TAX REFORMS IN EUROPE:
OBJECTIVES AND SOME CRITICAL ISSUES

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1. Introduction

From the early Nineties, European tax systems were requested to achieve conflicting aims. The targets set by the Maastricht Treaty and the Stability and Growth Pact required raising revenues. At the same time, European declining growth and employment rates called for a reduction of the tax burden. Tax rates and structures were affected by the different reactions of each country to an increased fiscal competition. However, the purpose of improving the efficient working of the single market called for simpler taxes, neutral and harmonised at European level. The result has been a twisted stop-and-go of tax cuts and tax increases, of continuous shifts from one tax to another and of repeated minor tax codes updates. As an unavoidable consequence, most tax changes introduced in the Nineties in European countries were narrow in size and limited in scope.

It is very hard to claim that such changes were the most suitable tax reforms for tackling the present needs of European countries. On the contrary, one should start from two current key factors which heavily impinge on European tax systems and on any future change hoped for. First, several years of tax competition and harmonisation efforts have failed, so far, to set out a basic common framework for a "European" tax system, *i.e.* a system improving the efficiency of the single market by making the movement of people, goods and capitals really free from fiscal distortions. Second, the current decline of European growth rates seems almost endless, while prospects for future recovery are continuously postponed. Can tax reforms really contribute to enhance economic growth and increase fairness?

It may be worthwhile to start an intuitive, although general and undetermined, discussion of how tax reforms should be shaped in order to be consistent with this environment. This may at least help as a *caveat* against giving too much room to endless debates of minute issues concerning tax reforms in Europe.

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2. Past tax reforms and the limits of European tax convergence: macro issues

In the European Union, from the early Seventies to the late Nineties (Eurostat, 2000), the overall tax to GDP ratio increased by about 10 percentage points (from 33.5 to 42.2 per cent),[1] thus leaving well behind both that of Japan (27.9 per cent) and of the US (28.3 per cent). The increase in the tax burden in central European countries (France, Germany, the Netherlands) was close to the EU average increase; it was smaller in Ireland and the United Kingdom; it was much larger in the Mediterranean countries, such as Italy and Spain.[2] Thus, the wide dispersion of tax levels among European countries, already apparent in the early Seventies, continued to hold firm.

Direct taxes and social security contributions were largely responsible for the overall tax increase. They respectively increased form 8.9 to 13.7 per cent (mostly coming from the personal income tax) and from 11.7 to 15.5 per cent of GDP. Indirect taxes increased by less than one point (from 13.0 to 13.9 per cent). It is commonly believed that in the Seventies tax increases (6 percentage points) were determined by the growth of social expenditure (van den Noord and Heady, 2001). In the Nineties they were related to the need to fulfil the requirements of the Maastricht Treaty (1.8 per cent). At the turn of the century, only some minor and scattered tax cuts were adopted.[3] The constraints of the Stability and Growth Pact continue to be at work, forcing European countries to keep up the tax-to-GDP burden (De Novellis and Parlato, 2003).

A set of macro-indicators of tax convergence for the period 1970-1997 is presented in Table 1. Broadly speaking, they confirm that tax convergence has been until now far from being complete among European countries. The convergence process (by competition or harmonisation) seems to have impinged upon direct[4] and still more indirect taxes[5] but neither on total taxes nor social security contributions. The classification by economic function (Eurostat 2000) points to a strong convergence for consumption taxation and to limited convergence for capital taxation.[6] Convergence for labour taxation and the total tax burden seems to have been very limited. Finally, implicit rates (Martinez-Mongay, 2000) show that taxation on labour increased by almost 50 per cent and at the same time diverged,

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1 International comparison of tax levels should be carried out with caution, especially when welfare provisions and financing show different institutional arrangements. One should take account, *inter alia*, of the spread between gross and net social expenditure and of fiscal pressure reduction due to the existing tax expenditures (Adema, 2001).

2 Italy adopted a fundamental tax reform in 1972, Spain not many years after.

3 Italy, the Netherlands, Germany and Ireland reduced the total fiscal pressure up to 2001, the remaining countries did not cut or increased their taxes (OECD, 2002a).

