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Making Fundamental Tax Reform Happen

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ABSTRACT

Making fundamental tax reform happen

This paper discusses the objectives of tax reform and explores the most important environmental factors that influence the reform process, focusing on the circumstances that explain when these objectives and environmental factors may become an obstacle to the design and implementation of tax policies. The second part of this paper discusses strategies that might help policy makers to successfully implement fundamental tax reforms.

FOREWORD

This paper has previously been published as Chapter 4 in “Making Reform Happen, lessons from OECD countries” (OECD, 2010).

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MAKING FUNDAMENTAL TAX REFORM HAPPEN

Bert Brys*

Introduction

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 no longer – or only partially – 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 have to be aware of the major challenges they are likely to face during the tax reform process.

Fundamental tax reforms go beyond small changes in tax rates and provisions. They can be confined to one tax, as for instance a value-added tax (VAT) or personal income tax (PIT) base-broadening reform that finances a cut in the statutory rate of the tax, or they can involve a more complex package of tax increases and reductions. Fundamental tax reforms can be designed to be revenue neutral – either in the first year after implementation or in the following years – or to increase or decrease tax revenues. They can be systemic, involving fundamental changes in tax rules and structures, or they can be limited parametric changes in existing taxes. Examples of systemic reforms are the dual income tax reforms in the Scandinavian countries; the 2006 reform introducing an allowance for shareholder equity in Norway; the 2001 presumptive capital income tax reform in the Netherlands; the 2004 flat tax reform in the Slovak Republic; and the introduction of the alternative minimum corporate tax (IETU) in Mexico in 2008. An example of a parametric reform is the VAT rate increase in Germany in 2007, which financed a decrease in social security contributions.

Policy makers have been successful in implementing tax reforms, as can be observed indirectly from changes in the tax mix over time (OECD, 2009a). Despite some significant differences in the distribution of the tax burden between tax instruments across countries, most OECD governments continue to extract the bulk of their revenue from three main sources: income taxes; taxes on goods and services; and social security contributions. On average, there has been a reduction in the share of tax revenue accounted for by personal income tax partly because of the introduction of “make-work-pay” policies targeted mainly at lower income workers and reductions in the top PIT rates in many countries in order to stimulate human capital formation, entrepreneurship and risk taking. Another recent trend in the taxation of personal income is that some OECD countries, particularly in Scandinavia, have introduced dual tax systems, which tax personal capital income at low and proportional rates, while labour income continues to be taxed at high and progressive rates. Several other countries have moved towards “semi-dual” personal income taxes. There has also been a continuously growing share of social security contributions, which are often levied at flat rates.

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Corporate income tax (CIT) rates have been reduced in many countries since the beginning of the 1980s. The share of the CIT in total tax revenues, however, has increased in the majority of the OECD countries, thanks largely to base-broadening measures, increased firm profitability as a result of globalisation (at least prior to the crisis) and greater incentives for businesses to incorporate – implying that the revenue effects of lower CIT rates will partly show up in lower PIT revenues (OECD, 2007). The increasing share of the financial sector in the value added of the business sector has also played a role, although this trend may now have come to an end. A growing feature of corporate tax systems is the use of tax credits or special deductions for research and development (R&D) expenditures. These are now available in most OECD countries (Palazzi, forthcoming).

The share of taxes on consumption has declined gradually, but the mix of taxes on goods and services has changed markedly. In general, there has been a shift towards the greater use of general consumption taxes, particularly VAT (although there remains a lot of scope for further VAT base broadening in most countries) and a reduction in the revenue share of specific consumption taxes such as excise duties. The share of property taxes (on immovable property, net wealth, inheritances and legal transactions) has been approximately constant on average. There has also been growing interest in the use of environmentally-related taxes, with several countries introducing new taxes to deal with specific environmental problems.

When reforming tax systems, policy makers must try to balance the different goals that tax systems aim to achieve. This implies a need to make difficult tradeoffs. Policy makers will have to balance the efficiency and pro-growth objectives/impact of tax reforms with their distributional objectives/impact, while also taking into account the impact on revenues, tax avoidance and evasion opportunities, and the costs of compliance, administration and enforcement – bearing in mind that those costs also feed into the marginal social cost of public funds. When reforming labour taxation, they must also consider the interplay between taxes and benefits. International tax issues, questions of fiscal federalism, the transitional costs of changing the tax system and complex timing issues also have to be considered, as do complex implementation, legal and administrative issues. The design and implementation of tax reforms are also influenced by the institutional context. Finally, political economy factors will have an impact on the outcome of the tax-reform process, for instance because elected politicians may seek to use the tax system to favour particular interest groups and increase their probability of re-election. Hence, the successful pursuit of tax reform involves not only public finance considerations, but also administrative, institutional and political economy factors.

Policy makers can follow certain strategies to make fundamental tax reform happen. These strategies help them overcome or circumvent obstacles to tax reform and allow policy makers to reconcile the different efficiency, fairness and wider tax policy objectives. Even though these strategies do not offer a menu that can automatically be applied to all possible fundamental tax reforms in OECD countries, the analysis that follows will offer insights that policy makers may find useful in facing the challenging task of implementing fundamental tax reform.

The remainder of the text identifies first the obstacles to fundamental tax reform by looking at issues of policy design and afterwards at political economy and institutional factors. The chapter then presents the strategies that might help to overcome these obstacles to the implementation of tax reforms. This is followed by a brief conclusion.

Obstacles to tax reform: issues of policy design

This section identifies the main obstacles to the implementation of fundamental tax reform by looking at tax reform from a public finance perspective (see also Bird, 2004). Tax reform is not only shaped by efficiency and international tax concerns but also by questions of horizontal and vertical equity (fairness)¹ and revenue potential. Tax avoidance and evasion considerations, fiscal federalism relations and

transitional tax-reform cost considerations are a key issue in the public finance analysis of tax reform as well.

Reform must balance efficiency and equity considerations...

Taxes are efficient if they distort agents' economic decisions as little as possible. However, efficiency-enhancing tax reforms may at the same time face efficiency *drawbacks*, which create obstacles to their effective implementation. For example, make-work-pay policies that reduce personal income tax rates and/or employee social security contributions for lower income workers tend to increase labour-force participation, but can discourage taxpayers already in employment from working more or trying to find a better-paid job. This is because, if targeted tax reductions are phased out as income increases, then lowering the *average* effective tax rate for those at the bottom of the earnings distribution may confront them with rapidly rising *marginal* effective rates as their incomes increase. A reduction in the CIT rate may increase economic growth (Johansson *et al.*, 2008), but policy makers have to consider that the overall burden on capital income cannot be too much out of line with the top PIT rate; otherwise, the self-employed will face incentives to incorporate purely for tax reasons.

A shift from direct towards more indirect taxes – a tax reform that is considered to be growth-promoting (Johansson *et al.*, 2008) – through an increase in the statutory VAT rate might increase tax evasion and cross-border shopping and might stimulate the informal sector. It might also result in pressures for wage increases, leading to inflation and a corresponding loss of competitiveness, and leading to an increase in the unemployment rate. If, however, the VAT rate increase is offset by a reduction in the direct taxation of labour, then the overall effect on competitiveness could be positive: this is because domestic producers will reap the full benefit of the cut in direct taxes, but the increase in VAT will be “shared” with foreign competitors, because exports are zero-rated for VAT purposes and imports are taxed at the same rate as domestically produced goods. A shift from direct to indirect taxes might therefore be achieved by broadening the VAT base as well as (or even instead of) increasing the VAT rate. As a general rule, there is much to be said for trying to keep most bases broad and most rates low.

Fundamental tax reforms may aim at improving equity. Some reforms, however, may be seen to benefit particular groups disproportionately, while other groups pay a disproportionate share of the costs. The adverse redistributive impact of these reforms would then reduce the tax system's equity. Distributive considerations might therefore become an obstacle to implementation. Also, because the efficiency gains from tax reform typically do not arise immediately but accrue over time, policy makers will not immediately be able to use these efficiency gains to compensate the losers from tax reform. In any case, the initial losers are not necessarily the final losers. The redistributive impact of tax reforms should therefore be assessed in a dynamic – and not a static – setting.

The question, of course, arises as to which degree governments would want to use the tax system to redistribute income. Non-tax policy measures that stimulate education, for instance, increase individuals' earning capacity and may therefore contribute to a more equal income distribution. A considerable part of income is redistributed within the same family types but over different periods in their lifecycle, for instance between periods with and without children. A reduction in the progressivity of the rate schedule compensated by a reduction in child tax credits and similar provisions, for instance, might leave many families relatively as well off when the entire lifecycle is considered.

