

TAXATION

The Annual Growth Survey identifies several categories of tax policy challenges currently faced by EU Member States. These tax policy challenges concern the potential of Member States for making their tax structure more growth-friendly as well as improving tax governance and the design of their taxes in their efficiency and fairness dimensions.

More detailed information supporting the findings in this document can be found in the 2012 edition of the report "Tax Reforms in EU Member States" and previous editions of this report, published by the Commission services⁽¹⁾.

1. More Growth-Friendly Tax Structures: tax shifts

1.1. The evolution of total tax burden in the European Union

The total tax burden to GDP ratio includes all taxes and social security contribution receipts. The total tax burden varies widely across Member States, mostly reflecting variations in social preferences for government interventions. According to currently available estimates, this ratio varies in 2013 from 26.1% in Ireland to 49.3% in Denmark.

However, there is so far only partial evidence that the total level of taxation impacts on economic growth. There is nevertheless a better understanding of how individual components of the tax system affect growth through the channels of total factor productivity, the growth of capital stock and/or the growth of labour supply. Positive outcomes can be achieved in two ways: by either providing the right incentives within the provisions of specific taxes or by shifting the tax structure in a desirable way.

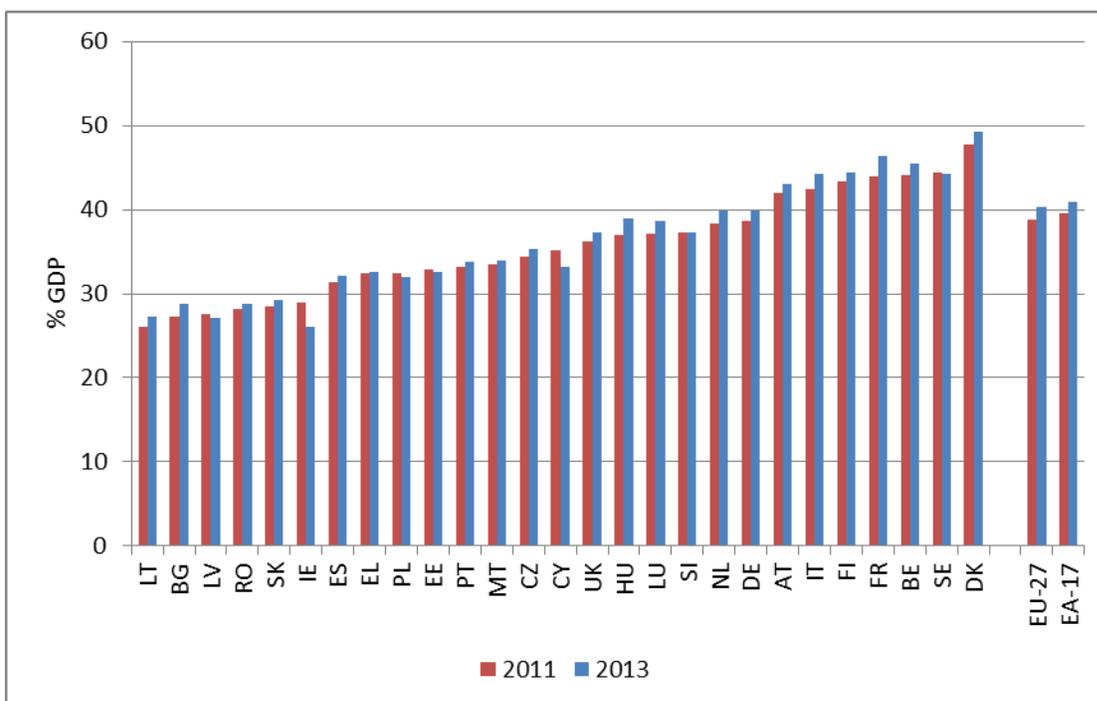
⁽¹⁾ Tax reforms in EU Member States 2012: tax policy challenges for economic growth and fiscal stability. *Taxation Papers* 34 and *European Economy* 6. This report can be downloaded from the websites of DG TAXUD and DG ECFIN:

http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_34_en.pdf

http://ec.europa.eu/economy_finance/publications/european_economy/2012/ee-2012-6_en.htm

Previous editions of the report, on which we draw as well, can be found in: European Commission and EPC (2009), Monitoring revenue trends and tax reforms in Member States 2008, *European Economy* 4; European Commission (2010a), Monitoring tax revenues and tax reforms in EU Member States, *Taxation Papers* 24 and *European Economy* 6; European Commission (2011), Tax reforms in EU Member States, *Taxation Papers* 28 and *European Economy* 5;

Figure (1): Total Tax Burden in EU Member States 2011 and 2013 (in % of GDP)

