



# Taxation and Economic Growth

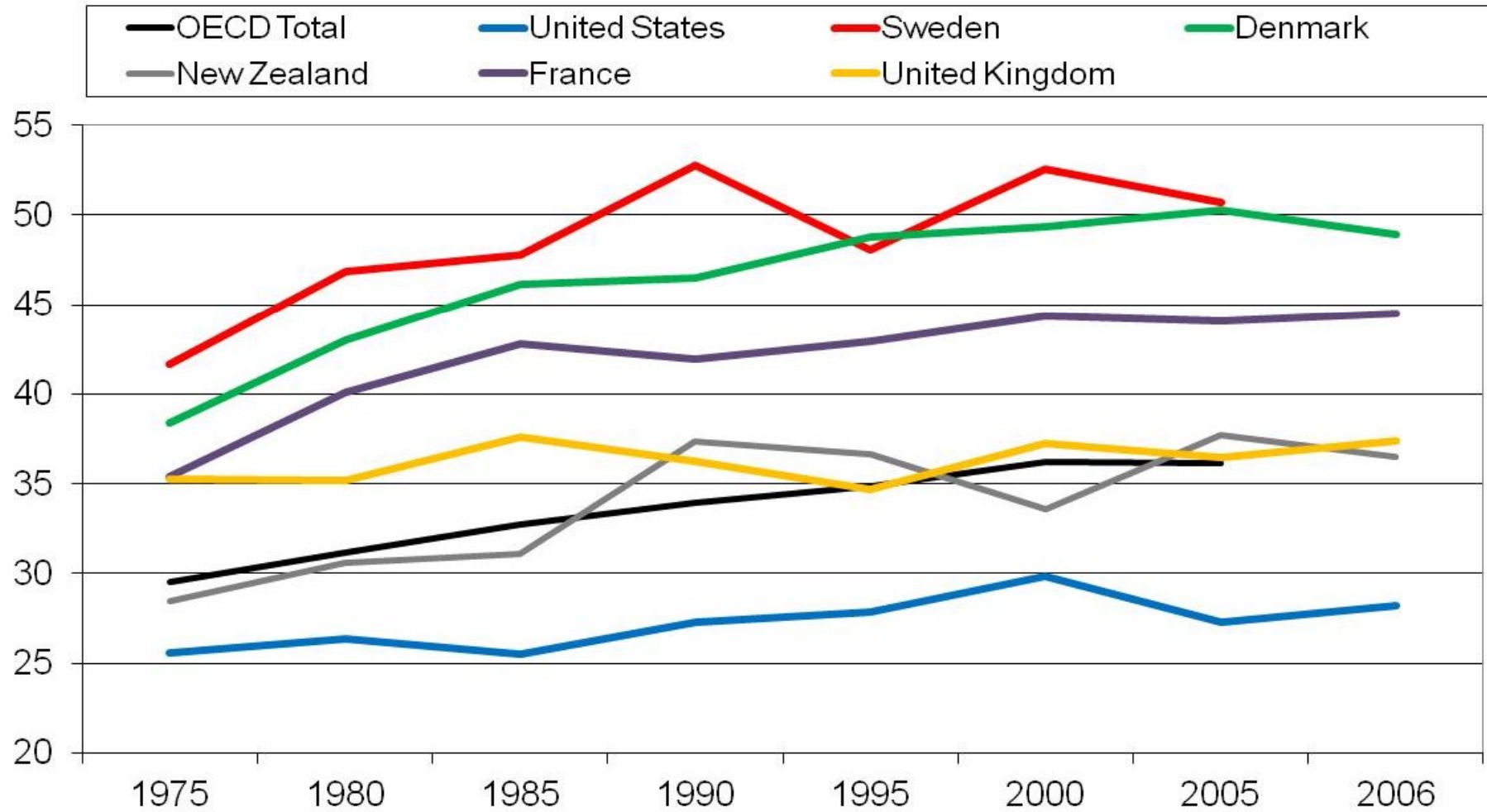
Study for WP1, March 2008

Joint work between the Economics Department  
and the Centre for Tax Policy and  
Administration, OECD

