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# TAXATION MATTERS

How Competition Can Help Restart Europe

ANALYSIS

# Imprint

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# Innovative Liberal Ideas for Tax Competition – How It All Started

As the International Tax Competitiveness Index states, the structure of a country's tax code is an important determinant of its economic performance. A well-structured tax code is easy for taxpayers to comply with and can promote economic development while raising sufficient revenue for a government's priorities. In contrast, poorly structured tax systems can be costly, distort economic decision-making, and harm domestic economies.

In 2020, the European Dialogue of the Friedrich Naumann Foundation in Brussels and the EPICENTER Network carried out a competition to find new, innovative ideas, on how tax policy regimes across Europe can become more competitive and driven by key liberal values of efficiency, neutrality, and fairness.

We would like to thank all participants, who shared their interesting, innovative, even sometimes controversial and far-reaching ideas with us. In the end, our jury chose four entries to receive prizes and to be featured in this publication. On the following pages you will first meet our jurors and read a few welcoming statements on the current state and future development of tax competitiveness in Europe. After setting the scene, we will dive right into the four winning entries of this competition. We hope you will enjoy meeting Jamie Whyte (1st prize), Prajwal Pandey (1st prize), Nicolas Marques (2nd prize), and Thomas Spencer (3rd prize) and their innovative liberal ideas for tax competition in Europe and wish you a good read!

# Europe's Re:start in Difficult Times – Taxation Matters

The Covid-19 pandemic has hit Europe hard. Health, economy, mobility - these are only the obvious fields in which drastic changes have affected the people in the 27 Member States of the European Union. For Europe is currently facing major challenges even without the effects and consequences of the Corona pandemic: Digitisation of the economy and public life, implementation of a smart climate policy, positioning Europe in a new, multipolar world order in competition with China and the USA - these are just three important issues that the EU must tackle collectively.

The EU Member States' response to the Corona crisis was a programme of unprecedented solidarity. That is what the „Next Generation EU“ instrument stands for. However, the political discussion and the policy-making power of the European Union and its Member States should not only focus on the expenditure side of public budgets. Alongside solidarity, it is imperative that we show stability with regard to the jointly agreed policies. Fiscal responsibility in Europe lies with the national governments. Solidarity in this case also means that each country undertakes structural reforms to increase its own performance and abides by the jointly established rules. Germany in particular has a great interest in a strong and stable Europe. In the end, stability and solidarity are two sides of the same coin.

Europe will only be successful if it emerges from the crisis through reforms and the right prioritisation of policies. To this end, it needs, among other things, a competition-oriented and growth-friendly tax policy. For me as a Liberal, it is clear: within and beyond the EU, we must use the opportunities that transparent tax competition offers - in favour of a common EU corporate tax base, against tax deals for large companies, against unfair tax dumping and for an internationally coordinated policy that ensures fair tax competition with clear rules, also beyond the EU. These are just some of the tasks at stake.

Competition is also a powerful force for generating ideas and discussing concepts. That is why I was happy to participate as a jury member in this essay competition, „The Future of European Tax Competition“, organised by the Friedrich Naumann Foundation for Freedom together with the European Policy Centre.

Max Weber famously said: „Politics is a strong and slow boring of hard boards. It takes both passion and perspective.“ This idea holds true to this day and our essay prize winners certainly make a contribution to this process. May the ideas presented in this publication inspire the current and future discussion on the best growth and tax policy!

**Bettina Stark-Watzinger**

# Tax Competition – What It Is and Why We Need It

This collection of essays examines two related questions. The first is that of how to reform and improve the tax systems of states, particularly member states of the EU. The other is the encouragement of tax competition between states, including between member states. The two are interconnected because without tax competition bad tax policies are much more likely to survive and it is hard to even start to know what might be a good tax reform (in particular one that is not counter-productive and self-defeating on its own terms). In this tax competition is like competition in general, it is best understood as a discovery process that helps us to identify flaws or problems and to discover new and better ways of doing things. Without it we would simply not know enough to be able to do either, too much would be in the category of unknown unknowns in both cases.

