

# ETUI Policy Brief

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### Taxation in the EU: facts and policy issues

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## Policy recommendations

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Tax policy is primarily the responsibility of Member States. At the EU level, the unanimity requirement makes any formal harmonisation very difficult. There is a wide disparity among Member States in the tax-to-GDP ratio and the taxation of labour, consumption and capital. Over the past ten years, we observe some tax shifting away from labour and a slight downward convergence in the taxation of labour. Tax policy must be part of the exit strategy from the financial and economic crisis. On the financial side of the crisis, there is a case for higher taxation of the banking sector. On the fiscal side, restoring sustainability in a context of a fragile recovery calls for a cautious increase in taxes: we should avoid making it detrimental to growth or inequitable. We call for a new tax package that could help Member States in restoring sound public finances while serving EU-specific goals like a smooth functioning of the single market and EU action on climate change.

## Introduction

This policy brief aims to present recent trends in taxation in the EU countries and to discuss on what tax policy should concentrate in the economic, social and environmental context we face today. We deliberately set the tax policy agenda in a context that is wider than the linkages between taxation and the European single market and consider soft coordination in addition to what could be achieved by means of formal tax harmonisation.

This paper is organised as follows. We start (Section 2) with a description of recent facts and trends, relying mainly on the annual publication *Taxation Trends in the European Union* published by the European Commission (2010a). We next briefly discuss the current economic, social and environmental context as Europe struggles to emerge from the major economic crisis with, amongst

other things, battered public finances (Section 3). On this basis, Section 4 sets out what could be the tax policy agenda for Europe today. Section 5 concludes.

## Taxation of labour, capital and consumption

We rely mainly on implicit tax rates (ITR) to assess the taxation of labour, capital, consumption and energy and the EU over the 1995-2008 period. The implicit tax rate is a macroeconomic indicator, based on collected tax revenue (numerator) and macroeconomic variables (denominator)<sup>2</sup>. Tax revenue, including social security contributions, is split, according to its primary economic incidence, between labour, capital and consumption. Payroll taxes, social security contributions paid on wages and salaries and the personal

<sup>1</sup> The author chaired the OECD Working Party on Tax Policy Analysis and Statistics from 2000 to 2009. He expresses here his personal views.

<sup>2</sup> The implicit tax rate on energy is quite different: It divides the revenue from taxes on energy by final energy consumption expressed in tonnes of oil equivalents. The "rate" is expressed as euro per tonne equivalent petrol. The denominator being a physical quantity, the numerator has to be deflated by the final domestic demand deflator in order to allow comparison over time.

Table 1: Taxation of labour, capital and consumption, environmental taxes: average and disparities – 2008

	Tax/ GDP ratio	Adjusted Tax/GDP ratio	Implicit tax rate						Env. taxes % GDP
	% GDP	% GDP	Consumption	Labour	Capital	Capital income	Corporations	Energy	% GDP
			% of their respective tax bases						(*)
Average (unweighted)	36.96	34.99	21.48	34.16	26.54	19.32	21.85	129.20	2.61
Minimum	28.03	24.83	14.12	20.17	10.74	8.23	7.61	26.19	1.63
Maximum	48.18	47.28	32.35	42.75	45.93	28.68	37.30	267.75	5.72
Stand dev.	5.70	6.39	4.46	6.49	10.21	5.95	8.17	55.78	0.84
Coeff. of var.	0.15	0.18	0.21	0.19	0.38	0.31	0.37	0.43	0.32
Correlation with tax/GDP ratio		0.98	0.27	0.40	0.37	0.38	0.20	Not applicable	

(\*) Euro per tonne of oil equivalent

income tax (PIT) levied on the same incomes are considered as taxes on labour. The Value Added Tax (VAT) and excise duties are the main components of the ITR on consumption. Taxes on capital encompass taxes on capital income of individuals, on corporations, and on assets. Relevant macroeconomic variables provide the denominator of the ITRs. For example, wage compensation, including employer's social security contributions and payroll taxes, provides the denominator of the ITR on labour.<sup>3</sup>

ITRs are “backward-looking”: they capture the effect of the current tax system on decisions to work, invest, save, consume, etc., that have already been made. In contrast, effective tax rates, that compute the effect of the current tax system on investment decision, labour supply or hiring decisions, are forward-looking. ITRs are not the most relevant indicators to assess the current signals resulting from the tax system, but they are well suited to assess what has been the tax policy stance, which is the primary concern here.

