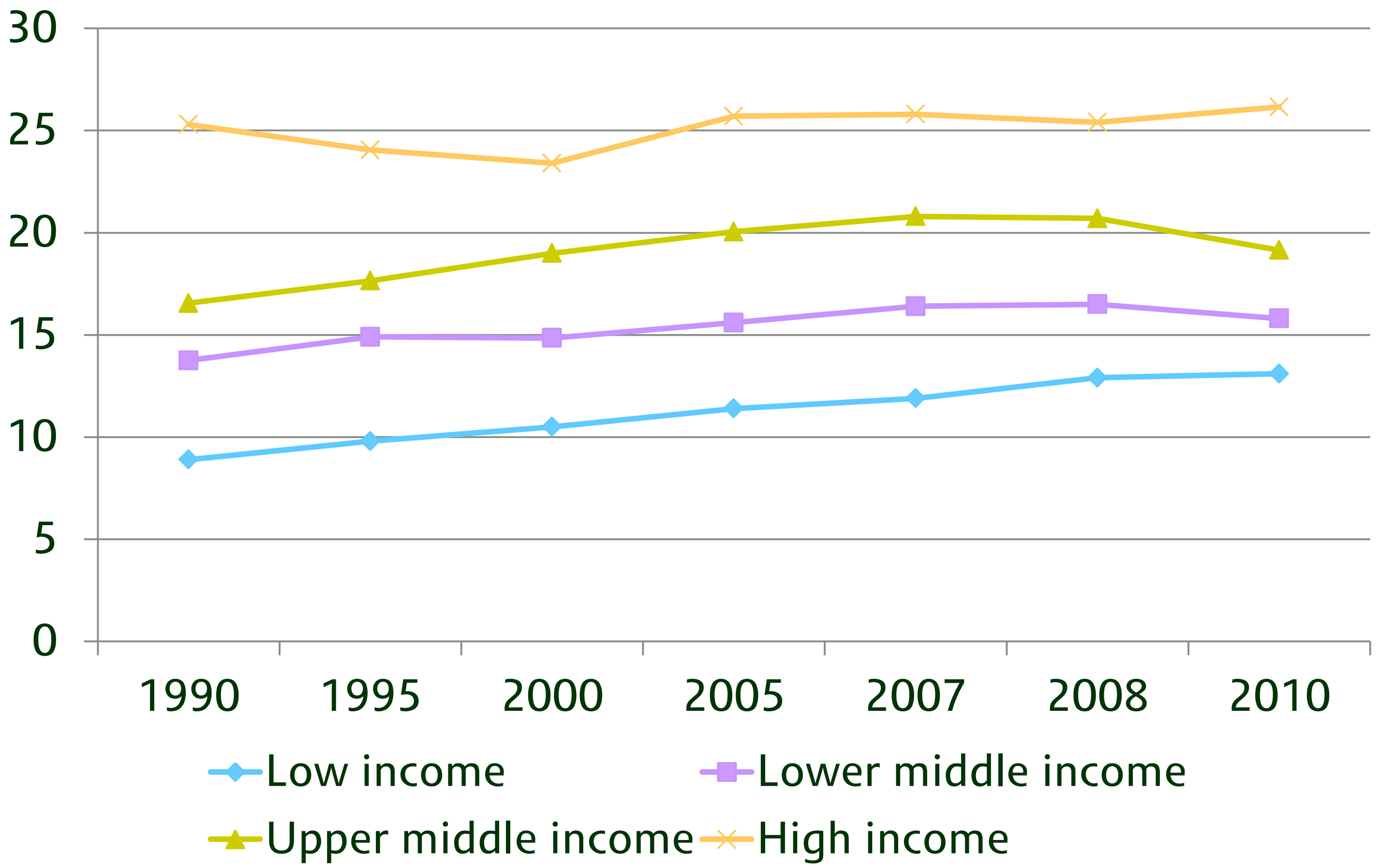
The Review also emphasises the role of:

- Simplicity
  - Closely related to the idea of neutrality
  - Helps reduce administrative and compliance burden
- Stability
  - Particularly important for taxation of savings/capital
  - But must not become an additional reason for complete inertia
- Transparency
  - Over objectives and consequences, it aids sensible policy in long run
  - Lack of transparency can lead to corruption and may reduce tax morale

Middle income countries: context (I)