The redistributive impact of tax reforms has to be analysed in the context of a country's entire tax and benefit system and not evaluated in isolation. This is especially true of the tax treatment of capital assets (Leape, 1990). Because taxes and tax provisions are capitalised in the prices of the assets, the current owners of tax-privileged assets are not necessarily the beneficiaries of these tax provisions. The price of owner-occupied houses, for instance, will be influenced by the presence and generosity of mortgage

interest relief and the possible absence of a capital gains tax. The final incidence of these tax provisions will then depend on how the gains of the tax privileges are shared between sellers and buyers. Leape (1990) therefore concludes that whether or not one would propose preferential treatment for housing if one were designing a tax system from scratch, there is good reason to be very careful when altering or abolishing such preferences, because of the inequities that would result. This argument holds not only for owner-occupied housing but also for pensions, because pensioners no longer have the opportunity to adjust their labour-market behaviour in response to change in the PIT. These examples also point to the need for predictable and consistent tax rules as the basis for long-term private sector planning of labour, saving, investment and consumption decisions. Complex tax incidence issues might create obstacles to the implementation of reforms of other taxes as well. The CIT is levied on corporate profits, but this does not mean that capital owners will inevitably earn a lower return on their investment. Investors might simply require a higher before-tax return on their investment in order to offset the impact of the corporate tax. As a result, capital does not necessarily bear the (entire) burden of the CIT. The corporate tax might also (partly) be shifted to consumers through higher prices and/or to labour through lower wages (see OECD, 2007 for more detail).

...as well as revenue and tax-avoidance concerns

Tax-revenue considerations become an obstacle to the implementation of pro-growth tax reforms if the reforms would reduce tax revenues – in the short and/or medium term – or increase uncertainty about the level of tax revenues that governments will collect in the future. This might be the case if the impact of proposed reforms on agents' behaviour is difficult to predict. Such reforms will therefore face stronger implementation obstacles from a tax revenue perspective. Even where there is an apparent tax “giveaway” as a result of a reform, this might reflect the use of fiscal drag or restraint on the growth of public expenditure rather than tax reform windfall gains.

The behavioural response to tax reforms merits consideration in another context, as well: tax avoidance and evasion considerations might create obstacles to the implementation of fundamental tax reforms. As noted above, in-work benefits can reduce average effective tax rates while confronting those affected with steeply rising marginal effective rates. This gives workers an incentive to conceal income in order not to lose part of the in-work tax credit – by under-reporting earnings from their primary job or by taking a second job in the informal sector instead of working more in the official economy. An increase in the standard VAT rate may increase informal sector trade and cross-border shopping, and an increase in the top PIT rate will reduce work incentives and might provide self-employed businesses with a tax-induced incentive to incorporate. This strengthens the case for a general rule of trying to keep most bases broad and most rates low because base-broadening measures will usually reduce the tax compliance costs and the opportunities for agents to engage in tax-minimising behaviour and the benefits of evading taxes. The tax reform obstacles created by tax avoidance and evasion considerations will especially be minimised if the increase in tax revenues as a result of base broadening leads to a reduction in tax rates.

International rules and commitments may limit reform options

International tax rules, European Court of Justice judgements and EU directives (applicable to OECD countries that are also EU members), internationally agreed tax practices and bilateral or multilateral tax agreements can put constraints on the tax reforms that policy makers can implement. Consumption taxes, for instance, have to be levied on a destination basis under World Trade Organization (WTO) rules, and international tax agreements concluded within an OECD context imply that countries cannot engage in harmful tax practices/competition² and have to exchange information on request.

The financial and economic impact of foreign tax systems may also impose constraints on the tax reforms that countries might want to implement. By reducing the CIT rate, for instance, governments

might try to attract foreign direct investment. However, a CIT rate reduction in the host country will simply transfer tax revenues to countries that tax their multinational enterprises (MNEs) on worldwide income but allow foreign tax credits for the corporate taxes paid at source (OECD, 2007), without changing the effective tax burden – or the investment behaviour – of the MNEs. (This argument, of course, ignores the impact of tax deferral, as MNEs can defer the taxation in their home countries until profits are repatriated.) The international tax environment also imposes constraints on the amount of tax simplification that can be achieved with respect to such taxes as the CIT. In order to protect the domestic corporate tax base, many countries implement thin capitalisation rules, transfer pricing rules, controlled foreign corporation (CFC) rules and additional anti-avoidance rules.

Fiscal federal relations may complicate tax reform

Fiscal federalism might create obstacles to the implementation of tax reform. Many countries have “tax-sharing” agreements between central and sub-national governments, which imply that sub-national governments are directly affected by reforms of shared taxes, possibly leading to financial or other compensation measures that could reduce the efficiency of the reform. Tax-sharing agreements often include complex equalisation formulae to obtain horizontal equity among sub-central jurisdictions. Tax reforms might have an impact on these formulae, possibly leading to complex negotiations and corresponding costs. The fact that some taxes might fall entirely within the jurisdiction of sub-national governments could become an obstacle to the implementation of reforms. A shift from direct towards indirect taxation, for instance, will be more complicated if direct and indirect taxes are levied by different levels of government. This is especially the case for property taxes which are often levied at the state, regional or local level, while income taxes are usually levied at federal level. A shift from income to property taxes, which could be beneficial for growth (Johansson *et al.*, 2008), would then imply an increase in tax revenues for the sub-national authorities and a fall in revenues for the national or federal level. This change might then have to be compensated by revenue transfers or changes in the tasks that have to be financed by different levels of government.

Tax reform at federal or national level requires co-ordination between the taxes levied and the tax and other reforms implemented at lower levels. For instance, if different states or regions within a country face different economic problems, it might be difficult to solve these problems only by changing the tax system at the federal level; tax reform that is good for some might not necessarily be good for all. This is, for instance, the case in Belgium, where the Flemish region faces relatively high unemployment among older workers, while the Walloon region has relatively more young unemployed. Tax measures that tackle the problems of some states or regions might then have to be accompanied by other tax changes that tackle the problems of the other regions. This could be costly in terms of tax revenues foregone. Where sub-central governments have discretionary power over rates and/or bases, special attention must be paid to prevent harmful tax competition between them, especially if sub-central tax rate and revenue reductions are automatically compensated – either partially or fully – by higher transfers from central to sub-central levels. Fundamental tax reforms therefore require that different levels of government and different regions within the country act coherently. The implementation of income redistribution policies could also be at risk if different taxes are levied at different levels of government, because, as noted earlier, distributional goals cannot be achieved on a tax-by-tax basis, but should be considered in the context of the tax and benefit system as a whole, irrespective of the level of government that levies a particular tax. This is for instance the case in countries where indirect taxes – mainly recurrent taxes on immovable property and/or VAT – are levied at the regional level while income taxes are levied at the federal level.

The transitional costs of reform must also be addressed

Additional obstacles to the implementation of tax reforms may arise as a result of the transitional costs that they entail. The implementation of a tax reform involves a period during which new rules are

implemented and firms and households adjust their behaviour in response to the new tax situation. These tax-induced changes in behaviour can be highly distortionary and very costly for the agents involved. High transition costs could be expected if, for example, the CIT were replaced by a corporate cash-flow tax, which no longer permitted the deduction of interest payments from taxable corporate earnings. In the absence of transitional measures, firms that were highly leveraged might then suddenly face a sharp increase in the cost of finance, which could lead to bankruptcy for some. The corporate cash-flow tax literature shows that most of the efficiency gains from having a corporate cash-flow tax might be lost during the transition period (OECD, 2007), because the new tax rules would have to be phased in gradually in order to prevent large economic disruptions. The provisions governing the transition period might have a big impact on the final tax reform outcome. For instance, increases in consumption taxes and excise duties could give rise to an increase in the inflation rate, especially if price increases automatically led to wage increases through the wage bargaining process. Other institutional factors, such as the presence and level of minimum wages, might strongly influence the impact of tax reforms during and after the transition period.

The mere announcement of a tax reform can have an impact on agents' behaviour even before it is implemented. The impact on short-run growth might be negative if, for instance, agents postponed investment decisions until the new tax rules were in force. Problems may also arise if, on the contrary, agents rush to make the most of a tax distortion before it is removed.³ The opposite result holds as well: the reduction or abolition of a growth-friendly provision could have *positive* short-term growth effects. For example, the announcement of the reduction of an investment tax credit in the near future could bring forward investment and thus stimulate growth in the short run. Similarly, the announcement of a future increase in the VAT rate, for instance, will bring forward purchases of durable consumption goods. Whether or not this is desirable will, of course, depend on the structural position of the economy at the time. Announcement effects can thus create obstacles to the implementation of tax reforms or give rise to unanticipated distortions, especially if government cannot implement the reform immediately.

The time between the announcement of a tax policy change – possibly via the setting of an aspirational tax policy goal – and the actual implementation of the reform then becomes an important factor in tax policy. The appropriate length of time will depend in part on the degree to which the reform will alter the affected taxpayers' circumstances. Changes in taxes that have a particularly “regulatory” character may have particularly pronounced “announcement effects”. The announcement of new environmental taxes or higher environmental tax rates, for example, might induce businesses to invest in pollution abatement, so that they can avoid paying these taxes. Yet when it is announced and implemented in a relatively short period, there is little, if any, actual opportunity for firms to abate immediately. Experimenting with new techniques, installing new equipment, making new products and switching inputs all take time. The tax therefore is effectively levied on current emissions (which are based on historical behaviour, given the inability to replace capital assets quickly or to change processes immediately). Yet it is possible to begin realising the benefits of abatement even without levying the tax: a credible announcement that environmentally-related taxation will be implemented in the future (in a year or two, for example) can provide firms with the abatement incentives of the tax without collecting revenue – and therefore without imposing a tax burden based on pre-tax production arrangements.