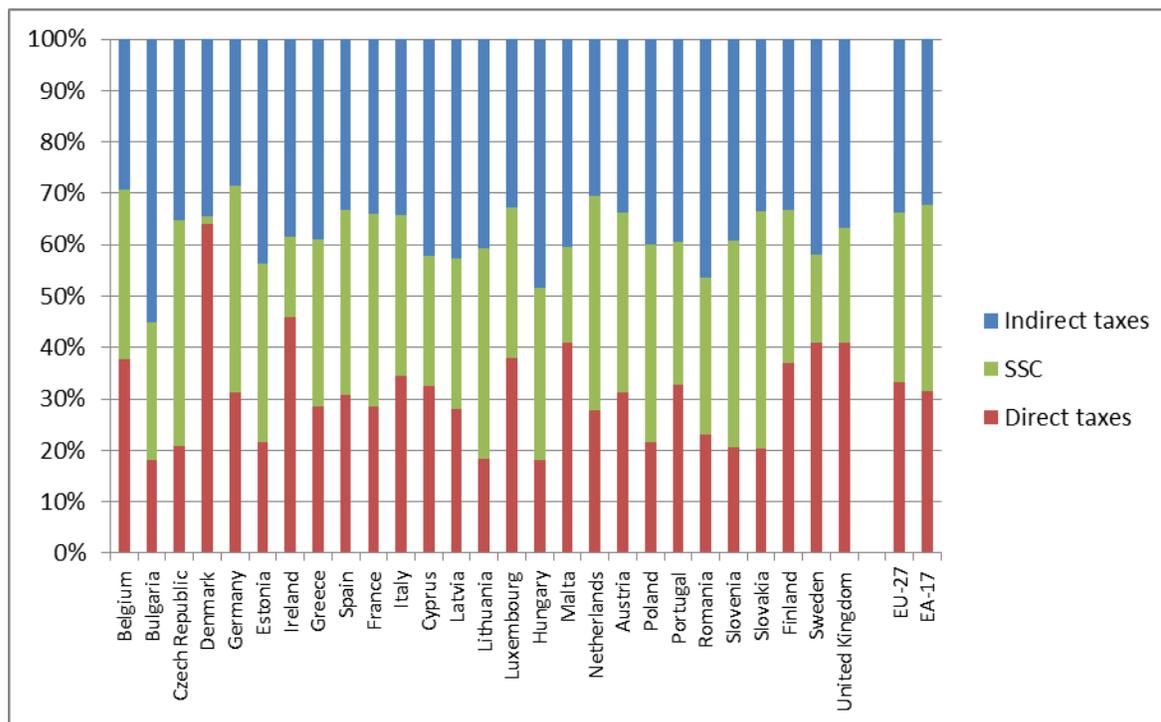


Source: European Commission: 2011 data: *Taxation Trends in the EU (2013)*; 2013 projections: AMECO database- spring2013 forecast

1.2. Growth and the tax composition

There are differences across the EU and between the EU and the USA and Japan not only in the overall tax level, but also in its composition. Member States raise different amounts of revenue from direct taxes, indirect taxes, and social security contributions. The new Member States, bar Malta (and, to a lesser extent, Cyprus), usually have fewer direct taxes in the total. Denmark social security is mainly financed through direct taxes, which explains the particularly high contribution of direct taxes to total revenues.

Figure (2): Structure of tax revenues by major type of taxes, 2013, % of the total forecasted tax burden.



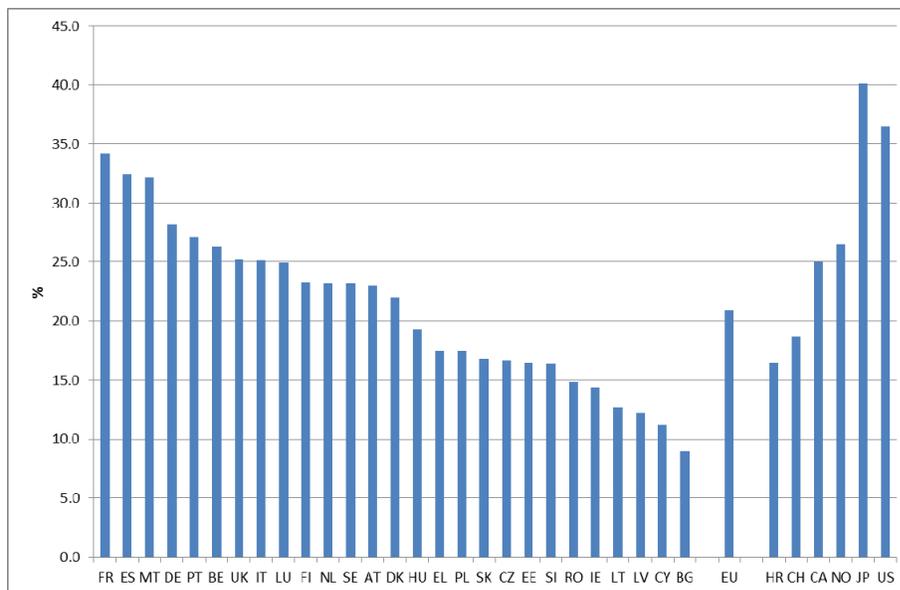
Source: European Commission (AMECO database – Spring 2013 forecast)

Taxes on corporate and personal income are usually seen as particularly detrimental to growth.

Corporate income taxes affect the location of businesses and decrease domestic and foreign direct investment.⁽²⁾ In addition, statutory corporate income taxes affect profit-shifting practices as multinationals tend to shift reported profits from high-taxed to low-taxed countries. The tax levels, definition of the base and compliance aspects are all important factors in determining the effect of a corporate income tax.

⁽²⁾ Evidence on the link between corporate income taxes and location can be found in e.g. Barrios et al. (2012), "International Taxation and Multinational Firm Location Decisions", forthcoming in *Journal of Public Economics*. De Mooij and Ederveen (2008), "Corporate tax elasticities: a reader's guide to empirical findings," *Oxford Review of Economic Policy*, 24(4): 680-697 found that a one-percentage point increase in the corporate tax burden reduces foreign direct investment by an average of 3.3%.

Figure (3): Corporate taxation – Effective Average Tax Rates 2012.



Note: The Effective Average Corporate Tax Rate (EATR) uses the Devereux-Griffith methodology to measure the taxes paid by corporations on infra-marginal investments (i.e. that produce rents, i.e. profits above the normal return to capital), which impacts on locational choices. Other measures such as the Effective Marginal Tax rate (EMTR) or simply the statutory rate impact respectively investment and profit shifting. Source: ZEW (2012), Project for the European Commission Effective Tax Levels using the Devereux Griffith Methodology, Intermediate Report 2012, http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/effective_levels_company_taxation_final_en.pdf.