### Disparities

Table 1 summarises the main statistics at the EU level for the last year available (2008). The un-weighted average of the tax-to-GDP ratio approximates 37%, with a minimum of 28% and a maximum of 48%. This illustrates a wide disparity in the size of government among EU countries<sup>4</sup>.

The last edition of *Taxation trends* innovates in providing cyclically adjusted indicators. The economic cycle may affect both the level and dispersion of tax/GDP ratios. Level effects mainly occur through corporate income tax: the asymmetric effects of losses on

the numerator and on the denominator of the ITR on corporations (and on capital) make it counter-cyclical<sup>5</sup>. Unsynchronised cyclical position of EU economies – including asymmetric shocks – may increase the dispersion of the tax-to-GDP ratio and of ITRs, mainly on capital.

**Table 1** indicates that, on average, the taxation of labour is higher than that of capital (34.16%, versus 26.54%) and higher than the taxation of consumption (21.48%). The dispersion of the ITRs among EU countries is higher than the dispersion of tax-to-GDP ratios. This reflects the fact that different tax structures add disparities to those arising from the size of government. Disparities are significantly more pronounced in the taxation of (income from) capital compared to the taxation of labour and consumption.

**Table 1** also indicates how the various ITRs correlate with the tax-to-GDP ratio. Other things being equal, a higher tax-to-GDP ratio will be associated with higher ITRs. The tax mix is the main component of the ‘non equals’. We could anticipate that the larger the tax base (expressed as a percentage of the GDP), the higher will be the correlation between the ITR on the corresponding tax base and the tax-to-GDP ratio. If, for example, two countries differ by 10 percentage points in their respective tax-to-GDP ratio, this should be reflected in the ITR on the largest tax base. Unsurprisingly, the ITRs on labour have the highest correlation with the tax-to-GDP ratio and ITRs on corporations the lowest. More surprising is the relatively low correlation of the ITR on consumption with the tax-to-GDP ratio. As the consumption tax base is very large, this reflects wide disparities in the taxation of consumption.

3 Income from self-employment is included in capital income.

4 The tax-to-GDP ratio is a rough approximation of the size of government. One of the most important limitations arises from different country practices on the taxation of social transfers. Others things being equal, countries that pay them on a gross basis and subject them to Personal Income Tax will have a higher tax-to-GDP ratio, compared to countries that pay social transfers on a net basis and exempt them from PIT. See Adema and Ladaique (2009).

5 From a tax point of view, losses are not deductible while incurred but carried forward (or back in some countries) while the net operating surplus of the corporate sector is net of losses, capturing them while they occur. A recession will decrease the net operating surplus more than the tax base, pushing up the ITR. When the economy is recovering, losses carried forward reduce the numerator and the ITR.

### How to define a tax shifting?

From a policy point of view, a tax shifting would be the combination of a tax cut and compensatory measures that result in increased taxation of other tax bases. We rely on ex-post data and check whether, over a longer period, the tax policy stance has changed the tax mix and whether the change is discretionary.

It might seem that it would be sufficient to compare GDP shares of various categories of taxes. For example, a reduction of the ratio of taxes on labour to GDP, associated with an increase in the ratio of consumption taxes to GDP, could be considered as a tax shifting from labour to consumption. However, such a method tells us nothing about the 'discretionary' nature of the change. Such a shift may simply result from an exogenous change in GDP composition. That is why we opt for opposite movements in the relevant ITRs as the criteria for identifying a tax shifting. Ideally, the ITR should be cyclically adjusted but the requisite indicators are not available.

### Any tax shifting away from labour?

The high taxation of labour is often considered to be one of the reasons for low employment rates. A high tax wedge may hamper the demand for labour, mainly for low-skilled workers. On the supply side, the tax wedge may result in employment traps. It is not our intention to enter here into the theoretical debate, but simply to check empirically whether this concern has resulted in taxation shifting away from labour.

The policy debate on such tax-shifting started in the early nineties and was initiated by Jacques Delors' White paper on Growth, Competitiveness and Employment (European Commission 1993). Chapter 9 of this document suggested shifting the tax burden away from labour to capital, consumption or the environment.<sup>6</sup> On the latter issue, the 'double-dividend' thesis added a policy rationale for budget-neutral tax reforms combining the introduction of a CO2 tax offset by a reduction in the taxation of labour.