The length of the transition period might therefore depend on the time that firms need to replace their existing capital stock with new machines that are less harmful to the environment. This, in turn, might depend on the actual age of the current capital stock and on whether better technologies are available or have to be developed first. Such a lead-in may also help to ease the implementation of environmental taxes where there are strong constituencies arguing against their introduction. This effect, however, depends greatly on the credibility of the government's promise to impose the tax in the future. The Swiss authorities adopted such an approach when introducing a new tax on volatile organic compound (VOC) emissions: the tax was announced two years before the government actually began to levy it (Box 1).

Box 1. The announcement effect of an environmental tax on volatile organic compounds in Switzerland

Volatile organic compounds (VOCs) are solvents used in industries that require quickly evaporating substances, such as paint-making and metal-cutting. Besides human health effects, VOCs also contribute to ground-level ozone formation (summer smog). In January 1998, the Swiss authorities approved a tax on VOCs of CHF 2 per kilogram (rising to CHF 3 per kilogram in 2003), but stipulated that the tax would be levied only from January 2000. The government decided to impose this two-year transition period in response to suggestions from industry as well as from the relevant state bodies that there was a need for time to develop both industry competencies and the infrastructure needed for effective administration of the new tax.

The tax has been effective, as emissions of VOCs have decreased significantly. Emissions of taxed products declined 12% during the transition period, as firms adjusted their behaviour in anticipation of the new tax. Emissions dropped a further 25% during 2001-04 when it was fully implemented. Thus the credible promise of future imposition of the environmental tax on VOCs did lead to some abatement even in 1998-2000. There were significant variations in the reactions of firms to the new charge. Larger firms generally innovated and adopted new technologies rather quickly, while smaller firms, due to financial or informational constraints, were less likely to act. The role of cantonal officials also varied. Some saw their role as facilitative and administrative; they therefore helped with information and technology diffusion. Others, by contrast, viewed their role as tax administrators only.

Source: Based on OECD (2009b), "Taxation, Innovation and the Environment", December, www.oecd.org/document/13/0,3343,en_2649_34533_44863437_1_1_1_1,00.html.

Tax administration issues may also raise obstacles to reform

Reformers need to be sensitive to the impact of reform on the tax administration itself, from an organisational perspective, including any major changes in the tasks performed by the tax administration. These tasks include the collection of information and the identification of taxpayers, the calculation of the tax liabilities, the collection of tax revenues, the communication with taxpayers, the provision of assistance and the enforcement of the tax laws. The tax administrative approach also focuses on any additional compliance costs imposed on taxpayers. Tax administrative issues might become an obstacle to the implementation of tax reforms if change would entail additional costs to the tax administration and taxpayers. Tax reform might be costly if it necessitates organisational changes in the tax administration, the development of new (or adjustment of existing) computer systems, the training of officials or the development of new compliance-monitoring systems. The new tax rules might also lead to an increased compliance burden on taxpayers. An increase in recurrent taxes on immovable property, for example, might require extensive – and expensive – revaluation of property. Property valuations are out of date in many OECD countries, and appropriate property valuation methods are lacking in some, although there are exceptions (*e.g.* Denmark and the Netherlands).

Obstacles to tax reform: political economy and institutional factors

The political economy analysis of tax reform includes voters, political parties, lobby groups and politicians in the public finance models and analysis. The incorporation of voter preferences and the incentives facing politicians in the analysis allows a better understanding of the formation of tax policy and the role of different political institutions in shaping it (Persson and Tabellini, 2002).⁴ The democratic political process is such that a number of its characteristics might create obstacles to the implementation of tax reforms. This section discusses the main political economy arguments advanced to explain why socially beneficial tax reforms are not always implemented (see also Olofsgard, 2003). The underlying issue concerns the heterogeneity of agents discussed in Chapter 1 of this volume: if tax policies affected all taxpayers in the same way, then it would be relatively easy to devise, adopt and implement optimal tax policies. The differential impact of tax reforms on groups with different endowments and/or preferences means that even welfare-enhancing reforms may contradict the interests of many.

For politicians, the visibility of tax-policy decisions is critical

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. Politicians might face incentives to reform the tax system in order 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, politicians might not understand or take into account the long-term implications of these measures, such as potentially negative impact on future tax revenues or the possibility that tax complexity might breed further tax complexity (Bradford, 1986). This entails the risk of making the tax system more complex without tackling the underlying economic problems and tax issues in the most efficient way. This process would seem to underlie the trend observed in various OECD countries at various times towards increasing tax expenditures. It is important to recognise, in this connection, that 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 partly explains why recurrent taxes on immovable property, which are highly visible, are rarely increased by politicians (Alt, Preston and Sibieta, 2008). This conjecture also seems to imply that employer social security contributions are more likely to be increased than employee social security contributions and that PIT cuts may be offset by increases in less visible indirect taxes. Another tax reform visibility example is linked to inflation. Alt, Preston and Sibieta (2008) argue that policy makers have an incentive to place greater reliance on taxes that need not be increased each year in order for revenues to remain constant in real terms. Policy makers therefore have an incentive to rely more on *ad valorem* taxes on capital and labour income and on VAT, instead, for instance, of *ad quantum* excise duties. The tax reform visibility argument offers an additional explanation for the phenomenon of “bracket creep” in many OECD countries. OECD (2008) concludes that most OECD countries do employ some form of adjustment, such as indexing tax band limits for inflation, in order to prevent large PIT burden changes as a result of inflation. These adjustments are, however, incomplete or infrequent in most countries. Because inflation might create a relatively hidden increase in the tax burden, the political process creates an incentive *not* to operate a system of full, automatic inflation adjustments (“full indexing”). Instead, the increase in tax revenues as a result of “not fully indexing” creates the opportunity for a highly visible tax reform after a number of years.

Uncertainty about the distributional consequences of reform may impede change

There can be considerable uncertainty about who will win and who will lose from a tax reform and whether (how) voters will change their voting behaviour in response. 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 s/he will join the winners, because the tax reform benefits will become clear only in the future. This individual uncertainty then generates a double hurdle for reforms: a reform must attract majority support both *ex ante* (to win adoption) and *ex post* (to be sustained). Olofsgard (2003) points out that this result hinges on the assumption that the winners from reform cannot credibly commit *ex ante* to compensate the losers *ex post*. As a result of this uncertainty, voters might become reluctant to vote for a tax reform that was expected to increase overall welfare.

Policy makers could also face tax reform outcome uncertainty as a result of uncertainty regarding the impact of reform on agents' behaviour, income distribution, tax revenues, etc. In the presence of high levels of uncertainty about the number of winners and losers and the extent to which they are (positively or negatively) affected by the tax reform, policy makers might become more careful in making a decision to engage in tax reform.

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. They have to base decisions on the information provided by their staffs, by the research departments of state bodies and/or political parties, by the social partners and by the academic community. 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 welfare-enhancing tax reforms, especially if the constituents of one of the coalition parties bear most of the costs. Ashworth and Heyndels (2001) analyse the impact of political fragmentation in OECD countries over 1965-95. They find that countries where political power is more dispersed change their tax system less frequently. When they do occur, tax reforms in such countries tend to be compensated by other changes in order to be acceptable to different parties. Hence, the more fragmented the government coalition, the harder it is likely to be for political parties to engage in fundamental tax reform.

Special interests may be very effective in influencing tax policy

An alternative political economy approach focuses on the political influence of the tax reform losers that may block the implementation of 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). The potential beneficiaries of tax reform are often silent in contrast to the losers. This is typical of many structural reforms: for a variety of reasons, including loss aversion and endowment effects, agents are, *ceteris paribus*, more likely to mobilise against a proposal that threatens them than in support of one that offers them benefits. In the field of tax reform, this is typically the case when tax breaks are worth a great deal to special interest groups, but their abolition would bring only a small reduction in the total tax burden for most taxpayers.

Politicians might be more willing to listen to particular special interest groups if they receive direct or indirect campaign contributions from them 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. Even when taxpayers did not lobby for a particular tax measure in the first place, they may lobby for its persistence and extension, even if the result is a less efficient, less fair, more complex and less growth-oriented tax system. 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 earlier, the benefits from tax expenditures can be targeted while the costs – the reduction in overall tax revenue – can be spread across all taxpayers. While there are good arguments for introducing tax expenditures in some cases, politicians that introduce tax expenditures do not necessarily internalise all tax expenditure costs. The political process might therefore lead to excessively high levels of tax expenditures which, once introduced, become very difficult to abolish.

The structure of the policy process can shape tax reform outcomes

Tax reforms may be blocked and changed, sometimes significantly, at the legislative stage (Bird, 2004). Sound tax policies might therefore lose many of the desired tax design characteristics. The growth-enhancing economic impact and/or the equity characteristics, for instance, of a fundamental tax reform might be reduced as a result of the changes made to the proposals during the parliamentary process. Tax reformers must therefore pay close attention to these critical aspects of the policy process and, in particular, to the ability of special interests to influence parliamentary behaviour.

