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PROPERTY TAXATION AND ENHANCED TAX ADMINISTRATION IN CHALLENGING TIMES

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Abstract: ***The financial and economic crisis continues to weigh heavily on Member States' government revenues. Fiscal consolidation has become more urgent as concerns about sustainability have become more acute and spread to hitherto unaffected countries. The weakening real economy, fragile public finances and the vulnerable financial sector appear to be mutually affecting each other in a vicious circle. Confidence and growth will only return once this negative interaction is interrupted. Following a wide range of tax stimulus measures over the period 2008-10, the focus of tax policy has clearly shifted towards a much needed consolidation of public finances. Several Member States will have to consider increasing tax revenues – as a complement to expenditure control – to consolidate their public finances. This is particularly relevant for countries that show unsustainable budgetary situations but, at the same time, have room for potential tax revenue increases. In this context good tax governance is more than ever needed. Combating tax fraud and evasion, reducing tax gaps and improving the efficiency of tax collection can play an important role in raising additional revenues.***

Keywords: ***Evasion, Reducing Tax Gaps, Additional Revenues.***

I. INTRODUCTION

At the same time, improving the growth-friendliness of the overall structure of taxation is an important element of the universal challenge to enhance the growth potential of the EU economies. While growth is a goal per se it is also a condition for making public finances sustainable. Research on the growth-taxation nexus has shown that shifting the tax burden away from labour and capital towards housing can contribute to reducing the distortions caused by taxation. The present conference proceedings gather together the views of academics, national policymakers and international institutions on these topical issues of great policy-relevance at the current juncture. The part on 'Housing taxation' touches upon different aspects of housing taxation and their characteristics with respect to economic efficiency/distortions, macroeconomic (de-)stabilisation and equity/distributional considerations. Country-specific contributions provide insights into facts and recent reforms of national housing tax policies. The theoretical contributions focus on the link between housing taxation and macro imbalances and the efficiency of current housing tax provisions, including their impact on low income households. Given political resistance against increasing housing taxation, limiting mortgage interest rate deductibility is suggested as one way forward in reforming housing taxation. Up-to-date valuation systems are found to be of high importance for an effective, efficient and fair taxation of housing property. The part on 'Efficiency of tax administration and improving tax compliance' discusses the main avenues in fostering voluntary tax compliance, improving tax administration efficiency, reducing compliance costs and complexity and safeguarding effective tax auditing and enforcement. The importance of third-party information for compliance is highlighted, as third-party information can dramatically lower the taxpayer's ability to misreport taxes. Furthermore, audit selection criteria and the effects of tax audits on compliance of audited taxpayers are discussed. Finally, country-specific contributions present some experiences with combatting the underground economy and the role of tax administration. Setting the incentives right appears to be vital for voluntary tax compliance, including through an improved understanding of non-economic factors determining taxpayers' behaviour. One important conclusion is that, in particular at the current juncture, attempts to increase tax revenues need to be carefully balanced against the long-term erosion of voluntary compliance and trust. The contributions collected in this volume were presented at the workshop 'Property taxation and enhanced tax administration in challenging times' organised by the Directorate General for Economic and Financial Affairs of the European Commission on 24 November 2011. We thank all the participants of the conference for their vivid presentations, insightful discussion and fruitful contributions. The Commission (DG ECFIN) pursued analysis in these two fields, by publishing two occasional papers in the DG ECFIN European Economy series, respectively on tax governance and housing taxation.

THE POLICY CONTEXT:

The European Semester, which is the new cycle of integrated economic coordination, pays attention to growth friendliness of tax systems/policy and sizeable consolidation need in some countries. These priorities are captured in the 2011 issue of the Annual Growth Survey, which launched the 2012 European Semester (AGS, 2011). The Euro Plus Pact, adopted in March 2011, by euro area Member States plus other volunteers, also calls for labour tax reforms, pragmatic tax coordination and structured discussion on tax issues. The 2011 issue of the 'Tax reforms in EU Member States' Report (TRR), jointly published by Commission services (DG ECFIN and DG TAXUD) on 10 October 2011, contributed to this discussion and serves as an analytical input to the 2012 European Semester. The 2011 TRR strongly benefited from discussions with Member States at the Economic Policy Committee attached to the ECOFIN Council. It represents an important step towards clarifying the analytical underpinning of policy recommendations in the area of tax policy. Further dialogue with Member States appears mutually beneficial to dig deeper into country dimensions and to go beyond the indicator-based identification of challenges. The report can be downloaded using the following web link: http://ec.europa.eu/economy_finance /publications/european_economy/2011/pdf/ee-2011-5_en.pdf. The forthcoming 2012 issue of the TRR will dig deeper into some aspects already covered in the 2011 issue, in particular with respect to housing taxation and tax governance, and extend the coverage of the analysis to all the EU Member States, including non-euro area countries. The TRR describes the structure of tax systems in the EU and their evolution over time and provides an overview of tax reforms implemented by Member States in 2010 and 2011. On the basis of individual country information, an attempt is made to identify common trends across countries. The TRR also discusses the multi-faceted concept of ‘quality of taxation’, reviewing the theoretical and empirical literature. The focus of this discussion is on the effects of taxation and tax reforms on GDP and on sustainable economic growth. Lastly, the report aims to identify the macroeconomic challenges that individual euro area Member States are facing in the area of taxation and tax policy in difficult times.