The reduction in the taxation of labour has never been removed from the political agenda. Concerns about the employment rate have resulted in an uninterrupted series of policy recommendations advocating lower taxation of labour.

Have these recommendations been implemented over the last decade? Table 2 lists the change in ITR on labour, on consumption, on capital and the change in the ratio of environmental taxes to GDP.

- A tax shifting from labour to consumption occurred in 10 countries of which 8 are new member states (NMS) of the European Union. The two remaining countries are Sweden and Germany. The tax shifting in NMS might be the result of a move to flat tax regimes, which lowered the personal income tax (PIT) component of the taxation of labour, combined with an increase in consumption taxes that were required by the EU accession. Germany underwent a very comprehensive tax reform during the last decade, which combined cuts in PIT and, to a lesser extent, in social security contributions that

were partly financed by a 3 percentage point increase in the standard VAT rate.

- According to our definition, tax shifting from labour to capital is more common than tax shifting from labour to consumption. It has resulted, moreover, in larger positive effects on the ITR on capital. This result is counterintuitive insofar as the higher mobility of the capital tax base and tax competition on nominal tax rates are expected to create an opposite effect. Moreover, the large changes in the ITR are suspicious: cyclical effects may add to the discretionary components<sup>7</sup>. Unfortunately, cyclically adjusted ITRs are not available.
- Green tax reforms that lead to a tax shift from labour to the environment are scarce and are again concentrated in new Member States. As increases in excise duties on energy were also required by the EU accession, these forms of tax shifting may be explained in the same way as those from labour to consumption.

### Tax competition and the convergence or divergence of tax systems

The point is often made that free movement of capital, goods and services may, in the absence of tax harmonisation, pave the way for tax competition, with a risk of tax erosion on mobile tax bases. If countries are cutting their tax rates in reaction to tax cuts occurring elsewhere, tax rates should converge around a decreasing trend. From a statistical point of view, tax competition should result in reduced dispersion around a decrease in the EU average tax rate<sup>8</sup>: Is this really the case, and, if so, for which of the ITRs?

Our investigations lead to a surprising finding (see graphs): the only ITR for which a 'tax competition effect' is visible is the ITR on labour. Trends of the ITR on capital and on corporations do not exhibit the symptoms of tax competition, while the ITR on labour exhibits a clear downward trend of both the average and the dispersion for the EU25.

<sup>6</sup> Implicit tax rates were not available at that time: the pioneering work started at the European Commission in the mid-nineties, precisely because the new suggested policy stance required indicators for its assessment. See Valenduc (1996) for the seminal work on Belgium. The synthesis report suggesting application of the ITR methodology at the EU level was not published.