Tax reform outcomes reflect not only the political rules of the game, but also the institutional context within which alternative tax policies can be analysed and evaluated and within which final tax policy decisions can be made (Hettich and Winer, 1999). This institutional tax reform perspective points to particular legislative rules of procedure, committee systems and other aspects of institutional design that can help or hinder the implementation of tax reforms. Much may depend on who decides to evaluate particular reforms – and when this evaluation decision is made, which tools and type of analysis will be applied in the evaluation and who will be asked to conduct it. Weingast and Marshall (1988) argue that the assignment of legislators to committees and the institutional arrangements that create agenda power for each committee are key issues in explaining tax reform outcomes. The tax reform process also depends on who has the authority to invite experts to appear before tax committees or otherwise to participate in the policy process, and who will participate in setting the future tax reform agenda. Other key factors are the institutional settings that determine how expert analyses will be submitted – and to whom – and what will be done with their evaluations. In particular, it may matter whether or not the government commits to making these evaluations and (intermediate and/or final) reports public and when.

The publication (or not) of such analyses is, in turn, linked to the reformers' communication strategy. A key objective of such a strategy might be to create public awareness of, and support for, tax reform. This might be achieved through public debates, consultation rounds involving the social partners or other representatives of civil society, etc. The ways that these communication processes are managed might have an impact on the tax reform outcome. The communication strategy of tax committees or other bodies charged with crafting reform proposals will be shaped by the rules governing their conduct: how can tax

committee members communicate about the work done by the committee and who decides on these rules, etc.

Similarly, the scope for tax officials or other civil servants to provide input in the tax reform debate and/or to make reform proposals should be considered. Tax administrations, for instance, are generally able to provide good quality input in the tax-reform process, and their role, involvement and support for reform is crucial, as they will have to implement and enforce the new arrangements. Tax administrations will generally be particularly sensitive to the administrative and compliance aspects of reform, about which others may know relatively little. They can therefore identify problems likely to arise during the transition period following a reform or warn of the dangers that may exist where proposals that are economically sound in principle may be administratively very problematic in practice. For example, proposed reforms may threaten to add to compliance burdens or to create new opportunities for tax avoidance and evasion.

Strategies for successfully implementing fundamental tax reforms

This section discusses strategies to successfully implement fundamental tax reforms. These strategies aim to allow policy makers to reconcile different efficiency, equity and other tax policy objectives and to overcome the obstacles identified in the previous sections.

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

As a starting point, governments might try to obtain a consensus on broad, long-term tax reform objectives. These might include reducing the country's debt-to-gross domestic product (GDP) ratio, increasing domestic saving and investment, attracting foreign investment or increasing the labour supply. A broad consensus on tax reform goals will facilitate the discussion and evaluation of different tax reform proposals that attempt to realise these broad objectives. Clear communication regarding long-term objectives might facilitate the creation of a broad social consensus that favours the introduction of the most desirable tax-reform measures. When designing a reform that achieves the broader reform objectives, governments might have to find a balance between such different tax design criteria as efficiency, equity, simplicity, enforceability, revenue-raising ability, etc. Clear communication with the public about these trade-offs and the choices that have to be made might help in obtaining support for the reform.

Even in the absence of a broad strategic consensus on tax reform, governments can reduce uncertainty and begin to guide tax-reform debates by announcing aspirational tax-reform goals before presenting specific proposals. In Australia, for instance, the aspirational tax reduction goals are announced before the start of the fiscal year. The goals can be postponed in case of a worsening of the economic or budgetary situation. The setting of aspirational future tax-reform goals can also be applied to announce future tax rate increases or future shifts in the tax mix, for instance. This approach allows policy makers to set long-term tax policy goals that go beyond the current government horizon. It also creates incentives not to deviate from these goals and to resist, for instance, the pressure of certain lobby groups during or after the implementation of part of the announced tax reforms, because the government's credibility is at stake. Moreover, aspirational tax-reform goals provide a measure of predictability even where the entire reform cannot be implemented immediately. This provides agents with the opportunity to adjust their behaviour over time, which will avoid large shocks in behaviour. This reduces the costs for the agents involved and the distortionary impact of reform on the economy as a whole.

Once the broader tax-reform objectives have been set, governments can start evaluating specific reform proposals and studying the degree to which these proposals achieve the desired objectives. The evaluation of tax-reform proposals should focus on their behavioural impact, their revenue implications, their distributional impact, their implications for compliance and enforcement costs, and any tax avoidance and evasion issues that may arise. In order to be able to draw well-founded tax policy conclusions, it is

important that all aspects of the proposed reform are analysed. Different types of models can assist in assessing the impact of new tax measures on revenues and welfare. Static tax policy models are simple and can provide a first indication of the effect of a reform on revenues and welfare, but do not model its behavioural impact. This is especially important in the case of reforms that are intended to increase efficiency since they “work” by changing behaviour. However, behavioural tax policy models are more complex to build and operate. They provide a more complete view of the impact of tax policy changes on revenues and economic performance, though their predictions may be subject to a wide margin of error. General equilibrium models are not based on disaggregated taxpayer information but do consider the interaction between different markets and prices as a result of the tax policy reform and are therefore useful as well.

Framing tax-policy debates may be crucial when equity issues arise

The evaluation of tax-policy reform implies addressing the impact of the tax reform on income distribution. However, policy makers should bear in mind – and communicate to the electorate – that distributional goals should not be assessed on a tax-by-tax basis. Alt, Preston and Sibieta (2008) argue that in order to pursue sensible tax policy, it is essential to see the tax system as a system rather than to consider its different elements in isolation. Disconnected tax debates may be particularly counter-productive for the implementation of fundamental tax reform. Broadening the VAT base, for example, might be difficult if the discussion of VAT-reduced rates on particular goods takes place in isolation. The framing of the debate on recurrent taxes on immovable property in isolation will likewise hinder its adoption. Alt, Preston and Sibieta (2008) argue that such framing could result from a lack of public understanding of the actual impact of different taxes and of the interconnectedness of the tax and benefit systems. Discussing tax-policy reforms in isolation could reinforce this lack of understanding by allowing the tax-reform discussion to focus on individual taxes only. Lobby groups might have an incentive to frame particular tax-policy reforms in isolation, but this approach is unlikely to be in the interest of the general public.

Advancing reform may require acceptance of some ex ante constraints

Accepting certain 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, reforms that did not lower total tax revenues or reforms that did not change the favourable treatment of, say, mortgage interest deductions. However, explicitly accepting some upfront constraints regarding key tax objectives might imply ruling out some Pareto-improving reforms. Ackerman and Altshuler (2006) argue that it is nearly impossible to design a tax reform that relies on base-broadening measures to finance rate reductions and is nevertheless both revenue- and distribution-neutral. They argue that, although imposing up front constraints on the tax-reform process can be beneficial, the trade-off is a greater likelihood that the reform that actually is implemented will not dramatically alter the tax system. Policy makers should therefore be careful in setting strong constraints up front, because they may dictate the outcome of any reform effort.

That said, accepting constraints on the reform process might also make it easier to implement reform. The more negotiable the reform details, the higher is this incentive, and the greater the likelihood of delay (Alesina and Drazen, 1991). Thus, governments must sometimes put themselves in a situation where burden shifting across groups is impossible. This is why affirming certain constraints on the reform *ex ante* might make it easier to pursue. Common examples include the reliance of national governments on international constraints, such as those coming from the International Monetary Fund (IMF) or the European Commission, to persuade stakeholders that some measures are inescapable or on tax reform principles that were agreed upon during prior reform processes, as was the case in Norway in the early 2000s (Box 2).

Box 2. Reforming the “split model” in Norway

The 1992 dual income tax reform in Norway introduced a flat PIT rate of 28% on personal income. The same rate is used for corporate income. In addition to the flat rate, a progressive surtax is levied on gross income from wages and pensions above a certain threshold. Double taxation of distributed profits is prevented by a full imputation system. Double taxation of retained profits was prevented through the so-called RISK scheme.

In order to ensure equal tax treatment of wage earners and the self-employed, the dual income tax system splits the income of the self-employed into a labour income component, as a reward for work effort, and a capital income component, which is the return on savings invested. The capital income component is calculated by imputing a return – the sum of a risk-free market interest rate plus a risk premium – to the business’ capital stock; the labour income component is then residually determined as total business income net of capital income. The part considered labour income is taxed according to the progressive rate schedule. The part accounted as capital income is taxed at the flat rate. This approach is also used to avoid giving active owners of closely held corporations an incentive to report their highly taxed wages as lower taxed capital income, given that at least two-thirds of owners are classified as active owners (OECD, 2006). The split model gave rise to a lot of tax-planning activities aiming to shift the amount of highly taxed labour income into lower taxed capital income. The most obvious strategem was to invite silent partners to take at least one-third of the shares in order to escape the mandatory income splitting. In many cases, the reduced tax bill alone paid for the giveaway of one-third of the shares (Riis Jacobsen, 2007).

In 2002, the government appointed an expert committee on tax reform, led by a former finance minister. The committee’s mandate went beyond the income-shifting problems connected to the split model; the committee had to consider reforming the tax system in order to make it more robust in light of increased international capital mobility and the European Economic Area (EEA) agreement. Tax simplification and strengthened redistributive properties were additional tax-reform objectives. The committee’s tax-reform suggestions had also to be in line with the dual income tax principles established during the 1992 tax-reform process. The committee considered several tax reforms. The least radical change it discussed was a tightening of the existing split model. Narrowing the gap between the marginal tax rates on labour and capital income, combined with a tight split model, would probably have been the easiest way to address income shifting. However, the committee had little faith in the robustness of such a reformed tax system, mainly because the problems with the former tax system were not due to the split model in itself, but arose because politicians had used the system to achieve (personal) political economy objectives that undermined its functioning. Because the committee did not believe that politicians would refrain from doing this in the future, the allowance for shareholder equity tax system was implemented (OECD, 2007).