- Tax and social contributions a lower fraction of GDP than in high income countries
  - Lower middle income – 18.8% (median)
  - Upper middle income – 24.7% (median)
  - High income – 37.6% (median)

Tax revenue as a percentage of GDP (%)



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  - e.g. Brazil relatively ‘high tax’, Mexico ‘low tax’, Turkey and South Africa in between
- Tax revenue structure differs from high income countries
  - Personal income tax and social contributions less important (with some exceptions – e.g. South Africa)

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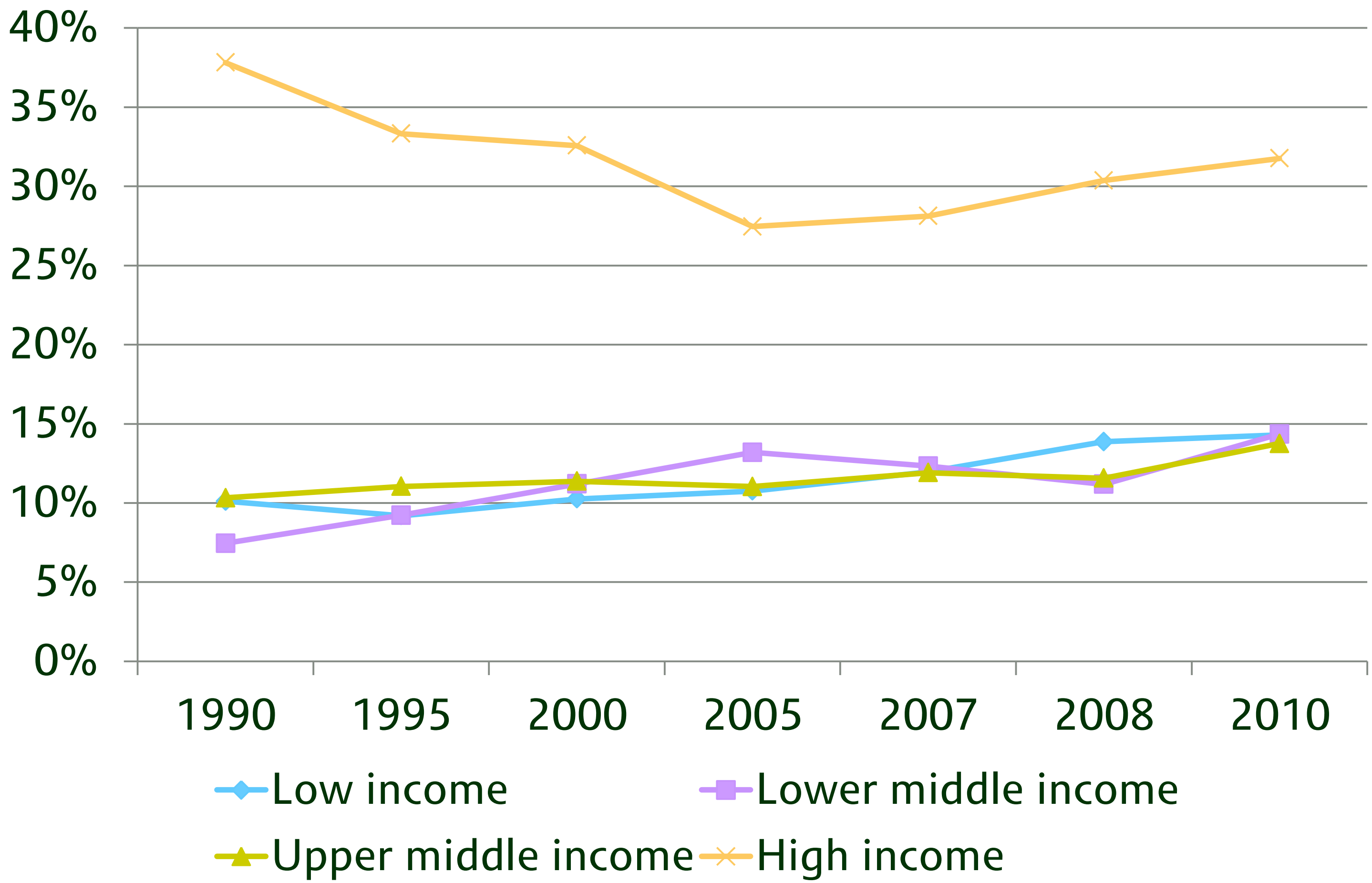
Personal income tax share in tax revenue



