COMMENTS ON SESSION I: TAXATION AND THE LABOUR MARKET

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I would like to start this discussion by congratulating the contributors to this session for their excellent papers and presentations. At the same time, I need to apologise to them: the papers are quite heterogeneous and the specific format of this workshop probably does not allow me to provide a detailed analysis of each individual paper, which implies that I cannot give them the attention they deserve. What I would like to do instead is to float a few general observations concerning the issues dealt with in the papers.

When I read these papers it struck me again that a tax is really very much a multi-purpose device. First, it obviously serves to raise revenue (in order to finance government spending). Second, it seeks to redistribute welfare from the rich to the poor. Finally, it also affects people's behaviour and it is sometimes used for that very purpose (environmental taxes being a case in point). Taking into account that taxes are set by politicians, one should probably still add a number of political economy objectives to that list.

One of the messages that I took from these papers, is that these objectives are often conflicting. We all know that the best environmental tax is the one that yields exactly zero, but the authors provide a number of other examples. Nødgaard shows, for instance, that a large part of the intended redistribution of a tax hike can leak away through behavioural changes. Frederiksen, on the other hand, demonstrates how the net revenue impact of a tax change is eroded by the same mechanism.

Hence, it seems crucially important that the people who are responsible for designing the tax system and for setting the tax rates are fully aware of all the consequences of their decisions and, obviously, papers like the ones presented in this session significantly contribute to this understanding.

The authors look at taxation from different angles. Martinez-Mongay provides a detailed overview of the trends in European tax systems over the last decades. Gokhale and Kaplanoglou and Newbery are concerned with the redistributive features of individual tax systems although, interestingly, their approach is completely different. Nødgaard and Frederiksen, finally, try to capture the impact of tax-induced behavioural changes in stylised theoretical models and in some cases arrive at slightly unsettling conclusions.

Zooming in on the Martinez-Mongay paper, I think one can hardly overstate the enormous task involved in estimating internationally comparable tax rates. Even

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if one overcomes all the accounting difficulties – and the paper does a really great job in this respect – one should still refrain from drawing hasty conclusions. Let me give just one example: Martinez-Mongay confirms that EU tax rates are significantly higher than the US ones. I believe he is right not to overemphasise this conclusion, however, because what does this really mean? One of the reasons for the lower US tax wedge, for instance, is that the health care system, except for the very poor and the elderly, is mainly outside the government sector. This only means, in my view, that there is no formal legal obligation to buy appropriate health insurance. However, considering that health care is a basic need and that those who can afford it, buy some form of private health insurance, it is safe to say that the absence of such a legal obligation does not make health insurance less necessary. I wonder whether one can draw very robust conclusions about the optimal size of government in this respect. It quickly boils down to a discussion where you basically have to weigh the share of people without any health insurance in the US (which I understand to be some 15 p.c.) against the alleged benefits in terms of allocative efficiency.

I found Martinez-Mongay's results on the tax mix much more interesting. Ideally, countries should make their tax systems more employment-friendly by reducing taxes on labour. The scope to do so is however often claimed to be limited as any attempt to offset the budgetary cost by increasing the tax rate on capital would be ill-fated because of the high volatility of capital tax bases. In this respect, Martinez-Mongay's findings are particularly interesting. On the one hand, he shows that tax rates on labour have been gradually lowered recently in the EU but remain significantly higher than the tax rates on capital which have stayed roughly constant. On the other hand, however, he finds that, in the US, labour is taxed at the same effective rate as capital. In addition, he demonstrates that changes in taxation in the EU have occurred in what should be neutrally described as an apparent co-movement. So the obvious question is: taking the roughly equal taxation of both factors of production in the US as an example, can a coordinated European strategy to shift taxes from labour to capital – with a view to boosting the employment rate – be successful?

