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on Contribution of the fiscal policy to the Lisbon Strategy

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Objectives of Taxation Policy

Taxation can contribute to growth and welfare via three channels: First and most elementary, the taxation system must raise sufficient revenues to finance a qualitatively high level of public services and social transfers. Second, taxation influences economic decisions and should provide incentives for more employment and for an efficient and sustainable use of natural resources. Third, taxation unavoidably redistributes income and should do so in a way that strengthens effective demand and social balance by curbing large gaps in income distribution.

The communications of the Commission explicitly refer to the first two targets while completely neglecting the distributional aspect of taxation. At the same time, the taxation systems in the EU Member States have changed most fundamentally especially in this respect. It has been increasingly acknowledged in modern economics that high inequality tends to hamper growth. Models can easily reproduce this effect, if they include only a few realistic assumptions such as imperfect competition, indivisibility of consumption goods, non-homothetic preferences. Tax measures that boost inequality and stifle demand will hardly contribute to a dynamically growing economic region as called for in the Lisbon Strategy.

Consequences of Tax Competition

The question is whether EU Member States regain room for manoeuvre to carry out taxation policy, which requires EU-wide coordination, or accept tax systems that are more and more deformed by the inherent logic of tax competition. The Rapporteur embraces the Commission's concern that "the lack of coordination between direct tax systems may ...lead to unintended non-taxation or abuse and, hence, erosion of tax revenues". (COM(2006) 823)

If capital is perfectly mobile and tax rates differ across countries, multinational enterprises can employ a full set of tax optimising strategies. Two common methods are the use of transfer-pricing to shift profits to low-tax zones, and the creation of financial departments in tax havens to finance investments by group-internal credit lines.

Tax-evading strategies like these put governments under pressure, since countries with higher tax rates lose revenues and see domestic SMEs stagger because they cannot make use of similar strategies, yet compete in the same market. If multinational corporations do not only shift profits but productive investment to make use of cross-country tax differences, the pressure increases further to lower tax rates as a response. This process, known as tax competition, does not only occur in the field of corporate taxation. Since financial wealth is even more mobile than productively invested capital, the same logic concerns taxes on personal capital income or capital gains.

Labour is generally less mobile than capital, and low-skilled labour is less mobile than high-skilled labour. A very immobile tax base is consumption, particularly consumption of basic goods. As a consequence, tax competition leads to a fundamental change in the structure of taxation. Governments are blackmailed into easing tax rates on highly mobile factors and into increasing the tax burden on less mobile sources in order to protect revenues. In a situation of tax competition taxes will therefore be shifted from corporate to personal income, from capital to labour income, from high labour income to lower labour income and, generally, from taxing income and wealth to taxing consumption. The stylised facts about the evolution of taxes in the EU over the past decades confirm that exactly this has happened.

Evolution of Taxes in the EU

Indeed, statutory tax rates on corporate income have fallen strongly. In the EU-15 they declined from an average of 38.0 % in 1995 to 29.5 % in 2006. (Figure 1)

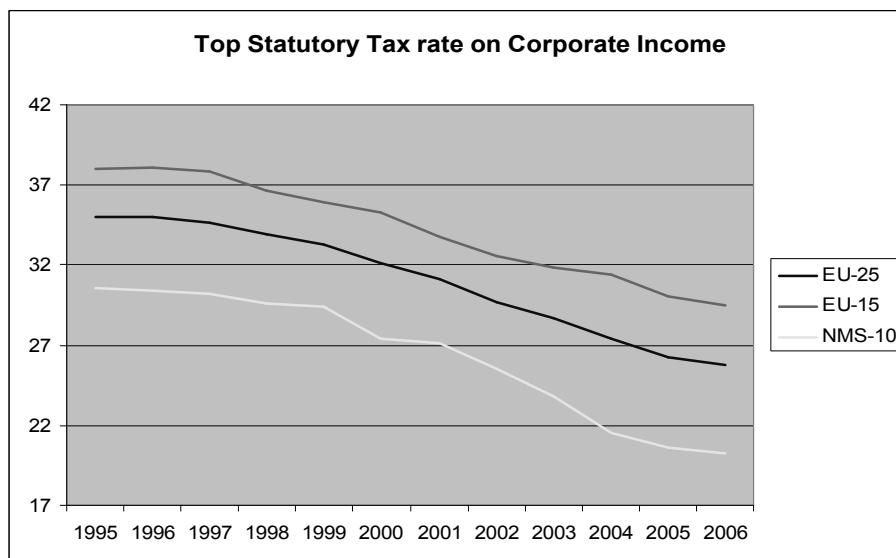


Figure 1. Source: EU Commission (2006)

The process is far from having been stopped yet. Germany is now preparing the next corporate tax reform, pushing down its statutory rate below a level of 30%. Denmark plans to reduce its statutory rate from 28 to 22%. These steps will certainly intensify the pressure on other countries. Since "high-tax location" is a relative term, a race to the bottom is not unlikely.