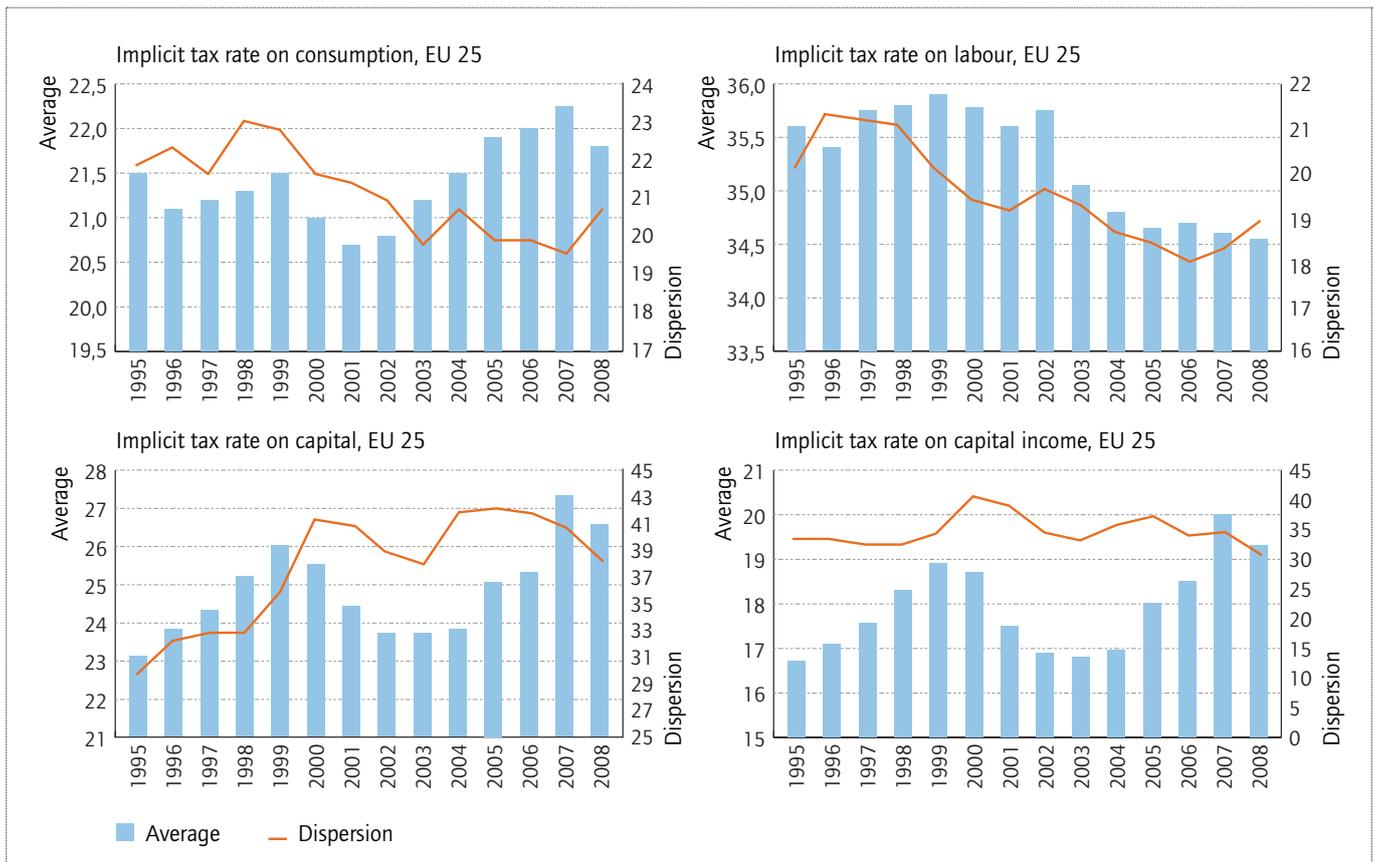
<sup>7</sup> See footnote 5 above.

<sup>8</sup> We use the coefficient of variation (standard deviation divided by the mean) to check for convergence.

Table 2: Where did tax shifting away from labour take place? 2000-2008

	Changes in Implicit Tax Rates			Change in env. taxes % GDP	Tax shifting to?		
	Consumption (C)	Labour (L)	Capital (K)		C	K	ENV
BE	-0.59	-0.97	3.15	-0.19		yes	
BG	6.77	-11.10		0.79	yes		yes
CZ	1.74	-1.18	0.64	0.13	yes	yes	yes
DK	-1.03	-4.52	7.08	-0.42		yes	
DE	0.92	-1.58	-5.26	-0.21	yes		
EE	1.46	-4.14	4.79	0.74	yes	yes	yes
IE	-2.77	-3.89		-0.16			
EL	-1.39	2.46		-0.39			
ES	-1.56	1.86	3.04	-0.44			
FR	-1.83	-0.56	0.42	-0.40		yes	
IT	-1.48	0.59	5.76	-0.68			
CY	7.85	2.95	12.63	0.88			
LV	-1.15	-8.44	5.09	-0.19		yes	
LT	-0.42	-8.21	5.19	-0.21		yes	
LU	4.06	1.62		-0.32			
HU	-0.61	0.95	2.05	-0.48			
MT	4.10	-0.41		0.12	yes		yes
NL	2.95	0.88	-3.67	0.07			
AT	-0.03	1.20	-0.35	0.05			
PL	3.24	-0.78	2.00	0.49	yes	yes	yes
PT	0.15	2.65	5.02	0.31			
RO	0.70	-4.03		-1.82	yes		
SI	0.44	-2.00	5.94	-0.08	yes	yes	
SK	-3.29	-2.84	-6.22	-0.20			
FI	-2.51	-2.74	-7.95	-0.22			
SE	2.17	-3.82	-15.32	-0.16	yes		
UK	-1.36	0.74	1.21	-0.58			

Source: European Commission (2010a) – Own calculations



What might the explanation be? The mobility of tax bases is not the sole reason for tax competition. The same process may also result from 'yardstick competition'. In its original formulation, this approach states that voters look at tax rates prevailing in neighbouring jurisdictions and at the public services these jurisdictions provide for their citizens. If they feel overtaxed compared to their neighbours, they put pressure on their own politicians to cut taxes or to produce public services in a more efficient way. There is a lot of empirical evidence concerning the effect of yardstick competition on local taxation<sup>9</sup>, but rather little evidence on such competition between nations.