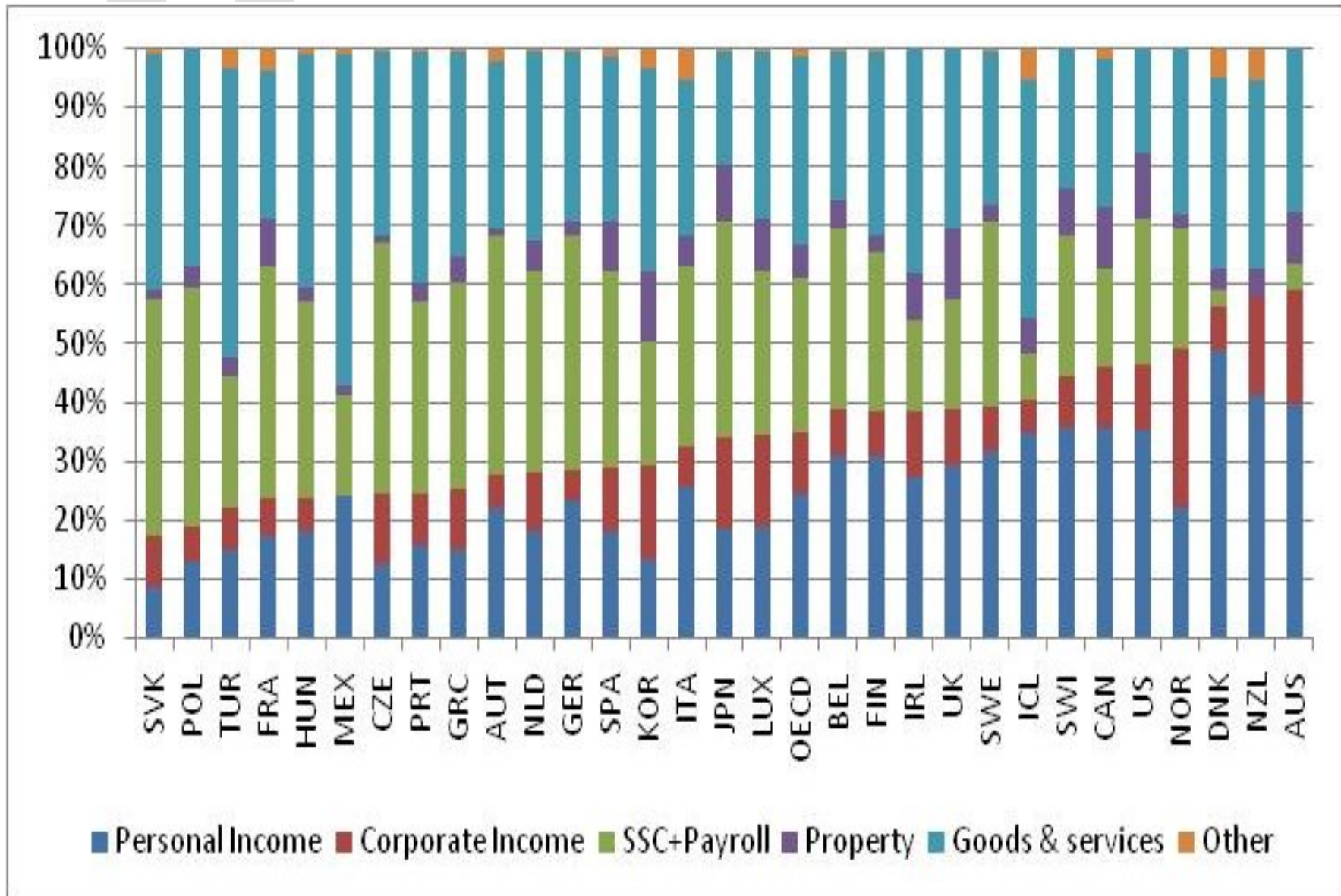
# Aims of the OECD study

- Does the tax structure, as opposed to the level of taxes, matter for GDP per capita?
  - Overall tax levels reflect societal choices about the level and structure of public spending.
  - Investigating which tax structures are likely to be least costly for growth is a key issue for tax policy making.
- To what extent do different tax provisions affect investment and productivity (TFP)?
- Does the industry/firm structure matter for the impact of taxes?

