

COMMENTS ON SESSION IV: TAX REFORMS

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I would like to thank very sincerely Daniele for the invitation to this workshop and Carlo for the perfect organisation. I would also like to thank the authors of the papers for their useful and very interesting work.

I will not discuss precisely the papers that have been presented to us in this session, and I apologise for that. I would simply like to make a few general remarks on the difficulties of implementing a fiscal reform. Upon reading the papers which describe national situations, I had the feeling that the key questions are similar to many countries. As I am more accustomed to the French system, I will draw on my country's example to illustrate my comments. I apologise by advance because many aspects of my comments have already been mentioned during former sessions of this workshop.

From my point of view, there are at least two keywords linked with the tax reform problem.

The first one is time, because a tax system is something which changes very slowly by itself. I would like to quote a sentence from Joseph Caillaux, who served as a Minister of Finance during the Third Republic and was to launch the income tax in France. He said : "Changing as the civilisation progresses and as the public wealth expands, the fiscal system is entrenched in a country's history and in its moral and political development. But, the changes are an integral part of the social evolutions. It means that they happen very slowly. The more entrenched the system is, the longer it takes to get things changed." This sentence was written in 1911, but is still topical : the French taxation system, given its very long and diverse history, has turned into a very complex one (with approximately 115 taxes, all with many tax exemptions).

As a whole, and in spite of the current budget deficit, the system seems to work satisfactory with respect to its traditional assignments:

- finding resources to public finance expenditure,
- carrying out a good income reallocation,
- correcting the market failure.

But due to its complexity, the system is fraught with losses and inefficiencies. An overhaul of the system is highly needed to cope with the difficulties and to make it more efficient to support growth and employment. It is no longer possible to wait for endogenous and marginal changes. Most of the economists and politicians are in

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favour of a huge reform of our tax system. They know that the current one is not sustainable, especially in the context of increasing expenditure on pensions and health, and of tax competition. But the ideal (or optimal) content or even the main objectives of the reform are discussed without any general agreement.

Some economists recommend a “liberal” reform, that is a strong reduction in tax pressure and as a counterpart, a reduction in public expenditure. They would like to support GDP growth with the help of incentive measures that could stimulate household’s consumption, companies investment and employment supply and demand. On the other hand, other economists ask for a “social” reform that favours a more fair tax-burden sharing, a better reallocation of revenues, incentive measures for low-skilled employment and a set of allowances for the poorest part of the population. At the present time, the tax system is a mix of those two kinds of organisation, leading to a lack of transparency for the medium-term.

“Liberal” and “social” reforms are often incompatible. That’s why the second keyword I would like to mention is the “equity versus efficiency” dilemma. I don’t want to develop the different meanings of equity, in particular the difference between horizontal and vertical equity. This has already been recalled in previous sessions. There is a dilemma between those two objectives not because it is impossible to reach them together, but also because tax policies serve for many different purposes and cause the system to shift from one direction to another. For instance, there is a preference for equity when the objective is the organisation of the regional development or the taxation of labour income. On the contrary, there is a will for efficiency when it comes to the taxation of capital and the financing of the welfare system.

Favouring the most relevant tool to reach the selected target and avoiding the creation of distortions and the development of excessive losses of efficiency gives way to a permanent debate. But there is a risk that the system may lack overall coherence. In addition, there is a need for fiscal stability. A permanent fiscal debate is detrimental to the economy because households and firms need to plan their allocation of resources over the medium-term. Constant changes in the government commitments weaken the politician authority because of a lack of credibility which alter agents’ behaviour.

In the past, the same questions have been debated for years and every new government gives a new answer. For instance, in 1982 President Mitterrand created a tax on wealth which has been removed by Prime Minister Chirac in 1986. Two years later, in 1988, Prime Minister Rocard, who was newly appointed, created a new tax on wealth which was to be reshaped and increased by Juppé in 1995. This tax is due to be lowered with a new fiscal base by the current government.

We have also learned from the past that a gradual reform leads to a more cumbersome system and most of the time has an impact which is both very slow and different or even may counter to the initial target.

A wide tax reform should be made of sudden and heavy changes and should not arise from the piling up of punctual adjustments and dusting. It means that,

ideally, a government, in addition to the definition of precise medium-term targets, is supposed to answer many fundamental questions before the implementation of the reform. It sounds obvious but it rarely happens. Let me take an example. The society, through its government, must choose some fundamental values. For instance the preference for work or leisure at different ages, the relative level of pensioners and wage-earners incomes, the will to uphold a well developed welfare system or not, etc... Those questions have been raised during the working time reduction process implementation but remain unsolved. They reappear now on the occasion of the debate on the pension system reform without any clear answer once again. There remain underlying questions, every time there is a tax reform concerning labour taxation or reallocation of income or tax competition issues. So I think that a tax reform is not only dealing with public finance issues but also with more general parameters of a country.