Source: Based on Riis Jacobsen, Michael (2007), “Economic National Report – Norway; Taxation of Capital and Wage Income; Towards Separated or More Integrated Personal Tax Systems” and OECD (2006), *Fundamental Reform of Personal Income Tax*, OECD Tax Policy Studies, No. 13, OECD Publishing, DOI: <http://dx.doi.org/10.1787/9789264025783-en>.

Ex post evaluation and international dialogue may help strengthen the case for change

Ex post evaluation of tax-policy changes might 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 evaluate *ex post* whether the tax reforms have achieved their objectives and analyse why certain objectives were or were not met. They might also assess the impact of tax reforms in terms of efficiency, equity, compliance, evasion and revenues. This will offer an opportunity to improve tax reforms that already have been implemented and might yield valuable insights for future tax reforms. *Ex post* evaluation might lead to a set of country-specific best tax-policy practices and clarify the need for specific tax policy evaluation tools and models that have to be developed. Policy makers might commit to an *ex post* tax reform review by a specific date in order to help legislation pass, as was done in the Netherlands in 2001 (Box 3). This commitment will also provide a motivation for evaluation. Another related mechanism is the use of “sunset clauses”, which implies that tax rules have to be confirmed. This might then provide an incentive for *ex post* tax policy reform evaluation as well.

Box 3. The 2001 comprehensive tax reform in the Netherlands

The 2001 tax reform in the Netherlands reduced corporate and personal income tax rates while broadening their tax bases, shifting the burden of taxation towards greater reliance on indirect taxes and “greening” the tax system. Tax allowances were replaced by tax credits, and the wealth tax and the taxation of personal capital income were replaced by the taxation of an imputed return on capital at the individual level. This “presumptive capital income tax” aims to ensure that all forms of personal capital income are taxed equally. It prevents taxpayers from realising capital income in the form of tax-free capital gains, as was the case before 2001. Instead of a tax on the actual return on capital, a 30% proportional tax rate is applied on a notional return of 4% on the net value of the assets owned by the personal investor. A basic tax-free allowance introduced a progressive element in the presumptive capital income tax (Brys, 2006, 2009).

The reform process that resulted in the 2001 tax reform started in 1997, when the tax rules for closely held corporations were revised. This resulted in the “Taxes in the 21st Century” report that was presented to parliament in 1997. It identified the main problems with the old tax system and presented the possible contours of a new system. The conclusions of this report were afterwards integrated into the coalition agreement of the second cabinet of Prime Minister Wim Kok. The 2001 Income Tax bill and the accompanying explanatory memorandum were put forward in parliament in September 1999. Different roundtable conferences were organised and the CPB Netherlands Bureau for Economic Policy Analysis released a report called “Economic Consequences of the 2001 Tax Reform”. The bill was amended several times and was accepted in parliament in May 2000. The coalition partners agreed that the 2001 tax reform would be evaluated after four years. Particular elements of the new income tax law which did not work out as planned were already reformed before the end of that period. The 269-page evaluation report was discussed in the Second Chamber of the States General (the lower house of parliament) at the end of 2005, leading to a number of tax reform adjustments.

Countries might also learn from other countries’ best practices. International organisations like the OECD play an important role in offering a platform for sharing experiences and discussing international best practices. In fact, the focus in such fora should not only be on best practices, but also on countries’ (partial) reform failures in order for other countries to learn and reduce the probability that they will make similar mistakes.

The potential for cross-border spillovers in connection with tax reform reinforces the case for such international engagement: the implementation of tax reforms might have repercussions for other countries and might depend on whether other countries implemented similar types of reforms. The introduction of a comprehensive business tax (CBIT), for instance, is probably only feasible if many countries implement the same corporate tax reform at the same time; otherwise, such a reform will discourage investment in the reforming country, as the CBIT will strongly increase the cost of debt-financing at the corporate level. Small countries that increase the statutory VAT rate might simply lose revenues as a result of increased cross-border shopping, unless neighbouring countries also increased their VAT rates. Co-ordination of tax policy, especially among neighbouring countries, can therefore be important. Co-ordination might also prevent countries from engaging in race-to-the bottom tax competition or implementing harmful tax practices that would undermine the efficient working of the overall tax system. The role of international organisations in this context is important, as they play an important role in creating a forum where countries can share information and views about tax (and other) issues.

OECD work on the Model Tax Convention, on the transfer pricing guidelines, on harmful tax practices and on the international tax information exchange agreements contributes to the creation of a level playing field. The OECD’s tax work avoids international double taxation but also attempts to prevent no-taxation; it reduces tax-evasion possibilities, contributes to the reduction of tax compliance costs, helps create an environment where individual taxpayers and businesses have greater certainty about the tax rules they will face and improves the tax system’s equity as it helps ensure that all taxpayers pay their fair share of the tax burden. Moreover, these international tax rules help broaden tax bases, thereby creating

opportunities to lower the tax rates and therefore a pro-growth tax environment. The participation of both OECD members and non-member countries in the OECD's tax work is therefore in itself part of a "making fundamental tax reform happen" strategy.

The proper timing of reform is crucial

Good reform proposals that are put forward at the wrong moment may be blocked.⁵ For instance, politicians will have to decide when to bring the 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 tax reform. The implementation of counter-cyclical pro-growth tax reform could anticipate possible economic downturns and mitigate their impact by putting the economy on a higher growth path before the downturn hits. In short, governments face incentives to engage in fundamental tax reform when times are good. However, it might not be possible to obtain support for fundamental reform in a cyclical upswing. An economic downturn might then create an opportunity to introduce pro-growth tax reforms and put the economy on a higher long-run growth path. Recessions sometimes expose very clearly the weaknesses of the economy and thus the need for reform. As a result, taxpayers and voters might more easily accept the necessity of reforms that tackle the underlying economic problems. The problem then, however, is that the deterioration in public finances brought about by the downturn may reduce the fiscal space available for financing reforms that might involve upfront costs.

It can sometimes pay to prepare ideas for tax reform in advance and wait for a good moment to launch them into the political arena. Politicians might, for instance, try to obtain political support within their own political party and gather data that provide support for tax reform before they express their tax reform ideas in the public domain. Governments might also have an incentive to postpone the presentation of tax reform ideas until they are ready to answer the most difficult questions and respond to the most severe criticisms. Aggregate tax-reform uncertainty might create an option value to learning. Policy makers' and other stakeholders' understanding of economic problems might be improving over time, as more and better information becomes available. In that case, it may be better to defer an apparently worthwhile reform until further information confirms the tax reform gains. This might then lead to tax reforms that are implemented late, but vigorously and quickly.

There are strong arguments for "bundling" 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 seems to suggest that comprehensive reform is preferable, at least when it is possible. Recent examples of comprehensive tax reforms include those in the Netherlands, described earlier (Box 3) and in the Slovak Republic (Box 4).

Box 4. The 2004 comprehensive tax reform in the Slovak Republic

The 2004 “comprehensive” flat tax reform in the Slovak Republic aimed at improving labour market flexibility and increasing work incentives, as well as attracting more foreign direct investment, on the condition that the tax reform had to be broadly revenue-neutral. Before the tax reform, the personal income tax system had five income brackets, with marginal tax rates varying from 10% to 38%. The average production worker faced a marginal personal income tax rate of 20%. The corporate tax rate was 25%, having fallen from 40% since the end of the 1990s.

The introduction of the 19% flat tax rate on corporate and personal income – the flat rate was set below the marginal rate faced by average workers – was combined with certain base-broadening measures and with a large increase in the basic allowance – it more than doubled – in order to offset the increase in the marginal tax rates for lower income households. At the same time, the government reduced social assistance benefits, introduced additional reforms that aimed to “make work pay” and shifted the tax burden from direct to indirect taxation. The two VAT rates of 14% and 20% were replaced by a single 19% rate – setting the new VAT rate slightly below the top statutory VAT rate of 20% might have helped gaining political support for the reform – and certain excise taxes were increased.

The tax reform turned out to be broadly revenue neutral as a result of the shift from direct to indirect taxation. A comparison of the estimated tax revenues that would have been received in 2004 in the absence of reform and the revenues actually received in 2004 suggests that the decline in PIT revenues (estimated at 0.8% of GDP) and CIT revenues (a further 0.8% of GDP) was almost entirely offset by the increase in VAT revenues (up an estimated 0.8% of GDP) and excise revenues (up an estimated 0.6% of GDP).

Various elements of the 2004 Slovak tax reform tended to change the income distribution in favour of more affluent households (OECD, 2005). However, the issue of fairness in taxation cannot be separated from the issue of efficiency. As the tax reform aimed at increasing the capital stock and improving the allocation of capital, labour productivity might increase; this should raise real wages so that workers, including the low-skilled, should also benefit from lower taxes on capital over the long term. As these benefits only arise over time, an increase in the basic tax-free allowance was crucial to obtaining the lower income workers’ political support for the tax reform.