4 This has been mainly due to the income tax, whose amount is largely prevailing inside this category.

5 Up to 1970, a true income tax did not exist in many European countries and VAT was in force only in France.

6 "Capital" here means all the heterogeneous incomes which constitute operating surplus in national accounting.

Table 1

Descriptive Statistics of Fiscal Systems in European Countries, 1970-1997

	PERCENT OF GDP				ECONOMIC FUNCTIONS				IMPLICIT RATES		
	1970				1970				1970		
	TOTAL	DIRECT	INDIRECT	CONTRIB.	LABOR	CAPITAL	CONSUM.	TOTAL	LABOR	CAPITAL	CONSUM.
Max. Value	36.9	17.4	19.4	13.5	18.9	11.8	16.0	37.2	34.2	55.4	21.1
Min. Value	25.6	5.3	6.6	2.8	8.4	4.7	5.3	25.6	16.1	16.6	7.3
Mean	33.3	10.0	12.8	10.0	13.9	6.3	10.7	32.6	26.6	29.2	16.1
St. Dev.	4.7	4.0	4.1	4.1	3.6	2.5	3.2	5.1	6.2	13.4	4.6
(Max-Min)/ Mean percent	33.9	121.0	100.0	107.0	75.4	112.4	100.3	35.5	68.0	132.9	85.9
SD/Mean percent	14.1	40.0	32.0	41.0	26.0	39.5	30.4	15.6	23.1	45.8	28.4
	1997				1997				1997		
	TOTAL	DIRECT	INDIRECT	CONTRIB.	LABOR	CAPITAL	CONSUM.	TOTAL	LABOR	CAPITAL	CONSUM.
Max. Value	46.6	16.5	15.8	19.0	23.9	10.0	12.9	46.4	50.7	42.1	23.7
Min. Value	34.0	10.1	10.9	4.5	12.9	4.0	9.8	34.0	26.5	20.5	15.7
Mean	40.6	13.4	13.6	13.8	19.4	7.9	11.3	40.7	39.7	30.7	18.8
St. Dev.	5.3	2.4	1.6	6.0	4.6	2.0	1.1	5.1	9.3	7.4	3.5
(Max-Min)/ Mean percent	31.0	47.8	36.0	105.1	56.6	75.9	27.4	30.5	61.0	70.3	42.6
SD/Mean percent	13.1	17.9	11.8	43.5	23.5	25.9	9.9	12.5	30.2	18.6	18.6

Sources: Data and our computations from Eurostat, 2000: EU-9 up to 1979, EU-15 thereafter.

heterogeneous capital was affected by a stable rate converging taxation, and about the same happened for consumption.

These persisting divergences in tax systems prevent the efficient working of the single market, as the movement of goods, people and capitals is still subject to tax interference. The only process of convergence under way seems to be due to the growth of the income tax, the harmonisation of VAT and some tax competition on the most mobile capital.

3. Further on tax systems convergence: micro issues

It is commonly recognised that from the Eighties onwards the corporate overall statutory tax rates decreased markedly. Over the period 1980-2003, in the EU they declined by about 15 points (from less than 47 to close to 32 per cent – forecast figure) (Cnossen, 2002). This was probably the result of greater tax competition, due to the increasing degree of real and financial markets integration (Bretschger and Hettich, 2002). However, the tax burden decrease is not confirmed for backward effective (implicit) rates. This outcome has also been attributed to the broadening of the bases that usually matched rate cuts (Devereux, Griffith and Klemm, 2001). Thus, the total fiscal burden on corporations, as well the incentive to invest, might not have changed much (see Keen, 2002, for the German case, and Bernardi, 2002b, for Italy).

During the last decade, the EU average tax rate on interest income decreased by about ten points (from nearly 46 per cent in 1990 to slightly less than 37 per cent in 2000). This has been mainly due to the replacement of taxation within the personal income tax with withholding taxes. The reduction of the tax rates on dividends was smaller. The whole system of capital income taxation seems to be getting more divergent and less neutral (Gorter and de Mooij, 2001). The widespread shift to low withholding rates on interests widened the tax bias between interest and dividend incomes,[7] while national models of interest taxation became more uneven (Joumard, 2001; van de Noord and Heady 2001). Up to January 2003, non-residents were generally exempt, even if this was not formally the case in Greece and Portugal.