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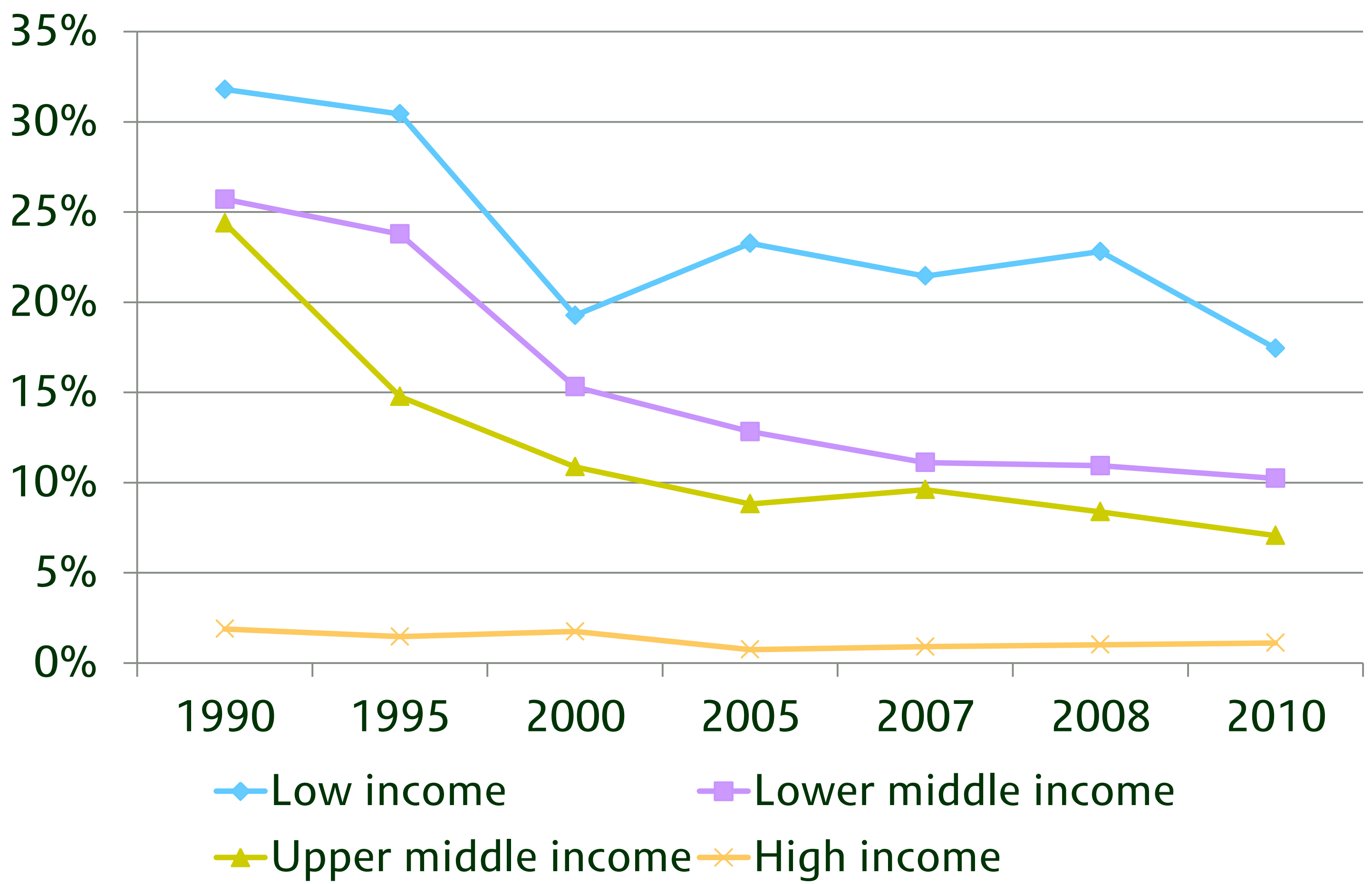
Trade taxes share in tax revenue