GENERAL SCOPE OF THE ANALYSIS: TAX POLICY CHALLENGES IN EU MEMBER STATES:

The 2011 TRR also suggests a first identification of tax policy challenges in EU Member States, using an indicator-based screening. The later offers a cross-country consistent method to provide preliminary indication of issues in national tax systems, deserving further investigation to avoid the one-size-fits-all fallacy. The last chapter of the report first focuses on two key macro-economic dimensions, namely i) the contribution of taxation to the sustainability of public finance and ii) growth-friendly tax structures and the potential for a tax shift from labour to consumption/housing taxation. The report also examines a set of cross-country issues, related to the specific design of individual types of tax, such as reducing tax expenditures in direct taxation, correcting the debt bias in corporate and housing taxation, increasing VAT efficiency (policy and collection gap) and moving toward environmentally friendly taxation. Lastly the report identifies challenges related to improving tax governance. As an example of the methodology used in the report, the horizontal screening undertaken to gauge whether there is scope for taxes to contribute to the fiscal consolidation challenge is carried out systematically and stepwise. The need for fiscal consolidation on the revenue side is assessed based on the fiscal sustainability assessment. The availability of tax space is determined considering the current level of the tax-to-GDP ratio and two complementary criteria (the extent of past increase in tax-to-GDP ratio and the scope to increase the least distortionary taxes, i.e. the share of indirect/consumption taxes of GDP). Based on this analysis, Table 1 shows that tax policy in the first half of 2011 (corresponding to the cut-off date of the report) might have a potential to contribute to consolidation in a few euro area countries. A systematic screening is also conducted to examine the need and scope for tax shifting with a view to raising the economic efficiency and employment friendliness of tax structures. It was appraised by examining the magnitude of the tax burden on labour, both in aggregate terms and on specific vulnerable groups. The employment rate in most euro area Member States is below the 75% target (20 to 64 years) set out in the Europe 2020 strategy. A tax shift from taxation of labour to other sources less detrimental to growth, making work pay, could help increase the employment rate. Low-skilled workers and those weakly attached to the labour market, such as second earners, often face a high inactivity trap. Furthermore, the

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responsiveness of these groups with respect to tax changes is particularly high. Reduction in the tax burden on labour should be targeted to these specific groups facing high disincentives to work. The scope for tax shifting is assessed through the relatively low level of indirect taxation, in particular consumption taxes and recurrent taxes on housing, which are supposed to generate less economic distortions than other revenue sources.

Table 1. Summary of the indicator-based screening of tax challenges

Country	Contribution of tax increases to consolidation	Need and room for tax shift	Cutting tax expenditure in direct taxation	Debt bias in corporate taxation	Debt bias in housing taxation	Increasing VAT efficiency	More environmentally friendly taxation: Review			Tax governance challenges
							Reduced VAT on energy	Company car taxation	Excise duty rates on fossil fuels	
BE		X	X		X	X	X	X	X	X
DE		X						X	X	
EE					X					
IE	X						X			
EL	(X)		X	X	X	X	X	X	X	X
ES	X		X		X	X		X		
FR		X	X	X		X	X		X	
IT		X	X		X	X	X	X		X
CY	X									X
LT				X	X		X	X	X	
MT				X		X	X			
NL		(X)			X				X	
AT		(X)	X			X		X		
PT	(X)		X		X	X	X	X	X	X
SI		(X)						X		X
SK	(X)					X		X	X	X
FI		X			X				X	

Source: Commission services, 2011 Report on Tax reforms in EU Member States

CHALLENGES IN THE AREA OF HOUSING TAXATION:

Shifting away from transaction to recurrent taxes and from labour to recurrent taxes Transaction taxes discourage property transfers, impact resource allocation negatively and reduce labour mobility. While it is sometimes claimed that they could possibly deter speculation and, thus, reduce the risk of housing bubbles, the empirical relationship is ambiguous. A shift towards recurrent taxes on real estate would reduce distortions and improve economic efficiency. Beyond the issue of shifting tax within property taxation, there may be a need to use property taxes, in particular recurrent taxes on housing, to shift tax away from labour. Recurrent taxes on housing have indeed been found to be among the taxes least detrimental to growth (OECD, 2008). Greater reliance on this tax base would be more growth-friendly for the economy, if the rise in recurrent taxes is revenue-neutral and allows for the reduction in labour taxes. Member States in which revenues are low and that do not levy a tax on imputed rents have scope to increase.