Frederiksen provides a theoretical framework to assess the relative merits of different tax policy options: taking into account behavioural reactions, what is the ex post budgetary impact of tax changes? His findings corroborate the claims regarding the large volatility of capital tax bases (even without taking into account international capital movements) and, in addition, point to large feedback effects for labour taxes on high incomes. I cannot help being surprised by the large impact of the behavioural changes reported by Frederiksen. In particular, the nearly self-financing nature of tax cuts for high-wage earners and the Laffer features of the capital income tax reform at moderate inflation rates seem "too good to be true". When reading the preliminary draft of the paper, it was not always fully clear to me which specific features of the model account for these strong results.

Nødgaard also provides results which somewhat qualify "conventional wisdom": increasing the tax rate for high incomes, *i.e.* making the tax system more progressive, could have only a limited impact on after-tax equality due to behavioural changes. Even though I fully agree with the basic message – behavioural changes have to be taken into account in order to assess the equity of a tax reform –, I was again surprised at the size of their impact, which might be related to the actual set-up of the model. In this respect, I wonder whether the technical assumption of a fixed labour supply of low-wage earners is as "innocuous" as the author claims. It seems worthwhile to check whether the model wouldn't give more standard results if this assumption were relaxed or, more realistically, if involuntary unemployment for the low-skilled were introduced.

More generally, cuts in labour taxes on low incomes – such as implemented in a number of European countries – can be criticised on the basis of both Frederiksen's and Nødgaard's paper: they are relatively costly (Frederiksen) and their positive impact on income distribution could be very limited (Nødgaard). However, in actual practice, these tax cuts mainly aim at increasing the employment rate for the low-skilled and, specifically, at eradicating unemployment traps and this issue is not explicitly dealt with in the papers.

Finally, let me turn to the two remaining papers in this session, which both analyse the redistributive features of individual tax systems even if their approach is very different. Kaplanoglou and Newbery work with micro consumption data to assess the Greek VAT system whereas Gokhale puts the whole US tax and transfer system in a dynamic computer model and gets a very interesting helicopter view. Curiously enough, both papers have convinced me that their approach is the appropriate one!

Gokhale shows that, if you only look at the progressiveness of taxes, you might be missing the point; in the US, for instance, most of the progressiveness is accounted for by government transfers. Hence, *all* financial relations with the government need to be taken into account in a lifecycle model as proposed by Gokhale. Incidentally, one could even extend the analysis to non-transfer government spending. Are the benefits of these expenditure categories shared equally by different income groups? For a number of European countries, studies have shown that some government spending (e.g. on education or culture) might exhibit regressive features; although I can imagine that the situation might be different in the US.

Kaplanoglou and Newbery prove a different point. The regressive character of VAT is often only attributed to the fact that the consumption share is dropping with income. The authors demonstrate, however, that this is not the end of the story: as consumption patterns differ across income groups and different rates apply to different goods and services, the indirect tax burden can be distributed unequally even among households with the same consumption share. On the basis of detailed household data, the authors show that the Greek indirect tax system has become more regressive in recent years mainly due to the significant reduction in taxes on cars and their use. I might add that similar studies conducted for the Belgian indirect tax system point to steep Belgian car taxes as making the system actually more progressive. Two more technical questions arose when I read the paper by

Kaplanoglou and Newbery. First, can the authors be sure that their results are not biased by the exclusion of durable consumption? One could indeed argue that the share of durable consumption increases with income. Second, do the household data adequately reflect reality (in the case of tax fraud, for instance)?

Taken together, the papers by Gokhale and Kaplanoglou and Newbery prove that any assessment of progressiveness which does not take into account the whole tax and transfer system and the actual incidence of individual taxes and transfers, runs the risk of being either incomplete or biased.

Summing up, the five papers presented in this session adequately reflect the wide variety of empirical research on taxation. What they have in common, is their authors' conviction that an issue as complex as taxation requires a detailed assessment which goes beyond "common understanding" and "conventional wisdom".