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VAT share in tax revenue

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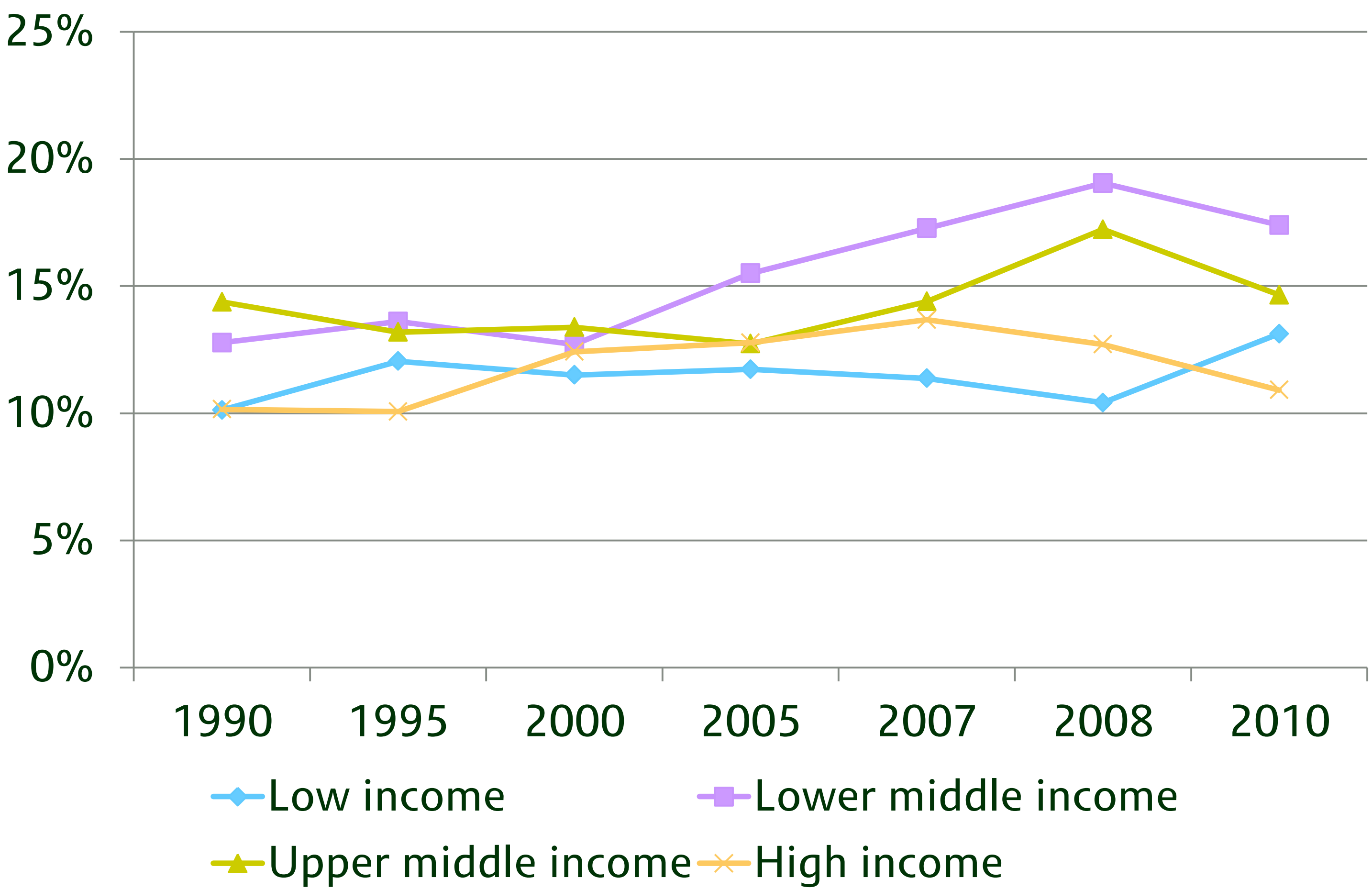
Corporate income tax share in tax revenue



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  - Low reliance on property taxes

Middle income countries: context (II)

Although heterogeneous, some broad differences compared to high income countries:

- Higher levels of income inequality
- Reliance on small number of personal and corporate tax payers
- A larger informal (tax-evading) economy
  - e.g. Informal economy estimated to be 40% of size of formal economy in Brazil, Ghana, Philippines and Paraguay
  - 12% and 9% in UK and US
- Weaker administrative and enforcement capacity
- Low tax morale (willingness to pay taxes)

With this in mind, improved tax design, and simple neutral system likely to be even more important in middle income countries

Specific Recommendations and Issues

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Direct taxation

- Income taxes and social security contributions smaller share of revenue than advanced countries
  - As seek to increase revenues, natural to look here
  - This part of tax system is the most amenable for use in redistribution

