Options for Fiscal Policy

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Issues

- Trade-off between revenue and redistribution
- Economic cost differences among revenue sources
- Can multinationals be made to pay more?
- Can international tax cooperation extend to the rich?
- Market pressures on unstable debt paths

Trade-Off Between Revenue and Redistribution

- Taxes can go for several purposes that are generally in direct competition for funds
  - Public spending
  - Redistribution
  - Debt reduction
- Stronger needs for one use means others may need to give way, as the alternative option of raising more revenue is subject to rapidly increasing economic costs

Trade-Off Between Revenue and Redistribution

- E.g., even if there has been an increase in inequality and hence a stronger desire for redistribution, it does not follow that the tax system should become more progressive
  - It may be that other needs outweigh the desire for redistribution, so it may be necessary to have a less progressive tax structure so that tax rates can be increased to raise more revenue for deficit reduction or for public spending

Economic Cost Differences Among Revenue Sources

- Given pressure to increase government revenues, it is especially important to identify revenue sources that incur lower economic costs
- Taxes on consumption have many advantages
  - Relatively easy to administer
  - Don’t discourage saving
  - Attractive in the context of population aging, given life-cycle differences in labor force participation and consumption

Economic Cost Differences Among Revenue Sources

- Given pressure to increase government revenues, it is especially important to identify revenue sources that incur lower economic costs
- Taxes on consumption have many advantages
  - VAT is the most common form of broad-based consumption tax
  - But its advantages can be undercut by a narrowed tax base, due to exemptions for necessities and other favored goods and services
    - These reduce revenue, distort choice, and are poorly targeted
  - Preferable to maintain broad base and use targeted transfers or tax credits to offset perceived equity problems

Economic Cost Differences Among Revenue Sources

- Means-testing of old-age benefits can also be thought of as a source of revenue, e.g., akin to taxing benefits
  - Have same advantage as consumption tax in the context of population aging
  - Can help sustain unfunded old-age benefit programs, with lower economic cost than an increase in taxes on working population
  - But might discourage saving in the future because of the implicit tax in the form of benefit reduction

Economic Cost Differences Among Revenue Sources

- While some approaches may involve a lower economic cost than a general income tax, others are more damaging
- In general, this includes “pre-distribution” policies – nontax policies aimed at influencing the pretax distribution of income
- Examples: tariffs, targeted Industrial levies
- While such policies may improve income distribution, they typically do so at greater cost than general taxes and transfers, as they involve additional economic distortions
- Yet they may be politically appealing if their costs are hidden

Can Multinationals Be Made to Pay More?

- An attractive potential source of tax revenue; but how possible?
- Current state of play – partial adoption of Pillar 2 of OECD's "Inclusive Framework" including 15% minimum tax and enforcement measures aimed to induce wider participation
- Has potential to make taxation of multinationals more stable
- But a number of challenges remain

Can Multinationals Be Made to Pay More?

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- US participation unlikely, unless exceptions are made
  - E.g., deeming current US system to satisfy Pillar 2, thereby suspending enforcement measures against US
  - This would give US tax competition advantages
- Digital service taxes are coming back, due to demise of Pillar 1
  - Could be a barrier to lessening trade frictions, given US opposition
- Incentives for tax competition still exist even under Pillar 2
  - Increasing tax revenue likely will require reform of the way multinationals are taxed, e.g., a move toward destination basis

Can International Tax Cooperation Extend to the Rich?

- Intuitively, seems like a next step, given at least partial success of cooperation with respect to multinational companies
- But there are important differences between the two cases
  - Most notably, multinationals operate across borders with weak notions of residence, while for individuals residence more stable
  - Makes residence-based taxation feasible for individuals
  - Means that shifting of income to avoid taxes more difficult
  - Even residence shifts can be dealt with through expatriation levies

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  - Thus, major aim of cooperation for taxing individuals involves imposing limits on "real" movements, e.g., avoiding the loss of future productivity of entrepreneurs and high-income individuals
  - But such cooperation for multinationals is explicitly omitted from Pillar 2, through substance-based exclusion
    - The agreement was to control profit shifting, not competition for real activity
    - Likely that the same limit would be needed for individuals to get agreement

Market Pressures on Unstable Debt Paths

- General growth in debt-GDP ratios around the world
- Where will the pressure of markets be felt?
- Major difference from typical situation: US
  – Fiscal policy has stopped responding to the debt trajectory, so less reason for confidence
  – Confidence further eroded by current US ambivalence toward inbound investment
  – US is in the process of adopting massive tax cuts, which will lead to substantial worsening of debt trajectory without (unlikely) major reductions in spending

Market Pressures on Unstable Debt Paths

- General growth in debt-GDP ratios around the world
- Where will the pressure of markets be felt?
- Major difference from typical situation: US
  - Likely a much less attractive location for a flight to safety
- Has offsetting effects on the prospects for other countries
  - Weaker alternatives for investors (+)
  - Higher general risk (-)

Conclusions