

Monitoring revenue trends and tax reforms in Member States

by European Commission (DG ECFIN-DG TAXUD) and Economic Policy Committee

Based on the mandate of the ECOFIN Council, the work program of the Working Group on the Quality of Public Finances (EPC-QPFWG attached to the Economic Policy Committee (EPC)) has identified the efficiency of tax systems as a key issue for further work. The EPC-QPFWG has decided that this work should, among others, take the form of an annual report. The joint EC-EPC Annual Report on Revenues (ARR) is prepared by the Commission (jointly by DG ECFIN and DG TAXUD) and the EPC-QPFWG.

It builds on the substantial work carried out by the Commission services, such as assessments of the budgetary implications of tax reforms, analyses on the key role of revenue systems for the sustainability of public finances and the studies considering their effects on employment, growth and equity and their contribution to the achievement of environmental policy objectives.

Revenue systems play a key role for the efficient allocation and the distribution of resources, and are a fundamental determinant of the sustainability of public finances. Making European revenue systems more conducive to employment, growth and equity while insuring stable revenues are important policy objectives underpinning long-term sustainability. Tax reforms that modify revenue systems in this direction are therefore an integral part of the Lisbon Strategy for Jobs and Growth and are key to assuring fiscal sustainability in the context of ageing populations.

The consequences of the financial crisis will be deeply reflected in Member States' government revenues. Tax revenues from profit and capital income are likely to be severely reduced, but also revenues from labour and consumption taxes will subsequently negatively affected, as employment follows the cyclical downturn, wage growth slows down and consumption weakens. Finally, active fiscal stabilisation policies on the revenue side will also directly and indirectly (via their effects on economic activity) affect government revenues. Tax policies are important instruments Member States have at their disposal to counter the financial crisis and its impact on the real economy. Revenue systems play an important role as automatic stabilisers and are a key instrument for active counter-cyclical fiscal policy. Sound tax policies to revive the economy should combine cost-efficient fiscal stimulus with improvements of incentives to invest and to work.

In terms of overall tax burden, a trend that emerges from the data is a renewed pick-up of the overall tax burden over recent years. The increase in the tax-to-GDP ratio slowed down in the 1980s before growing again more strongly in the 1990s. The total tax-to-GDP ratio in the EU peaked at the turn of the century before starting to decrease. The latest data, however, show a reverse in this downward trend.

The analysis of the composition of tax revenue or 'tax mix' shows that the vast bulk of tax revenue raised in the EU, indeed more than 90 per cent, comes from three main sources: income taxes, taxes on goods and services, and social security contributions. With the caveat regarding the disentanglement of cyclical and structural components of the actual movements in mind, it appears fair to say that indirect taxes have slowly been gaining importance over recent years. At the same time, social security contributions have lost some importance, potentially reflecting the fact that governments have been trying to reduce the tax burden on labour. As regards direct taxes, there appears to be an upward movement as well, but this is more difficult to assess given the presence of pronounced cyclical effects. Tax revenues from environmental taxation have been falling slightly over recent years on average (in % of GDP), but their importance across Member States has been diverging since 2003.

Revenue systems in the EU seem to be slowly converging, much as a result of individual and country-specific actions of Member States. There is increasing awareness that all Member States could benefit from increased communication, co-operation and co-ordination. In the years to come, Member States should cooperatively work together to achieve mutually beneficial outcomes in line with the June 2007 ECOFIN Council conclusions which reaffirmed the need for Member States to exchange information on current and planned tax reforms and their impact on growth and employment within existing procedures.

Revenue systems can play an important part in the strong disincentives to take up work or to increase hours of work/effort levels in many Member States. In a number of Member States taxes and social security contributions contribute to substantial inactivity traps, unemployment traps, or low wage traps. These Member States need to consider how to design sound tax reforms to reduce these traps in view of their impact on employment. This may be partly achieved by shifting the tax burden to alternative tax bases, such as environmental or property taxes, or by a better balance of the tax burden across the tax schedule.

Member States need to continue their efforts to implement rate-cut cum base-broadening reforms taking into account their policy objectives and sustainability. However, they also need to be more aware of the limits of base broadening reforms. Taxation of firms, whether incorporated or not incorporated, needs to sufficiently allow for efficiency-enhancing provisions to avoid excessive distortions of firms' financing, operating and investment decisions.

Tax competition for mobile tax bases affects the design of revenue systems. Member States may be called to consider how such competition may be set in an appropriate framework to benefit from the healthy aspects of such competition, while limiting the downside risk of an accelerated race to the bottom which puts additional pressure on immobile tax bases with the associated efficiency losses.