- Admin and enforcement issues can contribute to low collection

- But current structure in many middle (and high) income countries is far from optimal and may contribute to difficulties; need to think about
  - Taxation of earned income
  - Taxation of savings/capital income
  - And how these interact

Direct taxation: earned income

- All remuneration should be subject to same effective tax rates
  - Many countries have differential treatment for overtime, bonuses, holiday pay, share options, benefits in kind, deductions for certain expenditures etc
  - Limit distortions and opportunities for avoidance
- When setting tax rates, need to consider equity-efficiency trade-off
  - Weak enforcement/admin, informality etc, mean more behavioural response and lower optimal rates in middle income countries
  - But this is a function of tax system (and scope for avoidance)
  - Debate about the role of flat income taxes
- Important to take into account full effective tax rate (e.g. Including benefits withdrawal, and social security contributions)

Direct taxation: capital income

- Principle of neutrality particularly important for this area
- To avoid distorting savings decisions, consider exempting normal return to capital from taxation
  - Exempting interest on bank accounts
- But exempting all capital income probably bad
  - Incentive to disguise employment income as capital income to avoid tax
- Mirrlees Review recommends a “rate of return allowance”
  - Deduct an amount equal to “risk free rate of return”
  - Apply same tax as on earnings to the rest (with refunds for ‘losses’)
- What about a schedular approach (like Swedish dual system)?

Effective tax rates on different forms of saving in UK

	Basic rate taxpayer (20%)	Higher rate taxpayer (40%)
Individual Savings Account (tax-free)	0	0
Regular Bank account	33	67
Pension (employee contribution)	-21	-53
Pension (employer contribution)	-115	-102
Capital gains from own house	0	0
Direct equity (share) holdings	10	35

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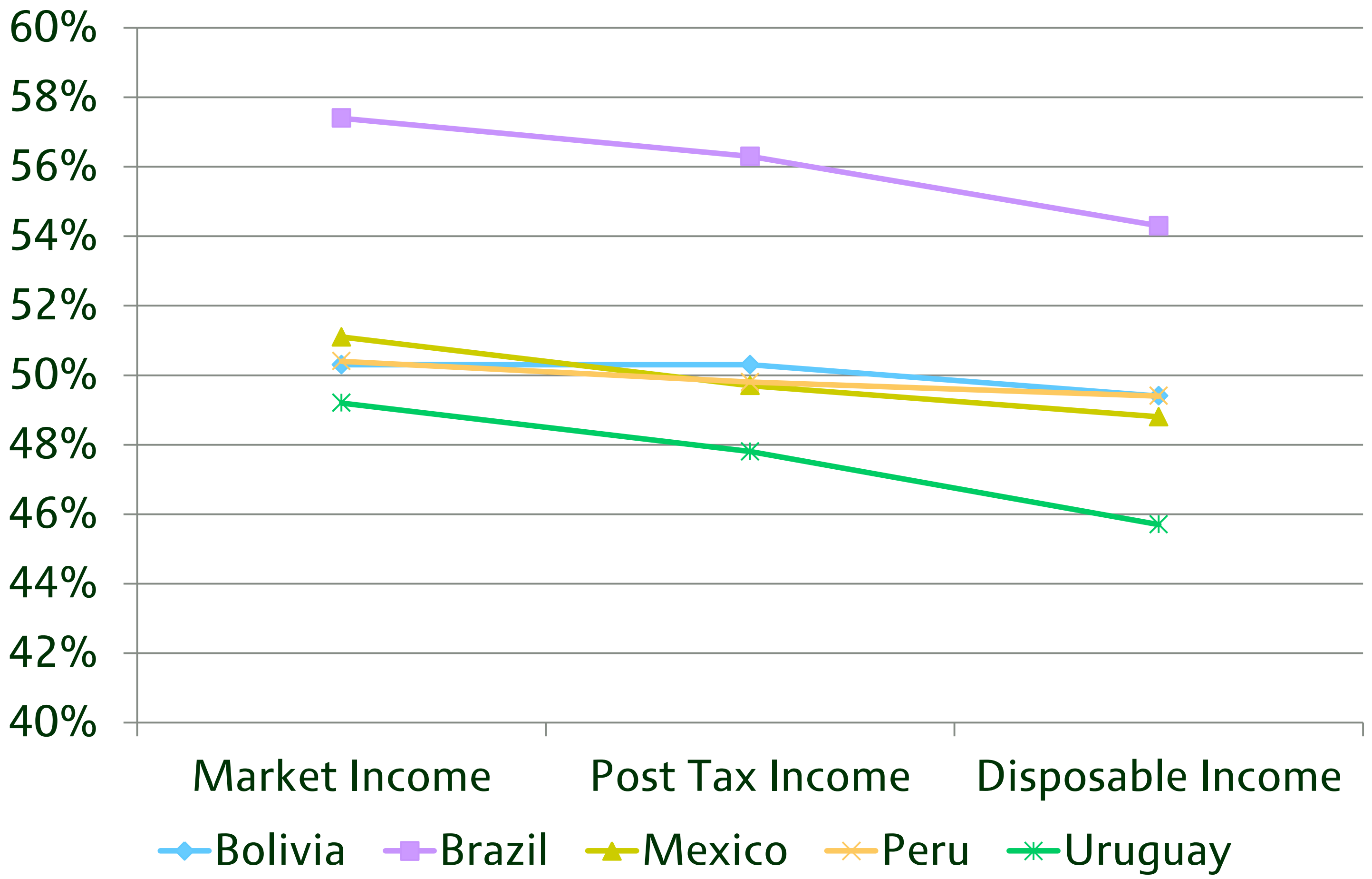
Redistribution: direct taxes and benefits