It has often been argued that the cuts in corporate tax rates have been compensated by measures that broaden the tax base. Two methods to calculate effective tax rates for a hypothetical standard investment project are the Effective Average Tax Rate (EATR) and the Effective Marginal Tax Rate (EMTR). These rates are generally lower than the statutory rates, but they, too, have taken a downward turn since the mid-1980s.

According to the Institute of Fiscal Studies, the EATR in the EU-15 declined between 1982 and 2005 by 11.0 percentage points, while the EMTR fell by 10.0 points. The figures provided by the Zentrum für Europäische Wirtschaftsforschung point to an even more pronounced downward trend, with an average decline of the EATR in the EU-15 of 13.6 points from 1984 to 2003.

The fact that tax revenues from corporate income have remained broadly stable as a proportion of GDP in the EU since 1965 is often taken as evidence against the hypothesis of harmful tax competition. However, this constancy confirms rather than refutes the downward trend of corporate taxation, since the share of corporate profits in GDP has been rising strongly. (Figure 2)

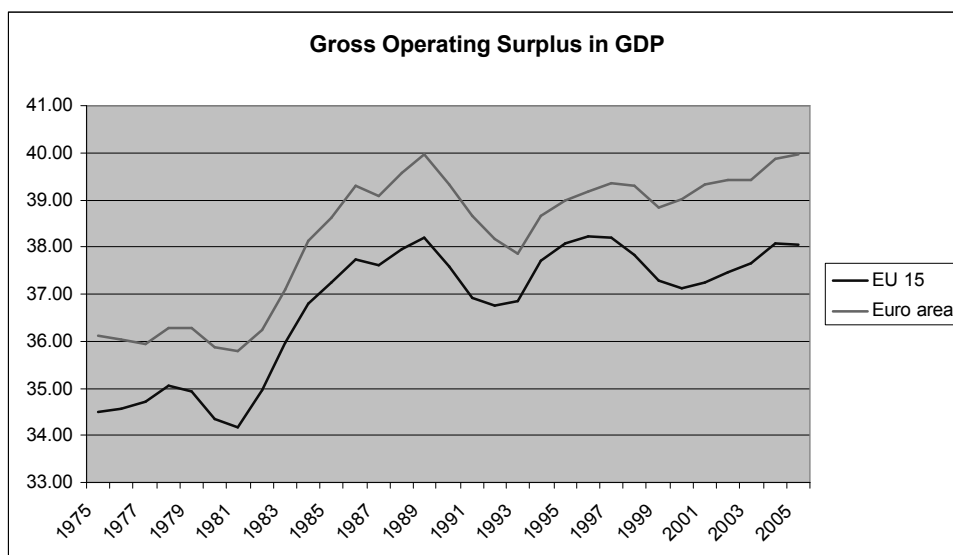


Figure 2. Source: Ameco database, EU Commission

It is difficult to determine the entire tax rate on capital. The Commission provides figures for an implicit tax rate (ITR) that has reached a level of 29.9% in 2003 for EU-15. The ITR on capital is lower in the new Member States (14%), but also Germany and Greece show low levels of capital taxation.

More and more EU Member States are starting to introduce a dual system of income taxation. While labour income remains to be taxed progressively, a flat tax that runs far below the top rates of labour income taxes is applied to capital income. Since capital income is much more concentrated than labour income, the shift towards dual income taxation corresponds to a large tax relief in favour of the wealthiest.

As acknowledged by the EU Commission, the tax burden on labour income displayed an upward trend until the mid-1990s. It reached a level of about 36% in the EU-15 and has remained rather stable since then. However, the top statutory tax rate on personal income has fallen by 4.7 percentage points since 1998, which confirms the tax shift from high to lower income earners. Several new Member States have even introduced a general flat tax on personal income.