The EU agreement of January 21, 2003 is based mainly on monitoring and exchanging information to allow taxation in the country of residence (with the exception of Austria, Belgium and Luxembourg). The results of the agreement are somewhat limited by the increasing exclusion of interest income from progressive income tax bases and the move to flat tax rates for all capital incomes. Strong cooperation in monitoring and information exchange will be required. It is also necessary that strategic behaviours do not dominate the fixing of national

[7] This bad result somehow could be avoided by adopting a true “dual income tax system” which should tax any kind of capital income at the same rate. However, in 1998 this solution was not adopted by all the Nordic countries which were promoting the system (see van de Noord and Heady, 2001).

withholding rates. Needless to say, tax regimes for dividends and capital gains are still more fragmented than those for interests. The claimed general shift away from the imputation system (whichever its doubtful merits) has been realised, to date, only by a minority of European countries (van de Noord and Heady, 2001).

In the early Nineties, the European average tax wedge on labour had already reached a level of about 50 per cent. The implicit rate was close to 35 per cent, some ten points above US level (EU Commission, 2000; Cnossen, 2002). It was often considered that this spread affected the different pattern of growth and employment observed in the two areas. The suggestion to reduce taxes on labour, particularly on non-skilled labour, was repeatedly raised both by the OECD and the European Commission. It was also formally stated by the EU Lisbon's Council of 2000.

Notwithstanding these statements, from the early to the late Nineties the average European implicit rate on labour was increased by about two further points (Martinez-Mongay, 2000). Just before the turn of the century, small cuts were introduced in social security contributions. They did not exceed a few percentage points and were usually implemented at the lower end of the wage scale (Gandullia, 2003). Similar cuts to income tax rates were implemented during recent years and were extended to the top rates. The burden for the (most dense) central income classes remained generally almost unchanged. Thus the total redistributive effect of tax cuts has not been particularly relevant.

Improving income taxation horizontal equity was not a main aim of tax reforms over the last two decades. Usually, changes did not cross the traditional border of adjustments of the tax regimes of households and of different working professions (Gandullia, 2003). However, a widespread innovation was the more favourable regime granted to aged and disabled people. The allowances for dependent parents were also widely rised but the increase was small in most countries.

4. Tax reforms for the recovery of European economy

Reducing rates and broadening bases in order to make tax systems supply friendly was the keyword of tax reformers in the Eighties, but the results were not as positive as expected (see Bosworth and Burtless, 1992, with reference to the US case). The taxation-to-growth link then became a topic of an endless discussion.

Today, the consensus opinion is that the elasticity figures of the supply and demand of labour differ from zero, but that their mid-range remains relatively small. Gross average estimates in the US case have been set around 0.15[8] for total supply and 0.25 for demand. The more unionised European labour markets may allow for a slightly higher supply value (Leibfritz *et al.*, 1997).

[8] This, for instance, means that a tax cut which can raise net wage by 10 per cent will increase labor supply just by 1.5 per cent.

Neoclassical exogenous growth models do not help very much, apart from the common sense advice to reduce the burden on investments and savings as much as possible. Endogenous growth models claimed to be able to provide much more robust and targeted prescriptions. However, empirical work showed that the general level of average and marginal tax burden has only a limited impact on the rate of growth (Myles, 2000). Specific allowances should however be allowed for physical and human capital accumulation (Tanzi and Zee, 1997). Once more, the link between taxation and growth does not seem clear-cut (Besley, 2001). Last, the so called "new theory of economic growth" stresses the need for taxes (Jones, 2002) and institutions (going back to North, 1990) not hindering or meddling with economic transactions induced by the market. Up to now, the list of specific prescriptions is however still short and selective (for taxes) or somewhat vague (for institutions).

Checks of statistical correlation between taxes and growth throughout a long list of exercises have showed that the hypothesis of a negative (or positive) correlation may result alternatively to be true, false and spurious, and finally also indeterminate (Agell *et al.*, 1997).