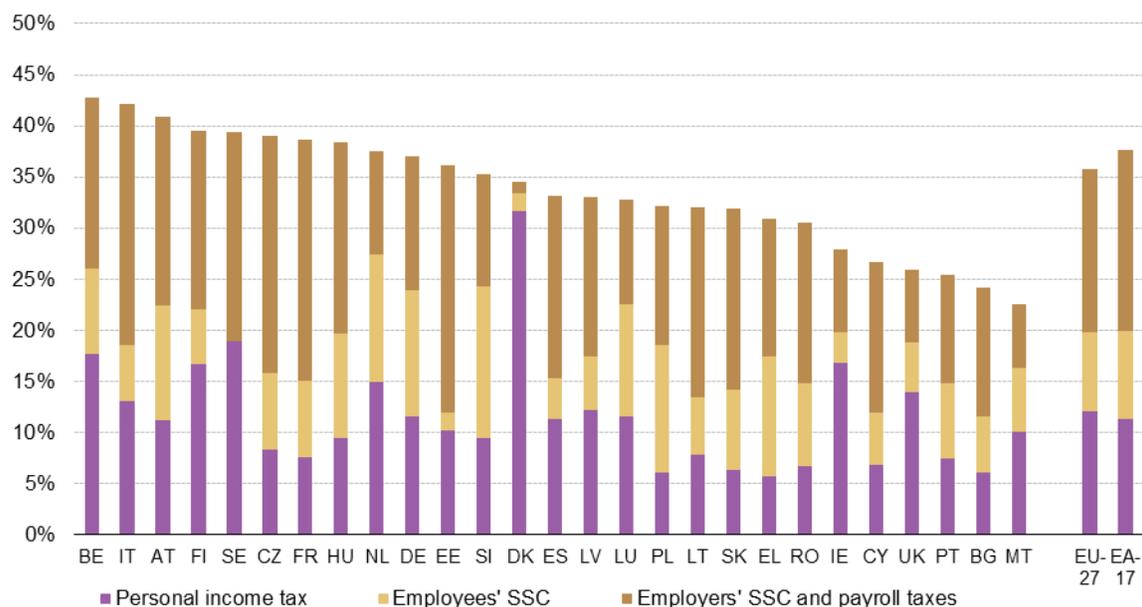
Personal income taxes and social security contributions paid by employees affect the decisions of individuals about taking paid work and the number of hours they work, hence impacting labour supply. This is in particular true for some specific categories of workers such as low-income, married women and lone mothers.⁽³⁾ The tax burden on labour, in particular social security contributions paid by employers, also affects the cost of labour for employers and hence the demand for labour ⁽⁴⁾. Employment responses for specific groups and distributional effects depend on which income level taxes are levied. However, high taxes on labour are in general detrimental to growth (Figure 4)⁽⁵⁾.

⁽³⁾ See e.g. Meghir and Phillips (2010), "Labour Supply and Taxes", in IFS editor, *The Mirrlees Review: Dimensions of Taxes*, chapter 3, Oxford University Press.

⁽⁴⁾ Moreover, labour income taxes affect the absolute level of saving, and hence investment and the capital base of the economy.

⁽⁵⁾ For further information, see the thematic fiche on labour taxation.

Figure (4): Implicit tax rate on labour (ITR) - 2011



Source: European Commission 2013, *Taxation Trends in the EU*.

Note: The implicit tax rate on labour relates taxes collected from employed labour income to compensation of employees.

Many Member States may want to achieve a reduction in corporate and/or labour income taxes in a budgetary-neutral way. Hence, they find a need to shift the tax burden to other tax bases. At the macroeconomic level, various studies ⁽⁶⁾ have indeed shown that taxes on income are usually associated with lower economic growth and that recurrent property taxes, consumption taxes and environmental taxes are the least detrimental to growth.

Consumption taxes are less distortive than personal income taxes. That is because part of consumption is made from accumulated assets (e.g. savings, wealth), which are a relatively inelastic tax base. In terms of property taxes, an increase in recurrent taxes on immovable property is found to have the smallest effect on GDP per capita. Environmental taxes can help to internalise externalities and generate at the same time tax revenues.

The potential room for a tax shift depends on the existing tax structure. High labour taxation together with a relatively low tax burden in one of the three areas: consumption taxes, recurrent property taxes or environmental taxes indicate room to shift taxes away from labour. Given the size of the tax base, which is relatively large for consumption taxes, but more limited for property taxation and environmental taxation, consumption taxes are largest in revenue terms. As a tax shift might also effect tax compliance, they should go hand in hand with measures to improve compliance, namely in the area of VAT. Note that

⁽⁶⁾ See an in-depth discussion in European Commission (2010a), chapter 4.

a thematic document on the tax burden on labour is available at http://ec.europa.eu/europe2020/pdf/themes/16_tax_burden_on_labour.pdf.