What though is tax competition and exactly how and why is it a good thing? To answer this question, we need a clear idea of what it is that we are talking about. Right now, tax competition is in bad odour. There are a whole range of people, politicians and activists, who are lining up to attack both the idea and the practice. The arguments are that tax competition encourages a 'race to the bottom' in which taxes, particularly those on firms, are driven down to levels that cannot sustain the levels of public spending that voters want and vote for. As a result, it is argued that the process or phenomenon of tax competition is an affront to democracy and the principle of popular sovereignty. The conclusion is that sovereign states should not set their tax rates independently of each other or vary the ways they are administered or the base they are levied on, except within very narrow limits. Instead, there should be a high degree of uniformity. We should in fact have a tax cartel rather than tax competition. It is hard to see how this also does not undermine popular sovereignty and democracy, since it removes the ability to determine taxes and tax policy, in important ways, from national electorates and puts it in the hands of a cartel of governments and international experts.

Nevertheless, there are clear moves in this direction. Within the EU there is growing discontent on the part of some governments with the tax policy of the Irish Republic and other member states such as Luxembourg and the Netherlands are also coming in for criticism, all for having tax policies and rates that supposedly undercut those of their neighbours. On a global scale, the Biden Administration has taken the lead in arguing for the creation of a global floor for corporation tax, which was formally adopted at the G7 summit. There is a growing body of opinion among (some) political leaders that reform of the EU should include severe restrictions on tax competition between member states and the establishment of floors for several taxes (somehow not ceilings though) and limitations on powers such as the ability to set different rates including one of zero for VAT. Faced with this tide, the case for tax reform and competition needs to be made forcefully.

One point that needs to be made very forcefully is that tax competition is inevitable and unavoidable as long as we have sovereign and self-governing states. It can still exist even in the absence of that, as the United States shows, but in that kind of case it exists only at the sufferance of the ultimate sovereign and federal or supra-national power. If states are sovereign then given that tax powers are at the heart of sovereign power there is bound to be variation between them in this regard as this is an inevitable result of the exercise of that power. In many cases this will be deliberate rather than accidental and taxes will be set or administered with an eye to what the policy of other states is - this is what we call tax competition. It is worth noting that there is also tax collusion where states take note of what their counterparts are doing and align their rates and policies but as long as they retain control this is not the same as the kind of treaty-based cartel that many want. It is also worth noting that the point about tax competition deriving inevitably from sovereignty applies also to money and monetary policy unless

that aspect of sovereign power has been deliberately pooled and surrendered, as it has in the Eurozone. The opponents of tax competition want to see a similar surrender of sovereignty (and therefore in current circumstances of democratic oversight and control) in the case of the taxing power.

What though is tax competition about. In reality states are competing with each other, for labour and citizens, particularly, but not only, skilled and productive ones and for capital investment and the location of important economic activities. Constructing a tax regime that will be attractive to workers, investors, and firms is a part of this. In some sense it is a competition to attract productive people and resources so as to grow the tax base. It is important to realise that this competition for workers and capital on the part of governments is not only or even primarily about the rate of tax levied. If that were the case everyone would be rushing to relocate to Somalia, which they clearly are not. Governments are also competing to provide services and an environment that is pleasant, safe, conducive to business, and supportive of a flourishing life in every sense. The taxation policy is best understood as the price at which sovereign governments offer this range of services. Clearly this is a case where price while important, is not the only consideration and as a result high tax rate countries are often very successful in this competition because they use the tax revenue efficiently and effectively and also have a tax system that is transparent, efficient, and rule bound. Low taxes by themselves will not attract people if the system is arbitrary, opaque and difficult to navigate, and excessively complex. However, as in competition between firms, it will tend to drive the 'price' (the tax level) down to an equilibrium level, and stop it rising above that to a predatory level where it exceeds the value of the services provided.

What competition and comparisons between different states does is to encourage experimentation and improvement in both the tax system and the delivery of services. It also increases efficiency to the extent that governments respond to this, so that it becomes possible to find ways of delivering an equivalent quality of service or institutional framework at a lower price (tax level). We can think of states as firms in the business of offering government services on a monopoly basis in a given territory and competing to attract citizens and investors/customers. Competition keeps them honest and also acts as a discovery procedure through which existing ways of doing things can be improved and new ones discovered, just as it does in commerce. Above all there is no evidence at all that this leads to a race to the bottom in terms of either taxes or public service. It does lead to improvement however and greater efficiency. Where there is a decay or decline in those things the blame actually lies with national politicians who use tax competition as a convenient excuse.

Tax competition between sovereign states is thus inevitable and beneficial. In the present climate and with the clear move towards diminishing it within the EU it is important to think of new ways to have transnational taxes that do not hinder it and to have better and improved and less burdensome national systems. The essays in this volume are an important contribution to that end.