# Increase in tax to GDP ratio



### 3 main sources of tax revenues: income taxes, SSC and consumption taxes, but large variation.



# Do differences in tax structures matter for growth?

- Why is it important to get the mix and the design of taxes right?
  1. The distortionary effects of collecting revenue from different sources can be very different.
  2. Re-designing taxation within the broad categories could in some cases also ensure sizeable efficiency gains.
- Empirical strategy:
  1. Cross-country analysis of the effect of tax structure on growth
  2. Closer look at underlying mechanisms by using firm and industry data and analyse the effects of taxes on productivity and investment.

## Cross-country findings: Broad tax structure

- The evidence suggests a “**tax and growth ranking**” with property taxes (particularly recurrent taxes on residential property) being the least harmful tax in terms of reducing long-run GDP per capita, followed by consumption taxes, personal income taxes and corporate income taxes.
- **Progressivity** in personal income taxes seems to reduce GDP per capita.

# Taxes and productivity

- Corporate (statutory/effective) taxes tend to impact productivity negatively and seem to matter more in highly profitable/risky industries.
- Statutory corporate taxes seem to have a **smaller** negative impact on productivity growth in firms that are both **young and small**.
  - large share of start-ups with zero/low profits for which corporate taxes doesn't matter much.
- Statutory corporate taxes seem to have a **stronger** negative impact on productivity growth in **'dynamic' /fast-growing firms**, that are profitable and experiencing rapid productivity growth.

## Taxes and productivity

- **R&D tax incentives** seem to increase productivity and seem to matter more in R&D intensive industries, although the effect is moderate.
- **High top marginal personal income tax rates** reduce productivity growth, especially in industries characterised by high entry rates of new firms/entrepreneurial activity



## Taxes and investment

- Corporate (statutory/effective) taxes affect **investment** negatively by decreasing the after-tax return to investment projects.
- The effect of corporate taxes on reducing investment seems to be **stronger in older firms**.
  - younger firms are less profitable than older; young firms benefit from targeted exemptions or reduced rates.

## Policy implications of the findings: Broad structure

- Broad simplistic implication for the tax structure: Revenue neutral shift towards more use of consumption and property taxes (particularly residential) and less income taxes, needs to be put into perspective of each country's tax system. Distributional concerns can be an obstacle: consumption taxes less progressive than income.
- Reducing income tax progressivity: Trade off between enhancing GDP per capita and increasing net wage inequality

# Policy implications of the results: Corporate taxes

- Cutting corporate taxes could positively affect investment. It is possible that product market regulations and large administrative burdens on firms can make investment decisions less responsive to taxes.
- Cutting corporate taxes may also promote productivity growth.
- Exemptions for small/young firms may not be efficient in raising investment and productivity.
- Effect on equity is hard to assess.

## Policy implications of the results: Personal income taxes

- Countries with a large share of industries with high entrepreneurial activity/turnover rates (or wishing to move in this direction) may gain from reforming their top marginal tax schedule. However, this could increase inequality.

## Key policy issues from the literature

- Broadening the base of consumption taxes is better for growth than increasing the rate.
- There is limited scope to improve growth by using multiple consumption tax rates, and their equity effects are best achieved by other means.
- Lower average labour taxes could help raise participation rates while lower marginal tax rates may be preferable for increasing hours worked.
- In-work tax credits can promote growth by increasing participation rates, but care is needed to contain costs and minimise adverse effects on hours worked.

## Conclusions

- GDP per capita can be increased, by shifting away from income taxes
- Recurrent taxes on immovable property are the least harmful to growth
- It is necessary to design individual taxes well in order to benefit most from any tax shift
- There is likely to be a trade-off between growth and equity.

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- Full report: ‘Tax and Economic Growth’, Economics Department Working paper No. 620.

<http://www.oecd.org/dataoecd/58/3/41000592.pdf>

- Overview chapter in Going for Growth, 2009.