2. Broadening of the tax bases

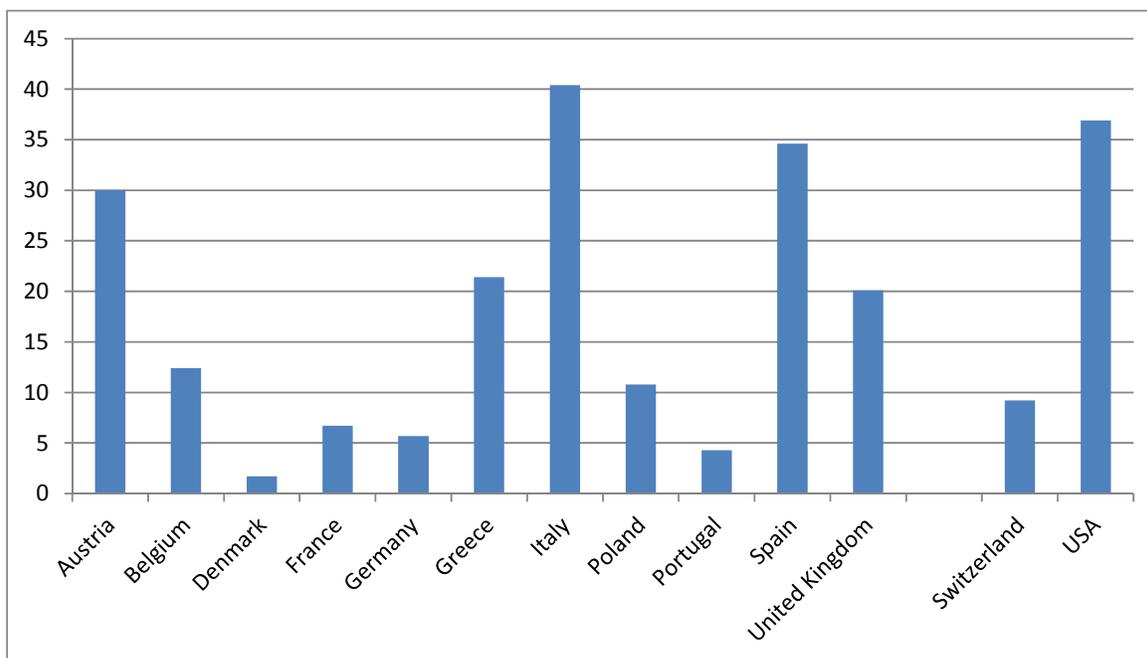
As a general rule, tax expenditures and more general reductions of tax bases create economic distortions and lower the efficiency of the tax system. They increase compliance costs and lower tax collection without always achieving their economic or social objectives. Broadening the tax bases can thus reduce the complexity of the tax system, compliance costs and the costs of tax collection.

2.1. Tax expenditures

Tax expenditures are widely used for personal income taxation and corporate tax purposes. For personal income taxes they come in the form of e.g. mortgage interest deductibility, commuter tax allowance.

Figure (5) gives an overview of tax expenditures for those EU Member States, for which data is available.⁽⁷⁾ The figures point to high foregone tax revenues in some countries.

Figure (5): Estimates of personal income tax expenditures in % of PIT collected



Note: Data for tax expenditure collected by the OECD is only available for eleven EU Member States. Tax expenditure estimates taken from the OECD refer to 2009 (Italy and Spain), 2008

⁽⁷⁾ It is difficult to produce a clear definition of what tax expenditures are. They can take the form of allowances, exemptions, rate relief, tax deferral or credits and comparison across countries therefore needs to be taken with caution.

(Germany, France and the Netherlands), financial year 2007-08 (UK), 2007 (Portugal), 2006 (Denmark, Austria and Greece) and 2005 (Belgium). Source: OECD (2010), *Choosing a broad base – low rate approach to Taxation*, Paris, data taken from European Commission (2011)

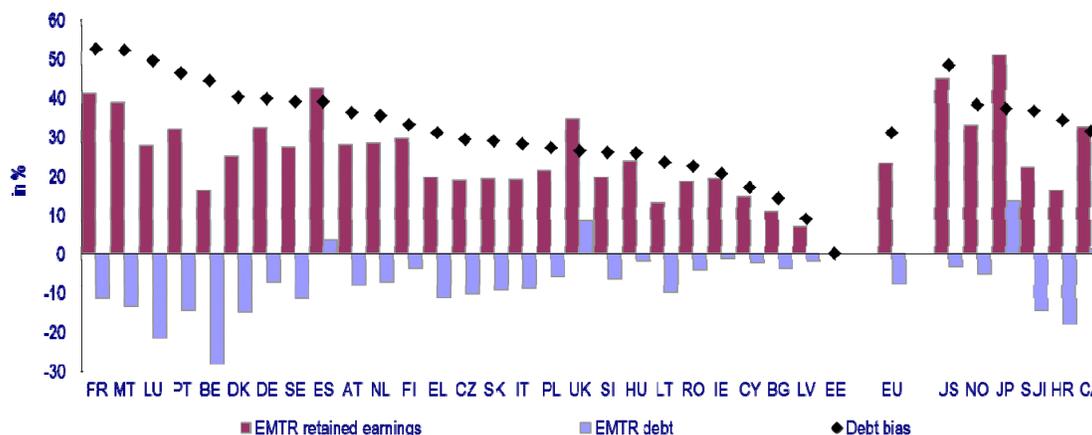
Tax expenditures in corporate taxation have been introduced by a large number of Member States in terms of incentives on the base and to a lesser extent by reduced rates.

Based on available information, a regular (partial or complete) assessment of tax expenditures (on labour and corporate) is carried out in less than half of the Member States only: Austria, Belgium, Finland, France, Germany, Greece, Italy, Netherlands, Poland, Portugal, Spain, Sweden and the United Kingdom ⁽⁸⁾.

2.2. The Debt bias

In most corporate tax systems, interest payments on debt-financing are tax-deductible for corporate tax purposes while the return paid on equity-financing is not. This creates a bias in favour of debt that makes firms more fragile in case of economic difficulties. A measure of this bias is the difference in the Effective Marginal Tax Rates (EMTR) between investments financed by debt and those financed by equity (retained earnings). The higher the difference – denoted as debt-bias in Figure 6 – the higher the incentive for debt financing. In the majority of Member States, debt-financing even provides an implicit subsidy to investment (i.e. a negative EMTR).