For a start, bundling reforms may make it easier to address distributional issues. There are examples of “bundled” tax reforms, involving the simultaneous adoption of multiple changes in taxes (and sometimes benefits) that will mitigate the costs of reform for groups that might otherwise be hard hit by individual measures. VAT base-broadening measures, for example, increase tax revenues that can be used to compensate poorer households through increased direct benefits. This approach was followed in Chile. Alternatively, the impact of VAT base broadening could be offset by a reduction in PIT rates in the lowest personal income tax brackets or increases in the threshold at which PIT begins to bite. A statutory CIT rate reduction could be accompanied by an increase in taxes on capital income at the personal shareholder level. An increase in the recurrent taxes on immovable property or VAT could be used to finance a reduction in employee social security contributions. Bundling reforms also allows governments to allocate the benefits of reform to particular types of taxpayers, for example through direct increases in benefits or indirect tax cuts. By choosing the details of the tax-reform package, governments will increase the probability of finding sufficient political support to implement the reforms. However, the compensation of particular groups of taxpayers will only be necessary if these groups have the power to block reform or are seen as possible swing voters in the next election.⁶ The potential to advance reform in combinations like these highlights the importance of viewing the tax system as a whole rather than considering individual taxes in isolation. In order to advance fundamental tax reforms, governments may need to combine tax and benefit reforms in different areas in order to achieve a balance among the broader reform objectives of efficiency, growth, equity and revenue.

While much attention is often paid to the very real difficulties of engineering a “big bang” reform, there are times when it may offer a far easier way forward than a more gradual approach. For example, a comprehensive package may be necessary in order to obtain sufficient support for fundamental tax

reforms. Olofsgard (2003) points out that bundling reforms may be necessary if there are a number of potential “veto players” whose support is crucial. Martinelli and Tommasi (1997) argue that often, and particularly in Latin America, reforms are an all-or-nothing process. Gradual reforms may be impossible, whereas big bang reforms may be feasible, even if only at some opportune moments. They propose a model in which each group has veto power such that divide-and-rule tactics cannot work: each individual reform measure pleases two groups and hurts one, so every single reform will be vetoed. Yet there is a “grand reform” that corrects all distortions at once. In that case, the strategy of bundling many reforms together becomes the only politically feasible strategy. In short, in countries where many groups, agents or institutions have *de facto* veto power over tax policy, reforms might be delayed until the time when the distortions of the status quo hurt all groups, who then accept a grand reform.⁷

The comprehensive (big bang) approach to tax reform might be preferred over the incremental tax reform approach for a number of other reasons (Olofsgard, 2003). Comprehensive reform might prevent the formation of lobby groups powerful enough to stop the reform or to adjust the reform proposals in such a way that its main goals are no longer (or only partially) achieved. By acting quickly, governments might actually increase the probability that fundamental tax reforms are implemented. Olofsgard (2003) also argues that the big bang approach may also be preferred if the full tax reform package is necessary in order to realise the long-term benefits of reform or if there is a risk that the tax reform will be stopped or reversed. Tax-reform support may be withdrawn if the realisation of long-run benefits becomes uncertain because of the risk of getting stuck at a partial reform equilibrium. Finally, a good comprehensive tax reform package is, if it can be accomplished, better than an incremental approach, which runs the risk of losing focus and degenerating into *ad hoc* measures that do not lead to the fundamental change that might be needed.

As noted earlier, policy makers have a greater incentive to engage in tax reform if the gains will be visible by the time of the next election. Given the four- or five-year political cycle in most democratic societies, this implies that fundamental tax reform – especially comprehensive reforms that require more time before the benefits of reform become visible – will have to be introduced at the beginning of a government’s mandate in order for the gains to be tangible by the next election.

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

The attractions of comprehensive reform notwithstanding, there are circumstances in which sequencing reforms may be the desirable – or even the only feasible – strategy. In fact, even if a comprehensive approach is followed, governments could still implement the comprehensive reform on a tax-by-tax basis instead of implementing all tax reforms at once. The distinction between the adoption of a grand reform and its implementation should not be overlooked, because the greater the complexity of the changes adopted, the more likely it is that implementation will take time. Yet there are also arguments for taking a more gradual approach to the *adoption* of reforms.

Uncertainty constitutes one such argument. Dewatripont and Roland (1995) propose a model in which a major reform can be split into two smaller, complementary reforms, both of which must be implemented to realise the benefits of the complete reform. However, uncertainty surrounds the benefits of reform. Implementing the entire reform at once would produce all benefits and costs immediately. The gradual strategy, however, would introduce only one of the smaller reforms first. Once the outcome of that smaller reform was observed, the population would decide whether to implement the second reform or to return to the status quo. The costs of reversal increase with the magnitude of the reforms already implemented. Thus, the gradual strategy dominates if the first reform has a sufficiently high probability of revealing that the whole process should be stopped: this saves on reversal costs. Because of the option value of an early reversal, gradualism also facilitates social acceptance of the whole reform process, particularly if the second part of the reform is “politically difficult”. In fact, the second reform will only be implemented if

that the experience of the first reform suggests that its benefits will be sufficiently great. Thus, some of the *ex ante* opposition to a comprehensive reform may be quelled by proceeding in stages and providing a possibility to block the entire process at the interim stage. Dewatripont and Roland (1995) also show that reformers should first implement the reforms that have: (i) the highest expected payoffs; (ii) the highest risk for any given expected payoffs; and (iii) a high probability of revealing information about the value of the entire reform process; the first and second reform should also be complementary.

It may also pay to unbundle reforms that cannot overcome the status quo bias, and hence to spread the implementation of the (comprehensive) tax reform over time (Dewatripont and Roland, 1992). The idea is simply to divide the reform in two steps that *do not harm the same voters* (or interest groups). The first measure targets a sufficiently narrow group of the population and thus enjoys the *ex ante* support of a majority. Once this first reform is passed, the group that opposed it may come to support the second step, which will target voters not threatened by the first. In essence, the strategy of sequencing here aims to divide and conquer those who would unite to reject a fundamental reform if it were undertaken all at once. Moreover, if the reform sequence proceeds in a consistent way, the process as a whole will gain credibility and agents will become gradually more accepting of subsequent reforms, not least because some will start to adapt their behaviour in anticipation of the changes that are in prospect.

If, however, there is too much uncertainty about when the next step in the tax reform will be implemented, taxpayers might wait to adjust their behaviour instead of immediately anticipating the reform. Moreover, the approach does provide taxpayers with an opportunity to start lobbying against reforms that are planned for the future. 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.

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). By first introducing relatively popular reforms, politicians might obtain a good tax reform reputation and build up support for the implementation of the more controversial measures (Olofsgard, 2003). However, Stiglitz (2002) argues that tax reform will generally be accepted if there is some kind of tax reduction in prospect. He therefore advises not to reduce the rates before the more complex issues have been put on the reform agenda. In any case, a comprehensive tax reform does not necessarily rule out the necessity for incremental follow-up measures. A big bang tax reform might create new loopholes, it might need to be corrected or amended subsequently, or it might exacerbate existing distortions that were not tackled by the original reform plan. The further “fine-tuning” of the tax reform will then require incremental tax reform.

A sequenced approach to reform may also better suit politicians with an eye on the electoral calendar. A comprehensive tax reform, even if it is implemented at the beginning of the electoral cycle, might take longer than four to five years to generate visible gains. Because politicians run then the risk of not being rewarded for the reform at the next election, they might prefer to follow the incremental approach, especially if there is a substantial probability that the next government in power will reverse the tax reform. Reforms that are more difficult to design, for which it takes longer to obtain sufficient political support and that take longer to implement might therefore be enacted first.

Whether reforms are comprehensive or incremental, some transitional arrangements may be needed

Governments may sometimes allow for “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, grandfathering rules that are not well targeted will reduce the gains that can be realised by reforming the tax system, particularly if agents are able to take actions that will lock in the old rules. Moreover, grandfathering rules increase the complexity of the tax code, which results in increased compliance and enforcement costs. They can create tax-evasion opportunities where new and old rules co-exist and they may reduce the revenues gains from fundamental tax reform. The old rules might be phased out over time, implying that after a number of years only one set of tax rules will apply. Government would then have to decide upon the proper length of this phase-out period.

Governments need to be careful not to implement transitional or other temporary policies that will in fact be difficult to reverse. The removal of special tax treatment for particular groups can be difficult, even if it was never intended to be permanent, because of pressure from those who benefit from special treatment. Temporary measures thus have a tendency to become permanent. However, the introduction of temporary tax measures can be beneficial in particular circumstances. If a government does introduce temporary measures, it might be advantageous to include the expiry date in the original legislation (sunset provision or clause). The special tax treatment can, of course, be confirmed by law for a new period of time if need be, but it will be harder to lobby to resist a return to the *status quo ante*. This approach signals the temporary nature of the special tax rules.