At the EU level, the Broad Economic Policy Guidelines have been recommending tax reductions on labour for many years and have translated this general stance into country recommendations. These recommendations and the associated Open Method of Coordination might well have worked as a sort of yardstick competition process. The convergence could be therefore be explained by the Member States' alignment on EU recommendations. If this is the case, then it could be considered a very good example of what soft coordination – in opposition to formal tax harmonisation – could achieve.

The ITR on consumption clearly exhibits convergence, but the average is increasing. The EU25 average of the ITR on capital fluctuates considerably over the 1995-2008 period but there is no clear convergence. The same holds for the ITR on corporations, while it is well known that nominal corporation tax rates exhibit

some downward convergence. Why is this trend not passed on to ITRs? How can the 'revenue paradox'<sup>10</sup> be explained? The reasons are base broadening, an increase of the operating surplus of the corporate sector ('profits') due to privatisation in countries of Central and Eastern Europe, an exogenous increase in pre-tax profitability and growing incorporation by firms. Most of these factors may cease in the near future: each of them has an upper limit. Cyclical effects or base broadening may mask a downward convergence.

### Today's context

The current situation is dominated by the debate on the exit strategy from the financial and economic crisis.

On the financial side of the crisis, there is an ongoing debate on the taxation of the financial sector<sup>11</sup>. Two types of argument are made for higher taxation of the financial sector. The first is political: the financial sector should pay for having being rescued by governments. The second is economic. The financial crisis is seen is the result of excessive risk-taking and a lack of regulation. Being 'too big to fail', the financial sector was able to pass its losses to the government. The consequence has been a huge cost for public finances and for society as a whole. In other words,

9 See for example Duboise, Lepince, Paty (2005) for a survey of the literature and an application to French local taxation.

10 The "revenue paradox" refers to the fact that in many EU countries, revenue from corporate income tax expressed as percentage of GDP has not been going down despite cuts in nominal tax rates. See Sorensen (2006) and Valenduc (2008).

11 We do not intend to discuss specific issues relating to the taxation of the financial sector (See EC 2010b for a presentation of the Commission's proposals).

the regulatory and tax environment in which the financial sector operates – including implicit guarantee by the government – generates a huge external cost, which society has now to meet. From an economic point of view, there is a case for a 'pigouvian taxation'<sup>12</sup>: in the same way as polluters have to pay for the external costs they impose on society in the absence of such taxes or appropriate regulations, the financial sector should pay for the external costs that it generates.

On the economic side of the crisis, two issues are prominent.

- There is a strong need for fiscal consolidation in Member States. The fiscal consequences of the financial and economic crisis are so severe that sustainability of public finance is at risk, in a period in which Member States should build surpluses to prepare themselves for the cost of population ageing upon public finances.
- The claim is made that the financial and economic crisis has lowered the potential growth rate of the European economies. The argument is questionable. Its empirical component is not robust: the estimates of the output gap and of the potential growth rate for the period 2008-09 are still fragile. While it is clear that the economic crisis had adverse effect on employment and on investment, the existence of a structural effect that will go beyond the effect of the economic cycle is not so clear cut.

Tax policy will inevitably be part of the means to recovering sustainability, given the size of the consolidation task, even if there is surely room for cuts in expenditures.

The 'potential growth rate' issue results in claims for structural reforms, and tax policy is part of such an agenda. The ongoing debate in the EU institutions (Council, Commission) is dominated by the OECD recommendation (Johansson et al, 2008) on the 'pro-growth' ranking of taxes: property taxes are the least damaging for growth, followed by consumption taxes, social security contributions and personal income tax, with corporation tax being the most damaging. According to that recommendation, a move from direct to indirect taxes should make the tax mix more pro-growth and pro-employment.

The climate-change challenge is of also part of today's context. The case for economic instruments – taxation or tradable permits – is well established (Watt 2011) and Member States have to fulfil their obligation on reduction of CO<sub>2</sub> emissions (Galgoczi 2010). The question of a more ambitious target at the EU level, one designed to keep warming below 2° centigrade, is still on the agenda.