Figure (6): Debt-equity tax bias in Corporate Financing



Note: EU is arithmetic average
Source: ZEW (2012)

2.3. VAT reduced rates

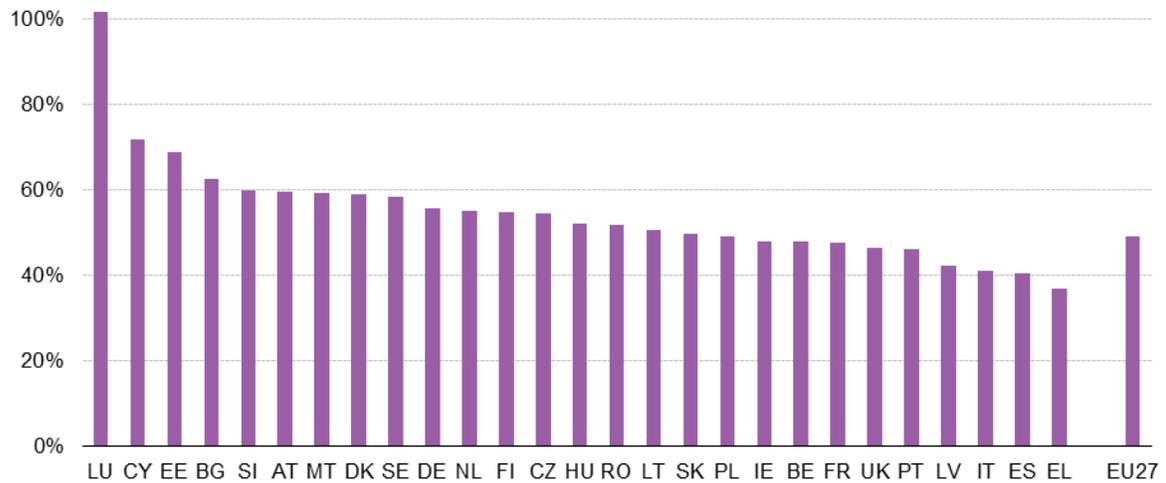
The economic literature ⁽⁹⁾ suggests that VAT should in general be levied to the extent possible on a broad base minimising revenue losses from exemptions and reduced rates. Deviations from uniformity usually do not fulfil their primary objective (e.g.

⁽⁸⁾ European Commission (2012).

⁽⁹⁾ See e.g. Copenhagen Economics (2007), "Study on reduced VAT applied to goods and services in the Member States of the European Union", *Taxation Papers* 13.

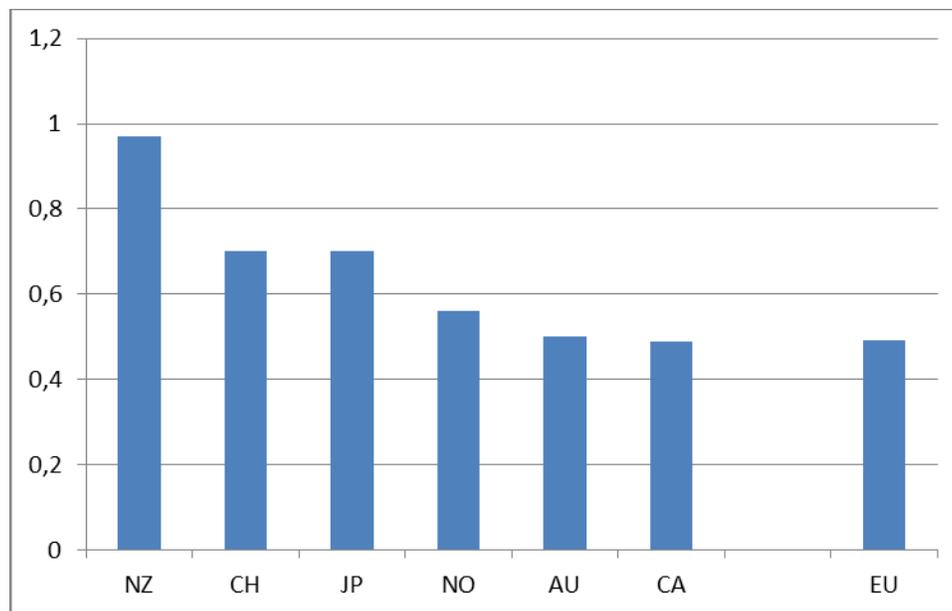
redistribution) and lead to economic costs (including compliance costs). In practice, VAT is heterogeneously designed across Member States and reduced rates and exemptions are heavily used and differ strongly. The extensive use of reduced VAT rates leads to low actual revenue collection compared to a situation where all private consumption would be taxed at the standard rate and revenue effectively collected.

Figure (7): Actual VAT revenues as a percentage of theoretical revenues at standard rates (2011)



Source: European Commission Taxation Trends in the EU, 2013 edition. Note that the high value for Luxembourg is to be related to the importance of consumption expenditures by non-residents.

Figure (8): VAT collection to theoretical revenues EU and selected OECD (2011)



Note: 2009 for non-EU and 2010 for EU. EU is GDP-weighted average.

Source: European Commission (Taxation Trends 2013) and OECD (2013), "Assessment and recommendations", in OECD Economic Surveys: Italy 2013, OECD Publishing.
http://dx.doi.org/10.1787/eco_surveys-ita-2013-en

This becomes particularly evident when comparing the VAT collection in percentage of actual revenues between the EU and other developed OECD countries. New Zealand, Switzerland and Japan levy a high proportion of theoretical revenues. This observation points to the fact that these OECD countries rely to a lesser extent on VAT rate differentiation than EU Member States. Moreover applying a single rate to all goods/services subject to VAT also reduces relabeling activities (classifying the good as something different which is subject to a lower VAT rate) and makes the system more transparent and reduces the room for tax fraud. Thereby, it increases the VAT revenues actually collected.