Since the mid-1990s it has been first of all indirect taxes that have risen in order to balance public revenues. In particular Member States with lower VAT rates have used the existing corridor of between 15 and 25%, which the European VAT Directive allows for, in order to approach the upper limit of the spectrum. Consistently, the share of VAT revenues in total taxation has been rising. (Figure 3)

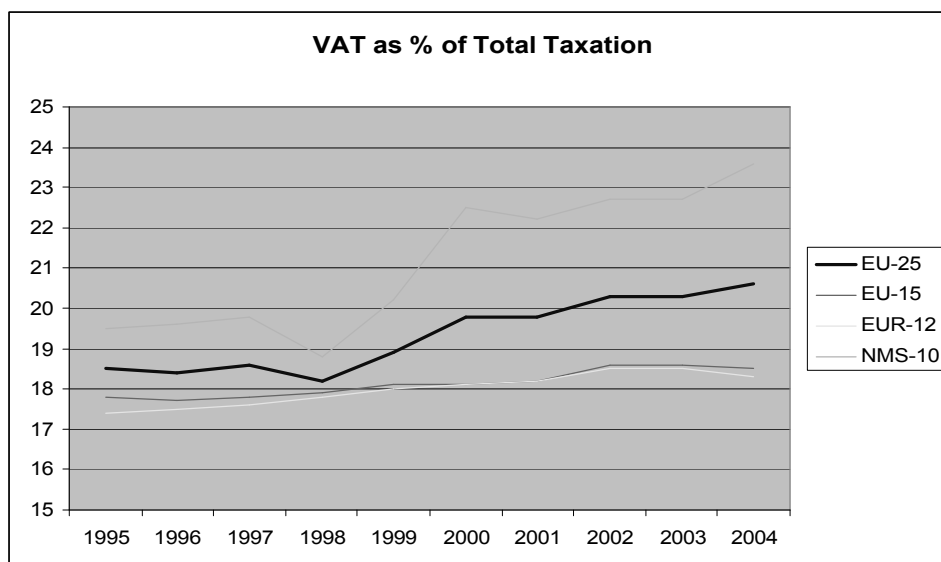


Figure 3. Source: EU Commission (2006)

In addition, the tax burden on resources like energy or gasoline has increased. The ecological effect of these taxes depends on whether the user has indeed a possibility to seek alternatives. Taxing the energy use of industries is most likely justified on ecological grounds, since energy-saving technologies are often available and become more attractive this way. In many other cases, however, so-called ‘green’ taxes have no other effect than to burden low-wage earners in particular, because poorer households spend a higher percentage of their income on energy bills and heating costs. Similarly, heavy taxes on gasoline only have a positive ecological effect, if cheap and attractive public transport is available. Otherwise it is only consumption that is taxed with the usual regressive effect.

Hence, the position of the Commission that a “shift from labour to consumption and/or pollution taxes could ...help ...to increase employment levels” (COM(2005) 532) is not convincing.

As shown, the general predictions about the consequences of tax competition are confirmed by empirical evidence. The main outcome is not so much a decline in total tax revenue, but a structural change in the tax system. This change primarily concerns the distributional impact of taxation. All considered changes relieve high-income earners while raising the tax burden on the lower end of the income scale. This is true particularly for the shift from direct to indirect taxes, but also for the cuts in top personal tax rates and the trend to introduce a flat rate on capital income. Instead of easing social contrasts the tax system further widens the gap between rich and poor.

Hence, a distinction between “harmful” and “healthy” tax competition is not justified. A redistribution of income from the bottom to the top is harmful in any case. It undermines social balance, diminishes effective demand and leads to unused capacities, deteriorating SMEs, low growth and high unemployment.

In the long run, a regressive restructuring of the tax system is also likely to diminish public revenues. Actually, total tax revenues have declined since the end of the 1990s. (Figure 3) If

this trend continues, the funding of essential public services and public investment will be in danger.