In short, taxation policy is an important part of the policy response to the main challenges facing the EU and its Member States.

## Proposals for a tax policy agenda

The diversity we noted in the first section regarding the taxation of labour, capital and consumption reflects the primary responsibility of Member States for tax policy. More fundamentally, according to the subsidiarity principle, it is up to the Member States to design their own welfare state and to make their choice on the size of government and on how they finance it. From this point of view, there is no reason, in the EU framework, for convergence of tax systems and tax rates as such.

On the other hand, however, subsidiarity also means that Member States should not be constrained by tax competition when designing their own tax system. We have to prevent a situation in which the absence of tax coordination would interact with the free movement of persons, goods, services and capital and exert a downward pressure on tax revenue such that Member States would be in no position to make their own choice about size of welfare state and government. The 'Monti paper' submitted at the Ecofin Council in Verona in March 1996 and which launched the discussion on the 'tax package' and the 'harmful tax competition issue' made the point that the unanimity requirement, while motivated by sovereignty protection, may act against economic sovereignty. The recent 'Monti report' makes a similar point<sup>13</sup>: an EU tax agenda can make subsidiarity more effective.

The tax policy agenda should of course also have an EU-wide component and serve EU goals wherever tax is the right instrument for this purpose. The debate on the Common Consolidated Corporate Tax Base (CCCTB) – a proposed harmonisation of the way in which profits are calculated for the purpose of levying corporate taxes – is clearly linked to the objective of the smooth functioning of the single market. Climate change may call for coordinated action on the tax policy side. The same holds for a tax shifting from labour to other tax bases, the employment effects of which may help EU countries to cope with the phenomenon of population ageing. The question of how tax policy could be used to raise the potential growth rate may also call for some coordinated action.

In the remaining part of the paper, we briefly discuss five specific issues: VAT, the CCCTB, the extension of the savings directive, the taxation of the financial sector and an EU-wide tax on CO<sub>2</sub> emissions. Most of these proposals may help fiscal consolidation and promote tax shifting from labour to other tax bases. They also serve EU-wide policy goals: a well-designed VAT regime can help the smooth functioning of the internal market. The same holds for the CCCTB, while the extension of the savings directive will make the taxation of savings more uniform and improve the allocation of resources.

12 A 'Pigouvian tax' aims to incorporate the external cost into the price. A CO<sub>2</sub> tax is a well-known example.

13 Monti (2010), pp. 79-88.

## VAT

While a call for indirect taxes is often considered regressive, many economists argue that such taxes serve to promote growth. We discuss both sides of this argument, before turning to the European aspects of VAT.

The point is regularly made that a tax shifting away from labour to consumption would be pro-growth. From a theoretical point of view, the argument relies on the fact that an income tax, insofar as it taxes savings, has an adverse effect on investment and growth that consumption taxes do not have. The OECD 'Tax and growth' study and econometric work at the EU level add empirical evidence to the theoretical argument<sup>14</sup>.

The argument is, however, not so self-evident as it might seem. While the effect of tax on the composition of savings – through differentiation of effective tax rates across assets – is well established, savings as a whole is rather price-inelastic. This means that a uniform taxation of savings should not necessarily be detrimental to investment and growth, while tax incentives for some assets may be.

From a practical point of view, more and more countries have been moving to dual or quasi-dual income tax systems<sup>15</sup>, that have in common a separate taxation of income from savings at a rate that is substantially lower than the top PIT marginal tax rates.

Finally, in today's eurozone context, the amount of savings located in a particular country is irrelevant. What matters is the amount of savings in the eurozone as a whole, and how it might be affected by income taxation.

Most of these points are captured neither by the traditional economic argument in favour of consumption taxation, nor by the empirical evidence to which we just referred.

On the other hand, a tax shifting from income to consumption is often considered regressive, since direct taxes are more progressive than indirect taxes. A lot depends, however, on how effectively direct taxes are reduced and indirect taxes are increased. While increasing VAT rates across the board to finance a linear cut in social security contributions or a cut in top PIT marginal tax rates would have an adverse effect on income distribution, the same does not hold for reductions of social security contributions (or direct taxes) that are targeted on low-wage earners and financed by a broadening of the VAT base. Reduced VAT rates are far from being the most powerful instrument for redistribution, even when targeted to food or other necessities. Tax cuts or income transfer targeted to low-income earners are clearly more efficient and less costly.