3. Better design of individual taxes

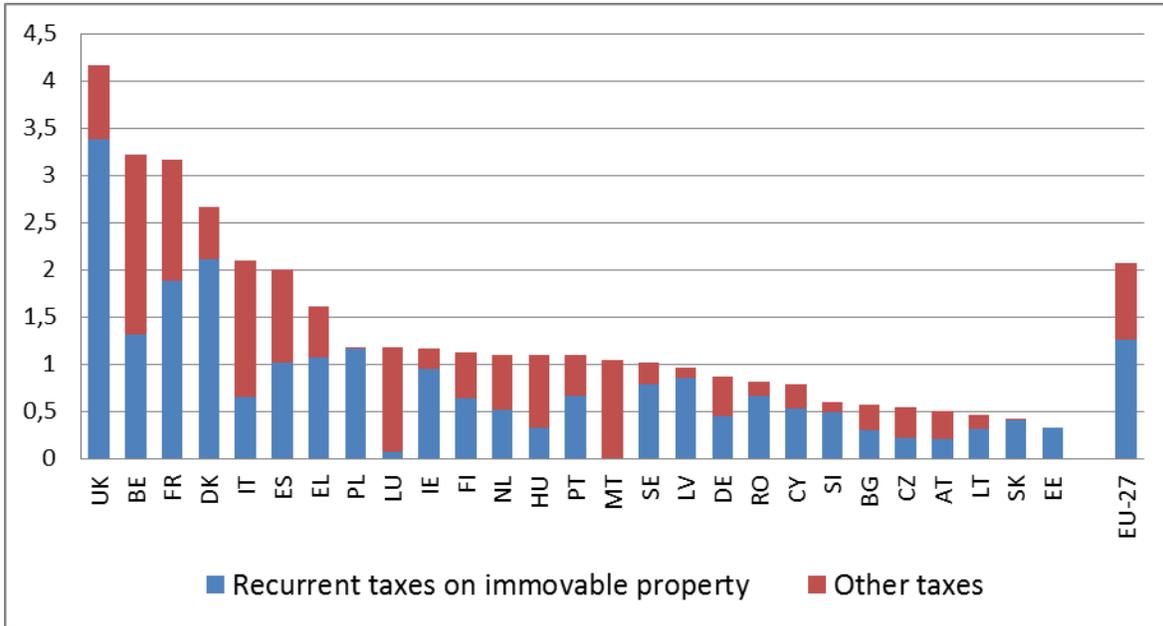
3.1. Housing taxation

Incentives towards debt-financing also exist in housing taxation as many Member States allow a rather substantial deductibility of interest payments on mortgages. This provides incentives for investors to take debt to invest in immovable properties and can contribute – in combination with no or weak taxation of imputed rents - to an overinvestment in immovable property to the detriment of other productive investment.

Property taxes, and in particular recurrent taxes on immovable property, are among the taxes least detrimental to growth. Taxes on immovable property or housing take various forms and include both recurrent and transaction taxes. Housing transaction taxes tend to discourage transactions, efficient allocation of properties and labour mobility. Recurrent taxes on real estate and land are characterised by a stable and relatively immobile and visible tax base, which is hence more difficult to evade and induces less economic distortions. Current systems for taxing immovable property that rely heavily on transaction taxes provide scope for improving tax design. A shift from taxes on transactions to recurrent taxes on real estate would reduce the distortions introduced by taxation and improve economic efficiency. It is important in addition that recurrent taxes are based on accurate and updated values for the tax base as many housing values are based on out-dated data⁽¹⁰⁾.

⁽¹⁰⁾ Property tax on market values are however not as stable as property tax on (updated) cadastral values.

Figure (9): Revenues from other taxes on property in 2011 (in % of GDP)

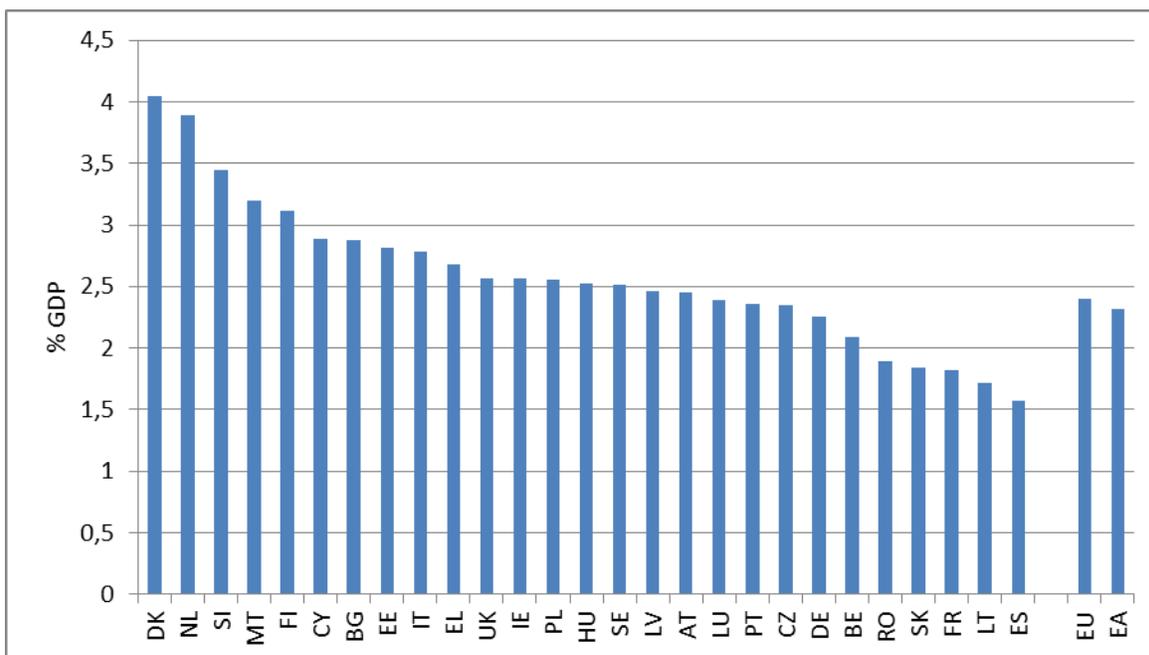


Note: "Other taxes on property" includes taxes on net wealth, inheritance, gifts and other property items as well as financial and capital transactions. Data does not include PIT on imputed rents. Source: European Commission; Taxation Trends in the EU 2013.