Much depends on the quality of the institutions charged with reform design and implementation

Bird (2004) discusses different strategies for “institutionalising” the process of tax reform. The recommendations in this section largely reflect the analysis in Bird (2004) and his review of McIntyre and Oldman (1975). The latter argue that countries that put in place appropriate institutional arrangements for tax reform would both improve the quality of tax reforms proposed and increase the likelihood of their adoption and successful implementation. Appropriate institutional arrangements are necessary in order to ensure the adequate drafting of the tax legislation, the collection and analysis of relevant tax and other data, proper tax-reform planning and effective communication with the broader public. They argue that better planning will increase political support through improved transparency and public understanding. It will be possible to make changes in reform proposals for political (or other) reasons more quickly, while at the same time remaining faithful to the underlying objectives and rationale of the reform. It is easier to resist politically appealing and populist arguments against reform where proposals are backed up by high-quality tax-policy analysis. Moreover, politicians introducing reforms will have more control of the process in terms of timing and presentation.

Good institutional planning of fundamental tax reform is a precondition for its successful implementation. However, it is also necessary for improving both the design of the many technical rule changes that might have to be made to accommodate tax rules to the changing environment (Bird, 2004). Moreover, good planning is also important to prevent the implementation of tax rules – or small changes to these rules – in ways that undermine the proper functioning of the tax system. Effective tax analysis departments can help reduce the uncertainty about the outcome of reform. Governments with tax reform ambitions therefore need to provide adequate resources for the development and maintenance of tax models that can provide good quality analyses of the impact of tax reform on agents’ behaviour and tax revenues and by investing in the human capital of its staff. Governments might also want to share the results of this work with the broader public on a continuous basis. Tax analysis departments then have the opportunity to establish credible reputations for providing high-quality work. Fundamental tax reforms that take into account the recommendations of the tax analysis department might then become easier to implement.

Governments might also ask independent bodies to calculate the effects of tax-reform proposals on firms’ and households’ behaviour, tax revenues, income distribution, etc. Alt, Preston and Sibieta (2008)

argue that external organisations – whether domestic or international – provide some level of scrutiny and accountability. This can help improve the draft legislation and make it more likely that the economic impact of reform proposals is fully thought through.

Policy advice could also be provided through specific tax-policy reform committees and commissions, such as the Tax Commission in Denmark, which has set a new benchmark to form a basis for the political negotiations on the 2010 tax reform (Box 5). The membership of such a committee may consist of academics and experienced politicians of high political stature, as well as senior officials. Their recommendations may provide valuable inputs to the tax reform process and might help sell the tax reform proposals to the legislature and the general public.

Box 5. The 2010 tax reform in Denmark

In Denmark, a Tax Commission was appointed in early 2008 with a former minister for taxation as chair and a number of primarily academic tax experts as members. The Tax Commission met academics, representatives of business and industry, labour leaders and OECD officials during the first six months of its work. On 2 February 2009, the Commission's presentation of its report on tax reform was broadcast live on television. Tax cuts and financing were around DKK 36 billion, corresponding to approximately 2% of GDP. Three weeks later, the government put forward proposals based on the Commission's recommendations, and on 1 March, a political agreement on the 2010 tax reform was reached. Some of the more controversial elements of the Commission report were either modified or dropped from the final proposals. The total value of the reform was also reduced to around DKK 30 billion. The changes made to the Commission proposals were mainly due to concerns about distributional issues and the burden on the business sector. However, the inclusion of some relatively ambitious and controversial elements in the Tax Commission proposal was important to the end result. It might be argued that the Commission proposal set a new benchmark for the tax system, on the basis of which political negotiations could proceed.

In structuring the tax reform, the authorities sought to balance financing and tax cuts among groups of taxpayers that were, or might be perceived as being, connected. This had much to do with the perception that the reform was fair and acceptable. First, the top marginal PIT rate was cut by 5.5 percentage points, while the tax threshold was increased. These measures were financed by cutting the tax value of interest deductions in excess of DKK 50 000, by introducing a limit to yearly tax-favoured pension savings and a tax on large pension income, and by reducing tax expenditures for business and industry. Secondly, the government followed a similar strategy by connecting a reduction in the bottom PIT rate and the introduction of "green cheques" (a standard cash transfer) with general increases in energy and environment taxes and reductions in the tax value of deductions of expenses like labour union fees and commuting expenses.

The most important issue in the public debate following the Tax Commission was the proposed reduction in the tax value of interest deduction in personal income taxation by 8 percentage points; a measure which was needed in order to finance a substantial part of the tax cuts. The government was able to implement this tax reform measure by building several safeguards into the reduction. First, the reduction of the tax value from 33.5% to 25.5% is to be phased in gradually from 2012 to 2019, while the tax cuts are taking effect from 2010. Secondly, the reduction is only effective for the interest deductions in excess of DKK 50 000 (DKK 100 000 for married couples) a year. This threshold is nominally fixed and thus will be gradually reduced in real terms. Finally, a special compensation scheme was introduced whereby individuals are to be compensated if the loss from the reduced value of interest deductions (and other personal deductions) exceeds the gain from the cuts in the PIT. Overall, the success of the reform owed much to its reliance on a rate reduction and base-broadening approach that balanced tax cuts and financing within broad income groups. The distributional analysis that underpinned the reform proposals focused not only on the immediate impact of the reform, but also on its longer-run distributional impact, which made it possible to take into account the longer-run tax reform efficiency gains. In addition, the timing of the tax cuts and financing was important in light of the international economic crisis. The emphasis on improving fiscal sustainability in light of the crisis therefore worked to implement this fully financed tax reform.

The transparency of tax reform processes can be 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. However, voters are typically imperfectly informed and they do not often have the information and/or skills needed to assess the effects of tax policies. Imperfect information may allow politicians to run their own agendas, which may not be in line with the preferences of the median voter.⁸ At the same time, it may also induce voters and other political actors to block beneficial tax-policy reforms. 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. Clear communication about tax-reform objectives and measures might facilitate the creation of a broad social consensus that favours the introduction of these reforms. A proper communication strategy will also help if the impact of the tax reform turns out to be different than foreseen. It will help to point out why the outcome could not have been foreseen and to explain why the outcome differs from the expected outcome.

Governments might inform stakeholders of how tax revenues are spent, for example, by including such information with the tax returns that citizens must complete. This strategy might be followed at all levels of government. Such information sharing could be done on a regular basis and not only when governments plan to raise taxes. Information sharing will also help to build tax morale and improve tax compliance. Many taxpayers might lack proper knowledge of which taxes are levied and why. For instance, in many countries, a large part of the tax burden on labour income consists of social security contributions levied to finance social security benefits (pensions, unemployment insurance, health insurance, etc.). Taxpayers are not necessarily perfectly informed about the level of these social security contributions, especially when employers pay a large share on their behalf.

Transparency is also a key element of government accountability. Governments and politicians are accountable to citizens (voters) for their performance in general and for the effective and efficient use of public resources in particular. Increased government accountability will weaken political incentives to manipulate tax and expenditure policies for purposes of electoral gain. Moreover, periodic assessments of existing policies – and clear communication about these assessments – may enable governments to make well-informed decisions concerning ineffective or outdated policy measures that need to be eliminated and to strengthen and update those that are retained. This need for periodic reviews, including tax expenditure reporting (Box 6), has been reinforced by the fiscal imbalances resulting from the international financial crisis.

That said, talk can be cheap (Olofsgard, 2003), and one-line slogans may 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 still very 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.

Box 6. Tax expenditure reporting

Fiscal information is critical to the overall transparency of tax policy. Yet substantial gaps often exist. In general, governments provide sufficient documentation regarding taxes collected and direct spending, mainly through the budget documentation. However, the publication of comprehensive information on spending through the tax system (tax expenditures)¹ is an area for potential improvement in many OECD countries (OECD, forthcoming). Many have no provision for systematic reporting of tax expenditures. Tax expenditures (TEs) have a significant effect on overall tax burdens and also on the budget (due to the tax revenue forgone). They also reduce fiscal flexibility, due to the opportunity cost of the revenue forgone. At the same time, TEs contribute to the growing complexity of the tax system and thus tend to raise administration and compliance costs. In contrast to direct spending programmes, tax provisions are not generally submitted to periodic scrutiny and they may be largely “invisible” to the electorate at large. However, like any other tool for achieving policy goals, TEs can be put to good use or abused.

Many OECD and non-OECD countries produce and publish regular tax expenditure reports, which include a list of their main tax provisions and estimates of the cost of such reliefs in terms of tax revenue forgone. Some governments even bring TEs into the budgetary process. However, systematic and periodical assessments of the effectiveness and efficacy of TEs are still the exception rather than the rule in most of the OECD. Greater transparency of and accountability for TEs might be ensured by reporting better information on their rationale, objectives and performance. If properly designed and implemented, a TE report makes tax expenditures more transparent by providing information on the government’s use of public resources and whether these measures are achieving their intended purposes and designed in the most efficient and effective manner. A TE report also encourages accountability by enabling policy makers, voters and other political actors to evaluate individual tax expenditures – in terms of their net social benefit and distributional impact – and to make well-informed decisions about whether to eliminate or continue them. Finally, a TE report contributes to the management of budget allocations and the overall fiscal position by estimating the opportunity cost of these reliefs in terms of higher taxes, reduced spending and/or higher deficits.

1. A tax expenditure can be seen as a public expenditure implemented through the tax system by way of a special concession (exclusion, exemption, allowance, credit, preferential rate or tax deferral) that results in reduced tax liability for certain groups of taxpayers (Altshuler et Dietz, 2008).