Lustig et al (2013) shows the following for 6 LA countries:

- Direct taxes do little to reduce inequality
  - They raise little revenue
  - There are often ‘loopholes’: effective tax rates much lower than statutory tax rates
  - Large-scale avoidance and evasion
- Direct transfers/benefits do a bit more but still relatively little

Gini coefficients (Lustig, 2013)



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Indirect Taxation

- Indirect taxes are a particularly important source of revenues for developing countries
  - Easier to collect than direct taxes
- How should these be designed and what role should they play?
  - VAT versus sales taxes? What about special regimes?
  - Role in redistribution?
  - Taxing 'bads' via duties (becoming increasingly important)

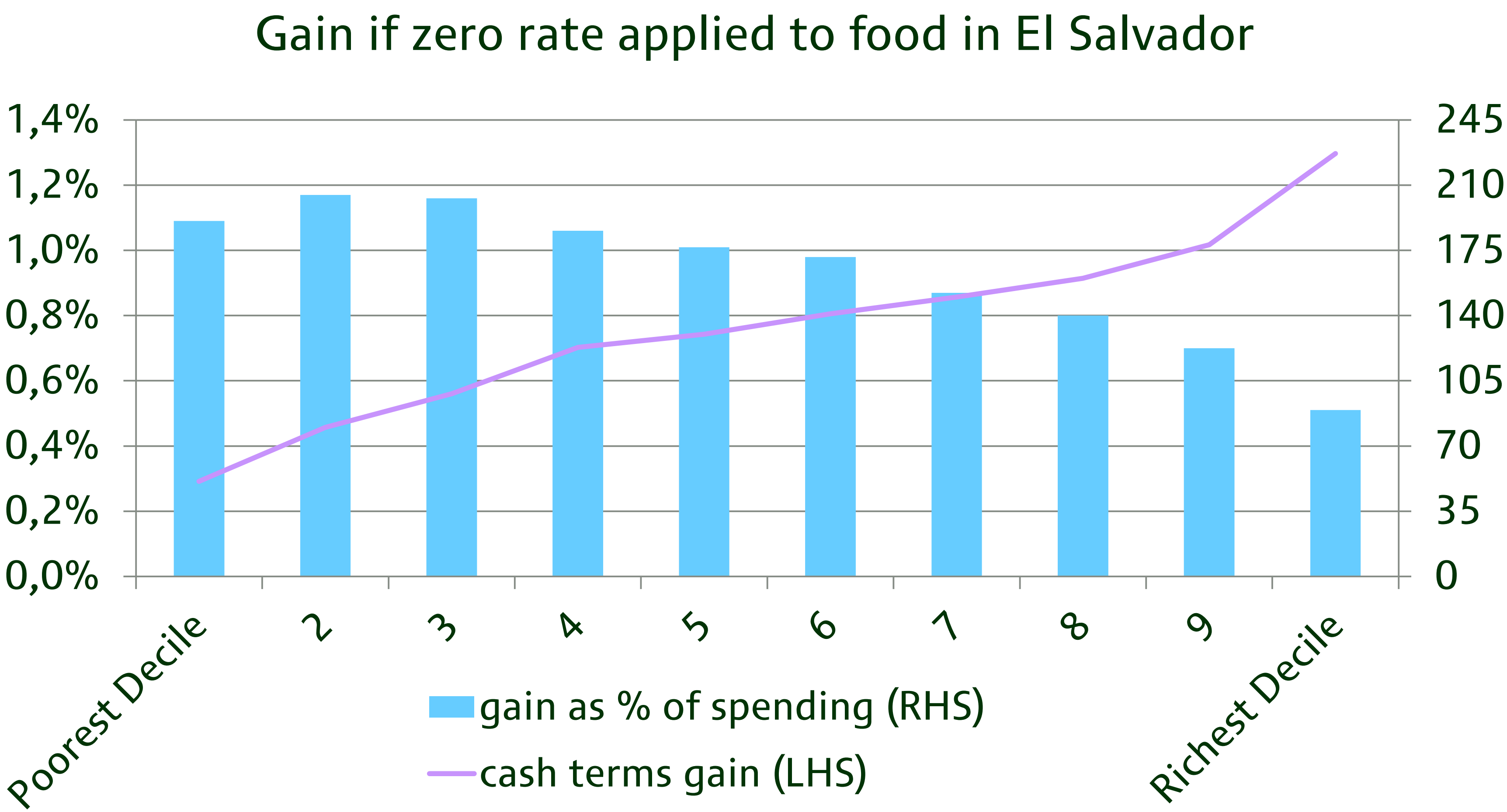
Indirect Taxation: basics of VAT

- VAT has a number of attractive features
  - Not distort production decisions (deduction of input VAT)
  - Fractional collection reduces incentives to evade and chain effects may help spread formality
- VAT exemptions (e.g. for financial services) break this system
  - Undermine whole logic of VAT
  - There is a role for a registration threshold, but careful consideration of 'small trader' schemes needed

Indirect Taxation: redistributing effectively?

- It is often argued that VAT is regressive as it makes up a "higher fraction of income of the poor"
- A response to this is exemptions or zero or reduced rates for items like food, or even subsidies for fuels or basic foodstuffs
  - e.g. Mexico and much of Europe
- But indirect tax differentiation not very effective at redistribution
  - Horizontal inequity
  - Relatively poorly targeted at vertical redistribution

Redistributing efficiently: indirect taxes



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- But indirect tax differentiation generally not good way to redistribute
  - Horizontal inequity
  - Relatively poorly targeted at vertical redistribution
  - Distorts consumption decisions
  - Complexity – admin, compliance, legal

Redistributing efficiently: indirect taxes

- Reasons why may be a stronger case for differentiation in middle income countries
  - Less ability to use direct tax/benefits for redistribution
  - Differences in the extent of evasion/informality by type of good
  - Home production
- These issues are subject of ongoing and planned research at IFS