3.2 Developing environmentally-friendly taxation

Environmental taxes remain underdeveloped in many Member States and their revenues in percentage of GDP declined during the period 1999-2008, despite efforts to move to a greener society. Revenues have however increased in 2009 and 2010. There is potential to raise revenue through tax increases as well as through reducing tax expenditure in environmental taxation.

Figure (10): Environmental Tax Revenue across Member States, 2011, in % of GDP



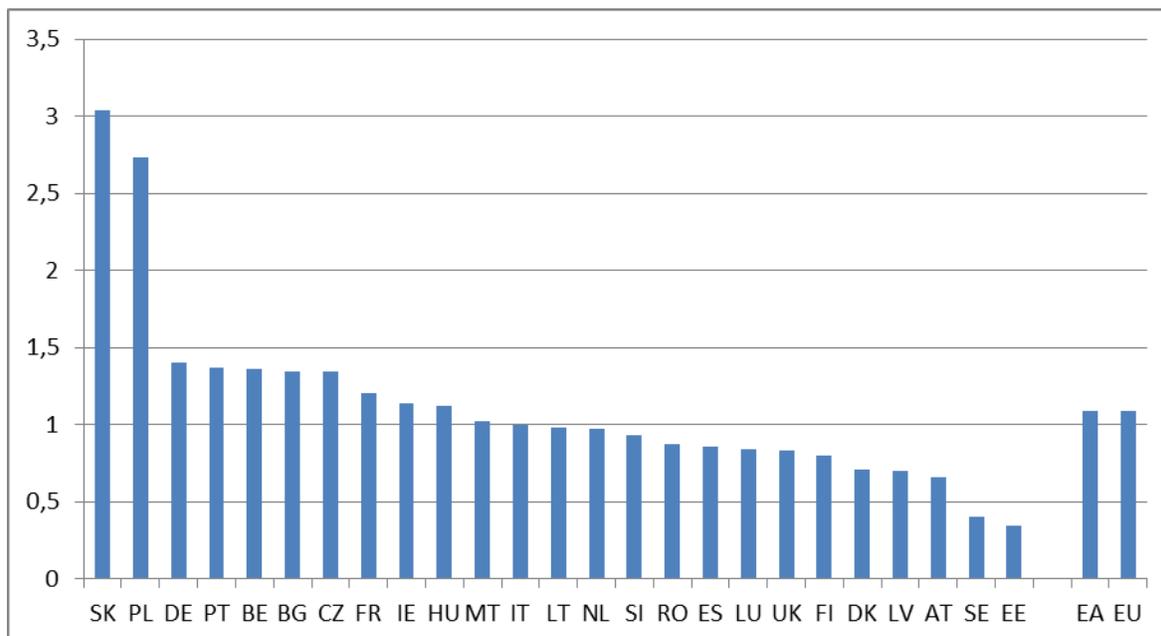
Source: European Commission Taxation Trends Report 2013 edition

Generally, environmentally-friendly taxation would also greatly benefit from the adoption by Member States of the revised Energy Taxation Directive (ETD), which aims to restructure the way in which energy is taxed to support the objective of moving to a low-carbon and energy-efficient economy, and to avoid problems for the Internal Market.

4. Tax governance

The goal for revenue authorities is to collect the full amount of taxes and duties payable in accordance with the law. Tax authorities should aim at reducing the tax compliance gap while at the same time minimising the administrative costs of collecting taxes for the government (collection costs) and of paying taxes for taxpayers, i.e. businesses and individuals (compliance costs).

Figure (11): Administrative cost per net revenue collection (cost per 100 units of revenue), 2001



Source: OECD; Tax Administration 2013 – Comparative information on OECD and other advanced and emerging economies. No data available for Greece. Data for Cyprus is currently under revision following a request by the Cypriot authorities for the year 2009 and over. EU and EA averages refer to 2009.

Note that a thematic document dedicated to the topic of shadow economy is available at http://ec.europa.eu/europe2020/pdf/themes/06_shadow_economy.pdf.

5. Redistribution

The relationship between income inequality and economic growth is complex. To address inequalities, countries typically use their tax and benefit systems. The most commonly used instruments are progressivity of personal income taxes, targeted tax schemes for low-income households, as well as various social programmes either in-kind or monetary. The degree of redistribution of the tax and benefits systems varies however widely across Member States and striking the right balance between social equity and economic efficiency is a national prerogative, which depends on national preferences.

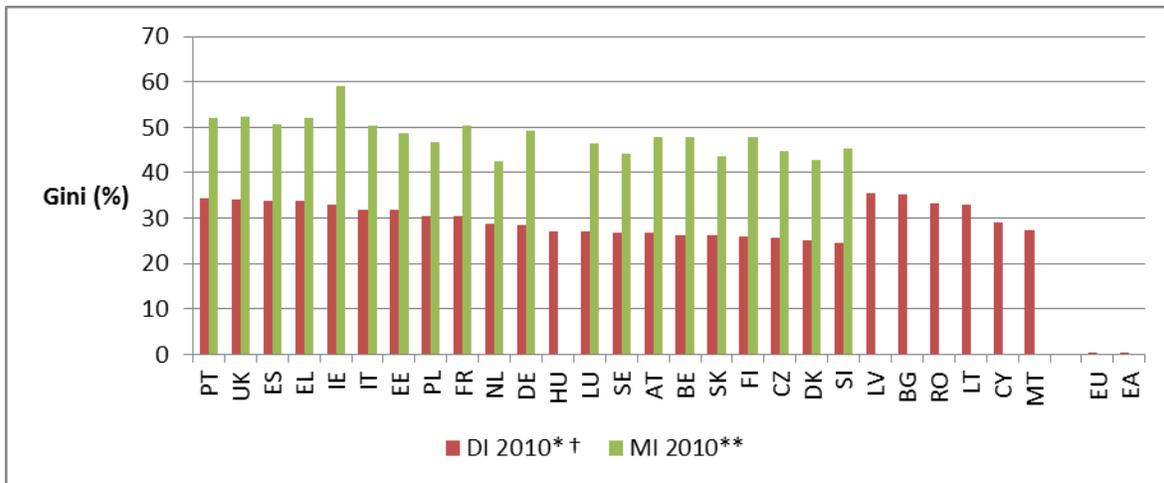
The distribution of market income, obtained either from labour or capital, is a prior determinant of the distribution of household (final) disposable income. The more unequal the market income, the greater the amount of redistribution required to achieve a given degree of equality in disposable income.