The story so shortly summarised has just one relatively robust conclusion. Negative relationships between taxes and growth seem to exist but their size is small and they can be caught up just by looking at selective channels. As a consequence, growth enhancing tax reforms should be huge in amount and strictly targeted. The difficulty to find enough budget backing suddenly arises. The analysis provided by De Novellis and Parlato (2003) makes it clear that the Stability and Growth Pact prevents almost any European country from having the room to reduce fiscal pressure without compensating for this. Expenditure cuts are widely suggested (for example Tanzi and Schuknecht, 1997) and may be useful in the long run,[9] although the welfare state should not be dismantled, together with its contribution to economic growth, social cohesion and fairness (Atkinson, 1999a).

Wide and selective tax shifts thus become the last option to consider. Labour and corporate taxes could be significantly reduced. On the contrary, the tax burden on rents, environmental externalities and especially consumption should become substantially heavier.[10] Can the reduction of the tax burden on labour and the increase of consumption taxes be really effective for enhancing growth? The traditional textbook equivalence of taxation on labour income and consumption obviously still has some good arguments (Cnossen, 2002), but it is increasingly open to question, mainly due to its lacking empirical support (Carone and Salomaki, 2001).[11] Further, the old idea that heavier taxes on consumption may increase savings and investments still holds. Finally, interesting econometric estimates have

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9 In the short run, rationalizing public expenditure may increase its level.

10 There could be an increase of these taxes from the present European average to the level of the countries that tax immovable property more heavily (United Kingdom, 3.5 percent) and environment externalities (The Netherlands, 1.7 percent) (Eurostat data).

11 The basis of EU taxes on consumption is one third higher than that for taxes on labor income. Tax basis for capital is half that for labour.

recently been performed with the EU Commission Quest II model. A one per cent of GDP shift from corporate to consumption taxation would raise GDP by 1.6 points and wages by 2.1 points from the average European baseline levels. The same shift from labour to consumption taxes would increase employment by 0.6 and GDP by 0.7 points (Leibfritz *et al.*, 1997).[12]

Thus we are tempted to conclude that wage and consumption taxes are not perfect substitutes and that shifting burden from the first to the latter may effectively enhance growth. However, Profeta (2003) introduces more than one *caveat* concerning the political feasibility of a tax shift of the amount and the nature here considered. The main problem comes for the fact that the shift of the burden would go almost entirely from dependent workers to all the consumers. Thus some part of the workers' contributions to their PAYG pension schemes should be charged on other tax-payers-voters. A not trivial escape route could however be suggested. The financing of a universal social security safety net, including also minimum pensions, could be charged to general taxation. This share of pension expenditure could therefore be subtracted from the funding via the workers' social contributions.

5. Tax reforms for social fairness

At the beginning of his volume on Welfare Economics, Pigou (1929) clearly stated that social welfare is given not just by the amount but also by the even distribution of income and wealth. Thus it seems worthwhile to look for an increase in tax and social fairness in order to sustain welfare and to compensate the current decrease of the growth rate. Even more, one should look for something akin to a Rawlsian society (Rawls 2001), *i.e.* the well ordered society of equal opportunities, highly endowed with freedom and social justice, particularly for the less advantaged, wherein the political process generates fair political and transparent outcomes concerning tax systems and even fiscal exchanges.

Tax reforms may first help by making taxation reliable and certain, by impeding tax amnesties, by heavily fighting evasion and corruption and by inducing tax administration to be efficient and correct with tax-payers. I recall these obvious fine tax systems features just because they are in fact largely absent from some European countries, especially the Mediterranean ones.

The aim of vertical equity, *i.e.* the redistributive purposes of tax systems, should be empowered and not dismantled for more than one reason. First, the common argument that redistributive targets can be better reached through the expenditure side of the budget (EU Commission, 2002) is very questionable. It has been frequently shown (Goodin and Le Grand, 1987) that welfare and other public services are mostly captured by the middle class. The redistributive impact should then be enacted mainly by social protection and particularly by public pensions.

[12] The two sets of results may not look symmetric, but the non-linearities and the substitution effects embodied in the model must be taken into account.

However, these estimates only look at one generation. They do not take into due consideration, within a proper lifecycle horizon, the effects of PAYG social contributions. These are commonly considered proportional when they lower net wages, and even regressive when they are passed on prices in non-competitive markets.