**Dr Stephen Davies**

## Meet the Jurors



### Bettina Stark Watzinger

Bettina Stark Watzinger is a member of the board of the Friedrich Naumann Foundation for Freedom, as well as a member of the board of trustees of the Karl Hermann Flach Foundation. She studied economics at Johannes Gutenberg University in Mainz and Goethe University Frankfurt from 1989 to 1993, before completing a graduate training programme from 1994 to 1997. She worked as a regional manager for BHF BANK AG in Frankfurt from 1994 to 1997, after which she spent time in the UK and took a career break to raise a family from 1997 to 2006. Bettina continued her career as academic manager in the Finance, Accounting, Controlling and Taxation Department of the European Business School in Oestrich-Winkel from 2006 to 2008 and afterwards served as manager of a research institute until 2017.

Bettina has been a member of the FDP since 2004, holding the following positions: Member of the executive committee of the Hesse Land branch since 2011; deputy chairwoman of the Hesse Land branch from 2014 to 2015 and since 2018; general secretary of the Hesse Land branch from 2015 to 2018, as well as member of Main-Taunus county council from 2011 to 2017. In 2017 she was elected Member of the German Bundestag, in which she served as Chairwoman of the Finance Committee from 2018 to 2020. She now holds the position of Parliamentary Secretary of the FDP parliamentary group since 2020.



### Professor Philip Booth

Philip Booth is Professor of Economics and Director of the Vinson Centre for the Public Understanding of Economics and Entrepreneurship at the University of Buckingham. He is also Senior Academic Fellow at the Institute of Economic Affairs and Professor of Finance, Public Policy and Ethics at St. Mary's University, Twickenham. He also holds the position of (interim) Director of Catholic Mission at St. Mary's having previously been Director of Research and Public Engagement and Dean of the Faculty of Education, Humanities and Social Sciences. From 2002-2016, Philip was Academic and Research Director (previously, Editorial and Programme Director) at the IEA. From 2002-2015 he was Professor of Insurance and Risk Management at Cass Business School. He is a Senior Research Fellow in the Centre for Federal Studies at the University of Kent and Adjunct Professor in the School of Law, University of Notre Dame, Australia.



### Dr Stephen Davies

Dr Steve Davies is the Head of Education at the IEA. Previously he was program officer at the Institute for Humane Studies (IHS) at George Mason University in Virginia. He joined IHS from the UK where he was Senior Lecturer in the Department of History and Economic History at Manchester Metropolitan University. He has also been a Visiting Scholar at the Social Philosophy and Policy Center at Bowling Green State University, Ohio. A historian, he graduated from St Andrews University in Scotland in 1976 and gained his PhD from the same institution in 1984. He has authored several books, including *Empiricism and History* (Palgrave Macmillan, 2003) and was co-editor with Nigel Ashford of *The Dictionary of Conservative and Libertarian Thought* (Routledge, 1991).



# Frax the EU

## Jamie Whyte

Most questions about taxes have the same answer. Which is Switzerland. Taxes should be done on all of Earth as they are done in Switzerland! Or, if the whole Earth is too much to ask for, then let's start with Europe.

The tax regime in Switzerland is not perfect. For example, they tax business profits and interest earnings, even though taxes on capital income are inefficient.<sup>1</sup> But such shortcomings should disappoint only a little and should not surprise us at all. The Swiss, after all, are humans. And, as elsewhere, taxes there are set by humans who seek votes from those they tax and those on whom they spend the taxes – which can only cause trouble.

Despite all of this, it causes less trouble in Switzerland than elsewhere because of something unusual about the country: namely, that Switzerland, in fact, has no single tax regime but, instead, a bunch of competing canton-based tax regimes between which the Swiss can choose. They have twenty-six of them in total. If a Swiss doesn't like the taxes he pays, he can vote with his feet and take his wallet with him. Tax-setting in Switzerland, unlike other countries, is subject to market disciplines and not merely democratic constraints. No wonder, then, that taxes in Switzerland are so good – or, in other words, so low (by current standards).<sup>2</sup> The Swiss governments combined collect only 28 per cent of GDP in tax. The European Union (EU) average is 40 per cent.

Even though this is a far cry from harmonizing taxes, as many Eurocrats dream of, ultimately, the EU should go Swiss.