The distribution of market income is more unequal than the distribution of disposable income in the EU. Based on 2010 OECD data, the euro-area⁽¹¹⁾ average Gini-coefficient for market income (0.482) is about 19 points higher than for disposable income (for EU countries with available OECD data). This reflects the significant role of (country-specific)

⁽¹¹⁾ The Gini-coefficient is the most used inequality measure. It varies between 0, when everyone receives an identical amount of income, and 1, when a single individual receives all the income. Higher values of the Gini-coefficient thus indicate higher inequality in the income distribution.

tax-benefit systems to smooth out market-income inequality. The range of the Gini-coefficient for the Member States surveyed by the OECD data is 16.7 points for market income (between 0.424 and 0.591) and 9.8 points for disposable income (between 0.246 and 0.344).

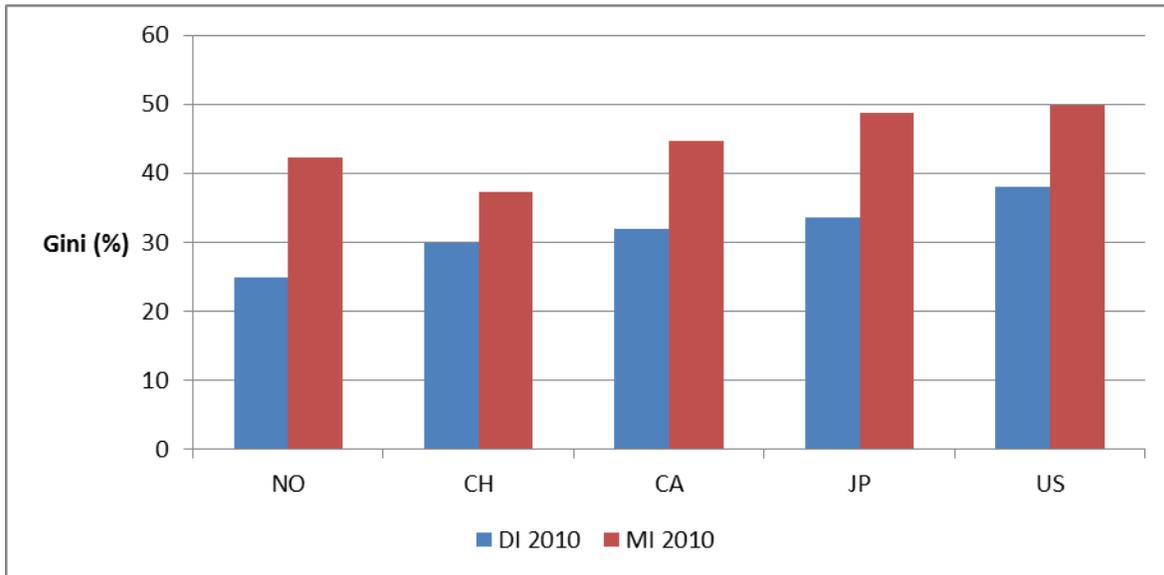
Figure (12): Gini coefficient for market income ⁽¹²⁾ and disposable income ⁽¹³⁾ – selected MS



Note: Data cover the entire population. Income data are adjusted for household size (equivalation). Source: OECD. * 2009 for IE and HU; **2009 for IE, unavailable for HU; † Eurostat, 2011 for EU, EA, BG, CY, LV, LT, MT, RO

⁽¹²⁾ Market incomes are gross wages, income from self-employment, capital income, and returns from savings.
⁽¹³⁾ Disposable income is market income plus social transfers less income taxes. Social transfers include all social transfers received in cash including old-age pensions.

Figure (13): Gini coefficient for market income and disposable income in selected OECD economies



Note: "2010" data refer to the income in 2010 in all countries except Switzerland and Japan (2009). Source: OECD

Joumard, Pisu and Bloch (2012)¹⁴ identify two types of tax reforms according to the presence or absence of a trade-off between equity and efficiency. The first type refers to tax reforms that are both growth-friendly and are likely to reduce inequality. Examples include tax expenditures that mainly benefit high-income taxpayers because they can deduct against a higher tax rate, tax breaks on stock-options, bonuses and carried interest, or low capital gains taxes.

The second type of tax reforms found by Joumard et al (2012) are those likely to be growth-friendly but that lead to an increase in inequality. Reshaping the tax structure to less growth-distortive taxes – in particular away from labour and corporate income taxes towards consumption – would improve incentives to work, save and invest, but could be regressive. Tax reforms or direct transfers targeted to lower income groups can be used to alleviate or even eliminate this trade off.

Another important issue linked to a growth-friendly tax shift is the role of combating fraud and tax evasion. Tax evasion affects negatively the level of inequality and poverty. In this context, measures which prevent or limit the reduction of a tax base by tax fraud and evasion might bring double benefit as they might positively impact on both fiscal consolidation efforts and financing of social transfers while decreasing the burden on tax payers willing to comply.

⁽¹⁴⁾ Joumard, Pisu and Bloch (2012), « Less Income Inequality and More Growth – are they compatible? Part 3. Income Redistribution via Taxes and Transfers across OECD countries », Economics Department Working Paper, 926.