Co-ordination of reform across levels of government is important

Sub-central governments in many countries are seeking additional resources for improving the services they provide; channelling these demands into the path of fundamental tax reform is a policy challenge. This strategy could help sharing the burden of tax reforms between the different levels of government, making the implementation of reforms more politically acceptable. Many obstacles to do so could be envisaged, but a justification of tax reform based on the need to be closer to citizens could actually contribute to the success of the tax-reform process.

It is clear that fiscal federalism could complicate matters, but it may also provide new opportunities to have a more globally efficient tax system. For instance, the assignment of a country’s taxing powers to the appropriate institutional level might imply that taxes could be reformed in a more efficient and equitable way. Blöchliger and Petzold (2009) have discussed the criteria for assigning particular taxes to different government levels. They write:

The conditions for a sub-central tax to be growth-enhancing are the same as for a national tax, but some additional constraints apply to make a “good” sub-central government tax. There is quite a broad consensus on what makes an effective sub-central tax mix. As a basic principle, sub-central government should rely on benefit taxation, i.e. taxes that provide, for households or firms, a link between taxes paid and public services received (Oates and Schwab, 1988). The criteria derived from this principle include: sub-central government taxes should be non-mobile and non-redistributive (to avoid tax erosion), non-cyclical (to avoid sub-central government running

stabilisation policy through debt and deficits), should not be exported to other jurisdictions (to avoid distortions in the tax burden), and the tax base should be evenly distributed across jurisdictions (to avoid strong disparities and/or the need for huge fiscal equalisation systems). Based on these criteria, the property tax would occupy an even more prominent place in the sub-central than in the central tax mix, particularly for local governments (King, 2004). Sub-central personal income taxes would lose out because of their redistributive properties, and sub-central consumption taxes, especially sales taxes, would lose because they divert taxes among jurisdictions. Sub-central corporate income taxes come last: corporate tax revenue is mobile, highly cyclical, geographically concentrated and tends to shift the tax burden to non-residents.

In assigning particular taxes or discretionary powers on rates and/or bases fully or partially to sub-central governments, it is important to avoid stimulating regions to compete in a harmful way. A compromise must be achieved between the possible gain in efficiency as a result of a higher level of tax decentralisation and the need for a coherent and non-distortionary tax distribution. Discretionary control over a particular tax base could also have important trade-offs between efficiency and compliance/administration costs for the whole tax system. Discretionary control over tax rates may be provided within tax bands; that is, states/regions are given the freedom to change rates within these bands. This should ensure that the overall links between taxes levied at different levels are maintained, *e.g.* that CIT rates are not reduced too far below the top PIT rate or that taxes on owner-occupied housing are not too far above or below the tax burden on other investment opportunities, at the cost of limiting the sub-central discretionary powers on taxes.

The co-ordination of tax reforms between different regions is important. There is a need for different levels of government to act coherently. Any tax reform must take into account existing taxes at the federal and sub-central level and shared tax agreements. This implies that the impact of tax reforms on other regions or levels of government is considered. Governments should create appropriate institutional settings that allow for tax reform evaluations across levels of government and regions. There might also be a need for mechanisms that allow for inter-regional compensation, for instance if particular federal tax reforms have a positive impact on some, but a negative impact on other regions.

Successful reform requires strong leadership

The implementation of fundamental tax reforms might require a political champion who can create circumstances that are favourable to their implementation. A political champion will recognise when there is a tax reform momentum and use this opportunity to introduce a tax reform. Bird (2004) states that the essential requirement for successful tax reform is a strong political will exemplified by one or more political champions who are prepared to put their reputations on the line. Their involvement will very likely increase the support for fundamental tax reform. In order to obtain sufficient political support for fundamental tax reforms, politicians may want to identify the winners and losers and the degree to which voters will win or lose as a result of the tax reform. Clear communication about winners and losers might be especially important for the implementation of fundamental tax reforms if many taxpayers think they will lose while they effectively will not (or not as much as they expect). In fact, the need for providing good quality information becomes more important the higher the costs for taxpayers to collect information.

Another strategy that may help introduce fundamental tax reform is to focus on the inequities of the current tax system. This may persuade voters that tax reform is necessary. For instance, levying reduced property taxes on out-of-date housing values will imply that some taxpayers that are entitled to be taxed at the reduced rate cannot benefit from this provision. Focusing on this inequity, politicians might build support for reassessing the property values of all houses. 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.

In the absence of sufficient political support, politicians may want to adjust the original tax reform proposals in such a way that political support increases. For example, a larger part of the tax reform benefits could be allocated to the losers from reform or they could receive offsetting benefits through the reform of other policy measures. Compensation will, however, only be necessary if the tax reform losers have the political clout to block reform or are considered to be the swing voters in the next election. It may also be warranted on equity grounds, if there is a widespread public perception that the benefits they may be losing were in some sense justified. The compensation of losers will divert the benefits of reform towards particular groups of voters. Compensation packages might then reduce the overall tax reform gains. Policy makers might therefore have to trade off the benefits of compensating losers in order to obtain sufficient political support against the costs as a result of the reduction in the overall tax reform gains for society. If too many voters will have to be compensated in order to be able to implement the tax reform, it might even be more beneficial not to implement the fundamental tax reform.

Barbaro and Suedekum (2006) argue that symmetric tax reforms – the same individuals gain and lose as a result of the fundamental change in the tax mix – are easier to implement than asymmetric tax reforms where the winners and losers are not the same individuals. An asymmetric cut in tax privileges might hurt a relatively small group of taxpayers strongly while a large group will be affected positively. Assuming a revenue-neutral tax reform, their gain might be small and have therefore no impact on their voting behaviour. The group of taxpayers that loses substantially faces a strong incentive to lobby hard against the reform. However, if the benefits and costs of tax reform are diffuse, there is a lower probability that new interest groups will be formed. Barbaro and Suedekum (2006) therefore conclude that tax reforms that share the burden of forgone privileges evenly among many groups or, alternatively, compensate losers for their losses, have the greatest probability of being implemented.

Politicians might try to link explicitly the abolition of a tax expenditure that is inefficient and beneficial only to some taxpayers with the introduction of tax measures from which most taxpayers will gain. This strategy might make the silent majority awake because they explicitly gain if the new tax policy is introduced, though it is likely to remain the case that the gains of the many will, at an individual level, be small compared to the losses of the minority.

Making fundamental tax reform happen in light of an economic crisis: concluding remarks

Strategies to overcome the obstacles to fundamental tax reform are of special interest because of the global financial and economic crisis. On the one hand, it is sometimes argued that the crisis might facilitate tax reform. The political economy obstacles to reform might be easier to overcome during a crisis, especially because of the increased pressure to raise more tax revenue in order to restore public finances and because of the pressing need to put economies back on a high-growth path. Olofsgard (2003) argues that a crisis might make the implementation of tax reform more likely, because it undermines the power of vested interests and it might imply that opponents of reform may change their perspective because they start to gain from reform as well. He argues that a crisis might create a sense of urgency, opening a “window of opportunity” for fundamental tax reform that would otherwise have been blocked. Harberger (1993) argues that a severe crisis may be necessary in order to convince policy makers that their view of what is “good” tax policy may not be entirely correct, that there are other alternative tax systems available and that fundamental tax reforms are necessary.

On the other hand, the crisis might make fundamental tax reform even more difficult to implement, especially because large groups of taxpayers have been, and will be, strongly affected by the crisis. The analysis in this chapter might therefore be helpful to explain why some countries are able to engage in fundamental tax reforms in times of a crisis while other countries face more difficulties in doing so, providing insights that might be useful to all countries in implementing fundamental tax reforms in the future.

NOTES

1. Horizontal equity from a tax perspective implies that taxpayers in an equal situation should be taxed in an equal manner, as they have the same ability to bear the tax burden. The tax policy objective of vertical equity prescribes that taxpayers with better circumstances should bear a larger part of the tax burden as a proportion of their income. Vertical equity thus implies that the distribution of after-tax income should be narrower than the distribution of before-tax income, or that the average tax rate should be increasing in income (OECD, 2006).
2. More information on the definition of such practices can be found on the website of the OECD's Centre for Tax Policy and Administration: www.oecd.org/ctp under the heading "harmful tax practices".
3. In 1988, for example, the UK government's announcement of changes to the rules governing mortgage interest relief at source, which were to take effect only four months later, triggered a rush to complete mortgage deals before the change entered into force. As a result, an already over-heated housing market was pushed still further, only for the boom to end in a house-price bust a short time later.
4. Of course, tax is only one issue among many determining voters' choices and it is by no means always the most salient, although elections may sometimes turn on major tax reforms.
5. Countries that have successfully implemented fundamental tax reform in the past would not necessarily have been successful given different (economic, budgetary, political, etc.) circumstances. Likewise, countries that have not been successful in implementing fundamental tax reforms in the past may successfully implement them in the future.
6. At least this is what standard voting models seem to imply. Policy makers may of course also provide benefits or tax reductions to taxpayers purely on equity grounds, for instance, even if they know that this will not (strongly) affect these taxpayers' voting behaviour.
7. In contrast, when the executive is sufficiently powerful to exploit divide-and-rule tactics *à la* Dewatripont and Roland (1992), as discussed later, then the gradual strategy might allow an earlier start to the reform process.
8. In some cases, however, imperfect information might allow policy makers to introduce controversial tax reforms that are in the general interest.

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