VAT is more harmonised than direct taxes. This does not prevent Member States from raising their tax rates above the minimum rates, bringing their VAT base closer to the base as defined by the VAT Directive, or from moving to a single-rate VAT system. Disparities in tax rates may, however, open the door to tax competition.

On the other hand, from a 'single market' perspective, the European VAT regime is not yet a final one. There is still room for improvement in VAT neutrality in 'Business to Business' (B2B): the VAT treatment of intra-EU trade still differs from the VAT treatment of purely domestic transactions, since VAT is destination-based. Full neutrality requires an origin-based VAT system.

Is it possible to design the VAT system in a way that should be 'pro-single market' and not detrimental to subsidiarity? The VIVAT proposal from Smith and Keen (1997) is still, in our view, the best instrument for combining neutrality in the single market and subsidiarity in domestic tax policy. Its implementation would, at the same time, represent a major contribution to the fight against fraud (carousel fraud notably). The proposal splits the VAT rate into two components: (1) a fully harmonized and origin-based VAT that applies to all B2B transactions, with reallocation to the destination country and (2) a domestic tax on final consumption. It builds on the well-known argument that economic policy is more efficient when a specific instrument is devoted to each policy goal. Pursuing neutrality and subsidiarity with a single instrument leads inevitably to sub-optimal arrangements. The splitting of the VAT rate into two components provides an instrument for each policy goal: using the domestic tax on final consumption to finance tax cuts on labour, or to tax luxury goods more heavily, would have no effect on the neutrality of VAT for B2B transactions.

For most of the EU countries, there is still room for base-broadening within the framework of the VAT Directive. Further improvement, for example by extending VAT to financial services and intermediation, clearly requires an EU-wide approach and a revision of the VAT Directive. This will be discussed later.

## Corporate income tax

A proposal for a CCCTB remains a fundamental element of any pro-single market strategy as it would be a major contribution both to the functioning of the single market. Piketty et al. (2011) make the statement that having 27 different corporation tax (CIT) systems in Europe is quite similar to having a different PIT system for each of the Parisian districts. More fundamentally, the multiplicity of CIT systems in a single market increases compliance costs and creates a host of tax planning opportunities that make CIT revenue fragile.

Ideally, a CCCTB should be cleared from any tax incentives. These should be granted only in a transparent way, in the form of tax credits, provided that these are in conformity with State Aid Rules. An EU-wide tax base could give Member States the possibility to broaden their tax base without suffering adverse effects on competitiveness. It is argued that CCCTB alone could, however, increase tax competition on rates. A rate-based form of competition would be more costly for governments compared to the current situation in which they compete with 'niche regimes' or with targeted incentives.

Ideally, therefore, a minimum rate should complement the CCCTB. From a global perspective, a CCCTB and a minimum CIT rate will

14 Cf. European Commission (2006)

15 Cf. OECD (2006b)

contribute to making Europe a single economic zone in the eyes of foreign investors. European countries as a whole could then benefit from the 'large country privilege'. The new economic geography models consider that large countries enjoy localisation rents that enable them to have higher CIT rates than small open economies. So a CCCTB coupled with a minimum rate could prevent further tax competition and could contribute to securing the tax revenue of Member States.

### Extending the scope of the Savings Directive

The main concerns that motivated the call for the Savings Directive were the under-taxation of income from capital of individuals and the misallocation of resources resulting from the non-taxation of income accruing to non-residents. By changing the location of their assets, savers were able to circumvent the domestic taxation of savings<sup>16</sup> and in many circumstances to avoid other taxes on capital due to bank secrecy and to the lack of exchange of information between Member States.

The Savings Directive created a system of automatic exchange of information on interest income<sup>17</sup>, in addition to which other initiatives at the OECD level were taken to promote the exchange of information. The new regulatory environment brings Member States closer to 'capital export neutrality' (i.e. taxation, according to the domestic rules, of the worldwide income from savings of their residents). Capital export neutrality makes the tax system more efficient and more equitable. It decreases the risk of capital flight and reduces the impact of taxes on portfolio allocation decisions, while the inclusion of the worldwide income of savings in the PIT tax base improves equity. It makes the tax base less mobile and gives Member States the possibility of having more revenue from the taxation of savings if they decide to rely on such taxes.