Regarding a tax reform, fiscal structural questions must also be raised and I would like to focus on some of these questions.

1) Do we prefer either a large fiscal base with low tax rates or a narrow fiscal base with high tax rates and a lot of tax exemptions?

The French system experienced the second option, using tax exemptions to modify some behaviours which were considered as undesirable. Thus, only 50 per cent of the households are subject to the income tax. Another example : the work of art is not included in the fiscal base of the tax on wealth. The principal effect of these exemptions is to reduce the tax base. The system also creates distortions as households and companies behave in such a way that they can take advantage of favourable tax conditions without having to care about the macroeconomic efficiency of the reform.

VAT is also a good example. In France this tax has been lowered for targeted goods and services : first, for subscription for electricity and gas providing, second, for all works and repair made in houses. Targeted reduction of VAT rate has two advantages : it impacts prices in a predictable way and it's a good way to support an economic sector or to fight against "grey or underground" economy. But on the other hand, the system turns increasingly complex as some producers may be encouraged to take advantage of the low rates to modify their production, which in turn urge the other economic sectors to ask for the same advantage.

Faced with this serious experiences, politicians are increasingly supporting a large fiscal base with low tax rates and the suppression of many tax exemptions. During the last three years, more than 40 small taxes have been removed and many tax benefits which were unintentionally incentives for the creation of fiscal niches have been cancelled. I think it is the good direction even though the transition might be difficult to organise.

2) Do we prefer either a progressive or a proportional tax?

Many economists are proponent for a progressive tax, such as the income tax, because it is considered to meet the equity target. But, the more the tax is concentrated on high-level incomes, the less it helps the redistribution of revenues. There is no evidence in the empirical literature that high marginal income tax rates are dissuasive or act as a deterrent to foreign high-skilled human resources immigration or on the contrary incite the French highly educated workers to move abroad. In addition, the marginal gain for a higher marginal tax rate is very small. So emphasising the efficiency concerns, some economists consider that it could be a better solution to leave the redistribution task to social and welfare expenditures and to simplify and rationalise the income tax with a proportional rate. I am also in favour of this approach. As yet, there is no attempt to reform the income tax with less progressivity in France.

3) Do we prefer to tax either labour or capital the most heavily?

Taxes were considered to be higher on labour mainly on account of high social contributions and this is one of the main reasons for the high unemployment level in France. Recently, a lot of reforms tried to reduce taxation on labour, with a view to supporting employment and improving competition. Indeed targeted cuts in employers' social contributions help to support employment during the economic downturn. But, employment as a whole has a limited mobility. So the changes on taxes levied on labour have actually a direct impact on employment and this is particularly penalising if it raises the mean cost of labour. On the other hand, if you rise the tax on capital, insofar as it incites the investors to delocalise, it could have a negative impact on domestic employment and then on wages. So, in the end, the wage earners pay also a part of the tax on capital, as an indirect effect. In addition to this point, and because they would like to promote entrepreneurship, economists are increasingly supporting a low tax on capital, especially in an open economy provided that this limited taxation is not offset by too heavy a taxation on labour. A solution, which could be used in the near future by France is the enlargement of the taxation on financial revenues.

International tax competition lies of course at the forefront of the debate on capital taxation. A lot of things have been said in previous sessions on this subject and I don't want to repeat them because I agree with my colleagues, especially on the need for a code of conduct to avoid a race to the bottom on tax rates and unfair competition.

As a conclusion, I would like to point out two issues:

- Tax system and public expenditures can not be considered separately. Especially in France, no tax reform can be undertaken without sizeable efforts to control and reduce public expenditure. For the time being, the French reform focused on

lowering the cost of labour for low-skilled workers and on the reduction of inactivity traps. The convergence Gabriella noticed for capital income taxation will probably be extended to other fields of taxation in the future.

- According to the recent experiences, France seems to be struggling to reduce its expenditure, especially those dedicated to the welfare system. The risk is therefore to lower the taxation of the mobile factors (big companies income, skilled-workers, capital income...) while non-mobile factors taxation (small companies, income, inheritance, non-skilled workers, household's capital income...) could be used to finance the expenditure. Even though the last reforms have avoided this temptation, the risk still exists that the recent reform benefits could be wiped out. I think this risk should not be overlooked as the tax pressure reduction process continues and could be one of the lever which contributes to the increase of potential growth.