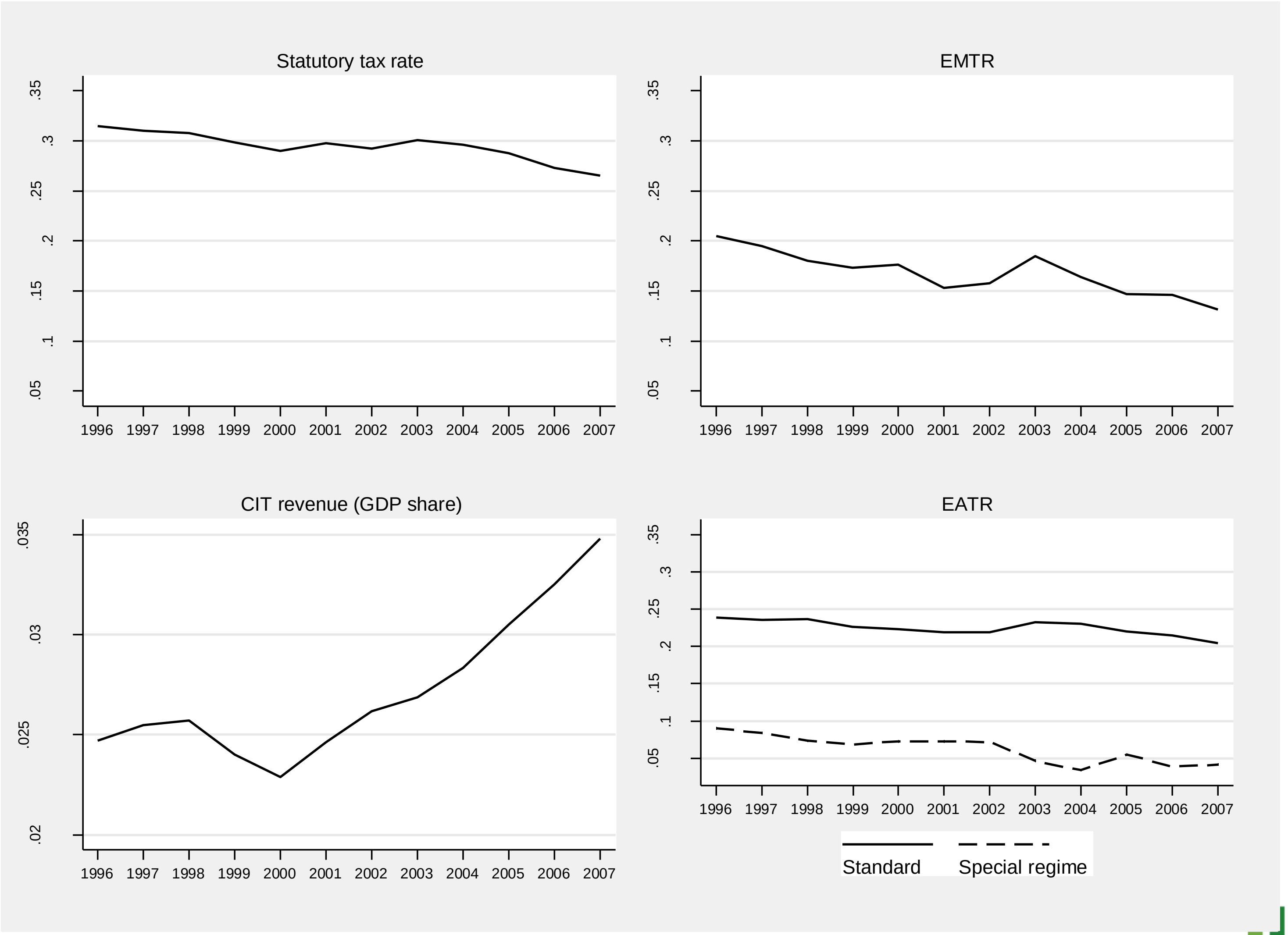
Corporate Income Tax

- Corporate income taxes make up 15% of government revenue, on average, in middle income countries (10% in high)
  - Share has held up well despite concerns about ‘race to the bottom’
  - But evidence that there is growing tax competition
- Important to be clear about the role of corporate taxation
- Business must pay “fair share”
  - Desire to tax owners of capital, and overseas investors/companies
  - But tax likely to be largely shifted to less mobile labour (workers)
- Has administrative benefits and plays a ‘backstop’ role
  - Easier to collect at corporate level than from shareholders
  - If properly integrated with income tax, reduce avoidance potential (e.g. via shifting labour to capital income)

Corporate Income Tax: design issues

- Most current systems distort investment decisions
  - Tax normal return (as with personal income tax), reducing investment
  - Equity/Debt financing decisions distorted
- Mirrlees Review suggests an Allowance for Corporate Equity (treating equity finance similar to debt) would be an improvement
  - Removes above (and other) distortions
  - But would have a number of difficulties in implementation
- Most developed and middle income countries have been moving in a different direction
  - Cutting statutory rates and broadening standard CIT base
  - Also use of special regimes – tax holidays, reduced rates, patent boxes
  - Attempt to attract mobile profits and investments

Overview of trends in middle and low income economies



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Corporate Income Tax: fit for purpose?

- In the long-term may be best to move away from corporate income taxes altogether
  - Vulnerable to exploitation by sophisticated multinationals
  - Tax competition could continue
- Replace with destination-based systems like “corporate VAT”? If much tax actually falls on labour, better to levy it directly?

Suggestions for further research

What research is especially needed?

- The Mirrlees Review argues that tax policy should be based on robust evidence of effects of taxes on individuals and firms
  - Need for more research in middle income countries

- Responsiveness to income tax rates
- The case for VAT uniformity in context of informality
- Corporate tax rates – base broadening versus normal return deductibility
- How to fund and structure benefits/transfers – contributory systems versus tax-funded universal systems?
- Ageing, informality and retirement