For the immediate future, broadening the scope of the savings Directive and of the automatic exchange of information is consistent with this 'win-win' situation and would reinforce it. The aim must be to include in the scope of the Directive financial products that are closest to interest-bearing assets, such as UCITS that are not yet included, insurance bonds, life-insurance products and also, of course, specific financial products that have been created by the financial sector to circumvent the Directive.

### Taxation of the financial sector

Various tax measures are under discussion in several international fora that aim to increase the taxation of the financial sector. As indicated above, there are strong economic arguments in addition to the political one. The main proposals are a financial transaction tax (FTT) and the financial activity tax (FAT).

<sup>16</sup> Tax competition had already resulted in bringing the taxation of savings income of non-residents to zero, as countries were competing to attract savings from abroad.

<sup>17</sup> Belgium, Luxembourg, Austria, as well as Switzerland and other non EU-jurisdictions, may substitute a withholding tax, for an infinite period. The rate of the withholding tax is planned to increase gradually over time and to reach 35% from 1 July 2011. Belgium has moved to exchange of information since 1 January 2010.

The financial transaction tax is derived from the well-known proposal of James Tobin. The tax base should be very large and the tax should have a significant revenue-raising power even with very low rates. It is, however, unclear if a transaction tax is the right instrument for addressing the main concern, i.e. the fact that the consequence of risk-taking are not internalised into the prices of the transactions. The proponents of a FTT claim it could stabilise financial markets by reducing speculative and technical trading, but it is unclear that it would reduce volatility and, indeed, several economic studies suggest opposite effects<sup>18</sup>. The final incidence of such a tax is also unclear and there is also a risk of circumvention: it is quite easy to relocate transactions without changing the location of the financial activity. Any European-based bank may locate its trading in a branch located in Singapore.

The rationale of the financial activity tax lies in the specific economic rents that the financial sector may earn from the strong interconnections between the financial sector and the economy as a whole. As they are at the heart of the system, financial companies are protected from default. They earn economic rents and may engage in risk-taking activities of which the external cost is charged to society.

In addition, there is a practical argument for a financial activity tax: financial services do not bear VAT, because of the difficulties of charging VAT on an intermediation margin. This creates a major hole in the VAT base. Value added can however be taxed in two ways: VAT does it by a 'top-down' approach: sales minus purchases, which is very difficult to apply to financial products. But value added can also be taxed according to a bottom-up approach: the sum of profits and wages fits with the net value added of the financial sector, and this could form the base for a financial activity tax.

Our view is that a financial activity tax addresses the basic concern in a more efficient way than does a financial transaction tax, and that it is less subject to the risk of relocation and circumvention. Whatever the choice, it is clear that a specific taxation of the financial sector (a) has a sound theoretical foundation, (b) should raise substantial tax revenue and help fiscal consolidation, (c) should do this in an equitable way and (d) should be implemented within a coordinated EU framework.

### CO<sub>2</sub> pricing

The case for the use of economic instruments in environmental policy is well established but, despite its theoretical merits, the use of environmental taxation has not been very successful in EU countries. The main problems countries face are the perceived adverse effects of environmental taxation on competitiveness and on income distribution<sup>19</sup>. The first of these problems clearly calls for EU-wide coordinated action. By acting in the same direction, countries would not suffer from adverse competitiveness effects among themselves. Moreover, cross-border adjustments, that may address the competitiveness issue vis-à-vis the outside world, may be enforced only at the EU border, as part of the common external tariff.

<sup>18</sup> See European Commission (2010)

<sup>19</sup> See OECD 2006a for further developments

## A new tax package?

During the 1990s, the 'Monti tax package' was innovative in setting tax policy in a wider context that included fiscal policy and employment and harmful tax competition, in addition to single market issues, and in moving from a case-by-case approach to a package of proposals, which should, and did, ease consensus.

The challenges that EU countries face today include similar issues, some of them even more acute, and we may add climate change to the list. Tackling each of these challenges may call for changes to existing tax instruments and also for new ones. Tax policy is primarily the responsibility of Member States, but soft coordination and formal harmonisation may in some important areas help Member States to achieve their goals while benefiting EU-wide objectives. For each of the five issues briefly discussed here, soft tax coordination and/or formal tax harmonisation could ease Member States' own constraints on action and at the same time benefit the EU as an economic entity. Thus EU initiatives could be win-win. A necessary condition is, however, that the spirit of cooperation should prevail between Member States.

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