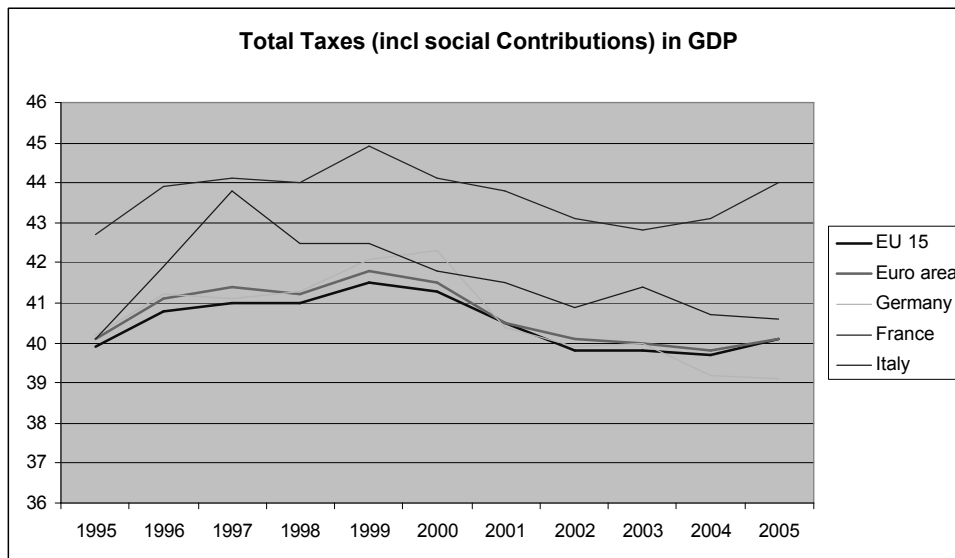


Figure 4. Source: Ameco database, EU Commission

National sovereignty in tax issues, however, is not only undermined by market forces. The EU Treaty, while not covering direct taxation, still restricts the tax policies of the Member States with its provisions. Hence, in recent years, companies have increasingly taken governments to court claiming that national tax laws were breaching European law. With its rulings the ECJ has created a common European tax law that has contributed to the erosion of national tax revenues by increasingly outlawing national provisions.

An Alternative Strategy

The introduction of a tax system that contributes to growth, employment and social balance requires coordination between EU Member States. In detail following measures are desirable:

1. The policy of the Commission to work towards a common consolidated corporate tax base only makes sense as a first step on the way to reaching harmonised corporate tax rates. Otherwise, corporations using European infrastructure, public services and well-educated employees can increasingly avoid contributing to the provision of all that. A harmonisation of tax bases without harmonising rates will not reduce but spur tax competition.

The Rapporteur supports the position of the Commission that "...tax incentives can help to address market failures and increase business research investment by reducing the costs of R&D". However, if R&D costs are partly covered by public funds, provisions must be made that the resulting profits do not end up in private pockets. Moreover, tax incentives should not be used as indirect subsidies for large enterprises but support innovative SMEs in particular.

2. The trend to introduce a dual system of income taxation or even a general flat tax should be stopped. Taxation has to contribute to social balance by progressively taxing personal income, independent from its source.

The 2003 agreement on mutual assistance as regards savings income was a step in the right direction. However, it fell short of covering not only interest income of natural persons but also dividend revenues or realised capital gains. These shortcomings provide the ground for tax evasion and undermine the desired effect.

3. In the EU-15, around 9% of the population account for 60% of private financial wealth. Since the accumulation of financial wealth as such does not support employment and growth, curbing it by taxation contributes to recovering public revenues and balanced budgets without diminishing effective demand. The trend to reduce or abolish wealth taxes should therefore be reversed.

As long as wealth, capital gains or bequests are taxed as unequally as currently is the case in the EU, exit taxes should be accepted as a legitimate measure to shield national tax provisions.

4. High VAT rates as well as other taxes on basic consumer goods have a strong regressive effect and stifle demand. Taxing expensive luxuries more strongly could be an alternative, since the demand for these goods is much less price-elastic and luxury taxes are not regressive.

Furthermore, the turnover on the financial markets should be taxed more strongly, for example by introducing/increasing taxes on securities transactions. Since the turnover on the European stock exchanges amounts to several trillion € a year, even a small tax could generate large revenues without damaging consumer or investment demand. Additionally, the EU should consider implementing a tax on currency transactions (CTT) which would not only have a stabilizing effect on financial markets, but raise revenues between €16 and €18 billion at a very low tax rate (0.01).

A taxation policy in the European Union which is oriented on those principles could indeed “contribute to raising employment and promoting socially inclusive economies” (COM(2005) 532).

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