TAX NEUTRALITY AND DEBT BIAS IN PERSONAL INCOME TAXATION:

The tax deductibility of mortgage interest rates favours debt leverage. This type of tax relief is considered to have contributed to the increase in housing prices and thereby to the housing market bubble. There is evidence that countries that favour homeownership through favourable tax treatment of mortgage debt financing also have higher ratios of mortgage debt to GDP. One of the aims of the tax system is to achieve neutrality vis-à-vis the taxation of other assets, to avoid distorting the resource allocation and impede overinvestment in specific types of capital assets. Housing would 'ideally' be taxed as other investment goods. Thus, a rental income net of depreciation allowances and interest payments may be taxed as part of personal income. This involves that the imputed rental income of owner-occupied housing should be covered by taxation, whilst recurrent real estate tax should be based on the market value of the house, rather than out-dated cadastral values, to justify interest rate deductibility. Only very few Member States explicitly tax imputed rental income, but in all cases considerably below a level corresponding to the current market value of the house. Recurrent property taxes could act as a second-best solution to the absence of taxation of imputed rents. However, their rates and/or bases are often too low for the tax to reflect actual rents paid for housing. Moreover, considerations of political economy often render it difficult to tax property at the level required to make the tax system neutral. Liquidity constraints of low-income earners and the nature of the asset, i.e. an illiquid asset providing a necessity service, make it socially difficult to treat homeownership in the same way as other financial assets. Another option could therefore be to reduce the debt bias by removing - or at least reducing - the interest rate deductibility in the tax systems. As a rule, tax deductibility of mortgage interest payments could be strictly targeted at low-income households and/or firsttime homebuyers. However, subsidised loans - as currently applied in a limited number of countries - could potentially be even more efficient to well target certain categories of homebuyers.

CHALLENGES RELATED TO IMPROVING TAX GOVERNANCE:

Many Member States have room for improving the efficiency of tax administration and better preventing tax evasion. The current economic and financial crisis heightened the need to improve tax governance by reducing the size of the shadow economy and fighting against tax fraud. Three different indicators tentatively define the challenge: i) the size of the shadow economy, based on Schneider (2010) but also Eurostat data; ii) administrative burden of the tax system for a mid-sized company (i.e. total hours to comply) computed by PricewaterhouseCoopers (PwC, 2011) and showed in Graph 2; and iii) administrative cost per net revenue collected, computed by the OECD.

As examples, the 2011 TRR mentioned the following measures, which could be considered to enhance tax governance:

• The recourse to third-party information on taxpayers' wage and interest income crucially reduces the possibility of under-declaring income. Tax authorities' resources may then be directed towards other segments.

• Audit resources could usefully target the biggest revenue risks (e.g. self-employed, large companies, shadow economy) by segmenting taxpayers by class of risks of revenue losses and by using 'flag systems' based on the analysis of audit data.

Legal sanctions against purchasers of undeclared work and the obligation to use electronic payment systems for purchases over a certain amount may deter tax fraud.

• Paying taxes could be facilitated by appropriate IT systems making it easy to declare taxes, but also by a simple tax system.

Conclusion:

Responding to two of the key challenges on the current agenda of taxation policy, the workshop 'Property taxation and enhanced tax administration in challenging times' discussed the role that property taxation and enhanced tax administration can play in addressing high consolidation needs, whilst optimising the impact on growth. It included speakers from national authorities, academia, the IMF, the OECD and the European Commission. Reforms of housing taxation and enhanced tax governance are of high importance in times of severe consolidation needs in many Member States. As stressed by Lucio Pench (European Commission, DG ECFIN) in his introductory words, good tax governance is more than ever needed and combatting tax fraud and evasion, reducing tax gaps and improving the efficiency of tax collection can play an important role in raising additional revenues. Moreover, and backed by research on the growth-taxation nexus, improving the growth-friendliness of taxation, including through shifting taxes from labour towards housing, is one important element in enhancing the growth potential of EU economies.

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