Furthermore, inequality of *ex ante* incomes is rapidly (and worryingly) increasing (Atkinson, 1999b) and must be fought against. Finally, looking at the most recent theoretical and empirical literature, it turns out that standard theory arguments against redistributive policies (*i.e.* their supposed incentive-reducing effect on growth) do not seem to hold yet and perhaps need to be reversed.[13] The same seems true with respect to tax-progressivity.[14]

Vertical equity has also been eroded by the decreased burden on capital incomes, due to fiscal competition. The Nordic "dual income tax system" has been viewed as a good compromise between equity and contrasting capital flights (Cnossen, 2002). But this applies only when income and wealth are evenly distributed and highly correlated. This may be the case in some European countries, but not in all.[15] Furthermore, a uniform level of capital income tax rate is required, and this is not the case in many European countries. For instance, for the mid-Nineties Joumard (2001) reports rates on interest incomes ranging from 12.5 percent (Italy) to 30.0 per cent (Sweden, not surprisingly).

Room for improving fairness can be found on the ground of horizontal equity. The modern "welfare view", restricting the need of allowances only to low-income families, is now contrasted by a renewal of the old "optimum size view", induced by the worries of a European declining population. According to this view, allowances should be extended also to the middle-to-high incomes and should reach a huge amount in order to work effectively.

Tax systems should contribute to make the social justice principle of equal opportunities effective. For example, human capital formation could be supported. Qualitative discrimination among incomes should be extended to encompass more features of the ability to pay. Recently this has been done by granting specific allowances to old and disabled people (see par. 3). Further steps in this direction might be accomplished (albeit this is not politically easy), in order to compensate

[13] The conventional OT idea concerning the unavoidable trade-off between equity and efficiency has recently been heavily challenged by a large number of empirical analyses. A negative correlation was repeatedly found between inequality and growth. More surprisingly still, growth rates seem positively influenced by redistributive policies, even if performed by increasing tax progressivity. The most convincing theoretical root of these evidences has been found inside endogenous growth models (see Aghion and Caroli, 1999).

[14] The standard competitive analysis of labour markets usually considers wage tax progressivity (*i.e.* the degree of substitution effect) conflicting with employment. This result is however generally reversed by unionised markets analysis (see, e.g., Pissarides, 1998).

[15] For the early Nineties, Wagstaff *et al.* (1999) report Gini coefficients on *ex ante* incomes ranging from 0.25 (Germany) to 0.41 (United Kingdom).

market failures concerning the distribution of individual incomes (due to rents, lack of information and under evaluation of the social value of some activities).

7. Conclusions

The tax reforms adopted by European countries from the Nineties introduced some improvements, mainly by streamlining existing systems, but have mostly been narrow in size and ambiguous in their objectives. Tax reforms targeted at tackling Europe basic needs should be more radical.

Economic integration and monetary union, together with the harmonisation efforts of European governments, have not yet determined the high degree of convergence of tax systems required for the efficiency of the EU single market.

Before any further analysis, basic common sense suggests that (average) tax wedges on labour at around 45 per cent and implicit rates over 30 per cent for corporations have something to do with the European declining growth rate and increasing unemployment. Theoretical hints and empirical data suggest that tax reforms can help, but only if the burden taken off from labour and corporate capital can be significantly reduced.

The funding of these huge tax cuts is problematic. The Stability and Growth Pact prevents the reduction of fiscal pressure and takes in any workable expenditure cuts. Thus, the escape route necessarily involves shifting the tax burden from labor (mainly social contributions) and corporations to rents, environmental externalities and, mainly, consumption (VAT). Theory and evidence are however not thoroughly reassuring about this policy, while political economy predictions warn us to beware of its electoral feasibility. To overcome this last obstacle, one can consider increasing consumption taxes in order to fund a universal social safety net, which also encompasses minimum pension treatments.

In a world where growth rates decline, an additional source of welfare is forcibly found in increasing fiscal and social fairness. What is needed is a legitimate and transparent political process of tax voting, an equitable fiscal exchange and well behaved tax rules between state and citizens. Even better, vertical and horizontal equity have to be strengthened in order to improve equal opportunities.

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