You may believe that it already has. After all, any EU citizen can live in any EU country. If a Frenchman doesn't like French taxes, he can move to Estonia, for example, which is only one of the 26 options. But moving from France to Estonia is costly. You end up too far from your old friends and family to see them at the weekend. You may lose your business contacts as well. You can't get snails for dinner. And you may not even speak Estonian.

"Free movement" within the EU is a legal fact, not an economic one. Moving homes between EU countries remains expensive – much more expensive than moving between Swiss cantons. If that Frenchman could change the tax regime he lives under by moving from Paris to Versailles, then the hypothetical Parisian and Versailles tax-setters would face a genuine market constraint that actual French tax-setters do not.

This then, is my proposal for tax reform in the EU: as a condition of membership, national governments should be allowed to collect no more than 10 per cent of national GDP in taxation, thus allowing for all other tax collection to be devolved to local governments. Call it the Frax system, short for fragmented tax.

I'll come to the political feasibility of Frax. But first I must flesh out and further justify my proposal, which I can do by answering the question, "How local is local?" Do I mean that most taxes should be collected by the states of Germany (Länder) or by the districts (Keise), by the regions of France or by the departments, by the autonomous communities of Spain or by the provinces?

I mean the latter (and the equivalent administrative area in other EU countries), and not just because the cost of moving between them is lower.

### Taxation and the Scope of Public Goods

Suppose, for example, I buy and eat a Big Mac. I get all the benefits of it. But if I buy a nuclear missile and threaten to retaliate if anyone sends one of theirs my way, then it is not only me who benefits from this deterrence but all my neighbours as well. Indeed, everyone within a radius of some hundreds of kilometres benefits because, when it comes to nukes, that is what counts as "coming my way"

Whereas a Big Mac is a private good because only the purchaser benefits from it, nuclear deterrence is a public good because everyone benefits, regardless of whether or not they paid for it. This makes people reluctant to pay for public goods, hoping instead to freeride on the payment of others. So public goods are undersupplied in a free market. People should be forced to pay for them. Or, in other words, public goods should be funded from taxation.

That's the standard argument for funding national defence, law-and-order, street lighting and other public goods from taxation. It's fine, as far as it goes, but it doesn't go far enough.<sup>3</sup> It leaves two questions unanswered. How much should be spent on any particular public good? And whose taxes should pay for it?

Let's start with the second question, since its answer also answers the first.

<sup>1</sup> Atkeson, Andrew., Chari, V.V., and Kehoe, Patrick., "Taxing Capital: A Bad Idea," Quarterly Review of the Federal Reserve Bank of Minneapolis 23 (1999).

<sup>2</sup> They would surely be even lower if not for the Swiss federal government steadily increasing its spending and taxation over the last century.

<sup>3</sup> Of course, some anarchists argue that it is not fine, even as far as it goes, because public goods can be adequately supplied privately (see, for example, Friedman, David. (1973)

The Machinery of Freedom. Illinois: Open Court, 1973). Though I have some theoretical sympathy, I cannot consider this idea in a short essay on practical changes to taxation in Europe.)

When I said that everyone benefits from public goods, I was exaggerating. The deterrence supplied by nuclear weapons is a public good, but the residents of China do not benefit from the UK's nuclear arsenal. They are too far away. Street lighting is a public good. But the residents of Berlin do not benefit from street lights in Munich. Again, they are too far away. Public goods have a geographic scope. And we expect those who live within that scope, and therefore get the benefit of the public good, to fund it. The British do not ask the Chinese to fund their nukes. And Berliners do not pay for street lights in Munich.

As things stand, however, the scope of public goods and of the tax collection that funds them do not overlap perfectly. Usually the tax collection is wider than the public good. Consider the safety enjoyed by the people of Oxford because they have a police force. These police are paid for not from local taxes, but from national UK taxes. In rare cases, the tax is narrower than the public good. Citizens of the Republic of Ireland benefit from the nuclear deterrence provided by the UK's nukes, but they don't pay for them.

Why does this mismatch matter? Because it results in too much or too little being spent on public goods. Maybe the people of Oxford would prefer lower rates of tax and more crime, or perhaps, higher tax rates and less crime. Local democratic decision-making will reflect local preferences better than national democratic decision-making will. The patchwork of different local expenditures on public goods and, hence, local taxes will satisfy more preferences than will a single regime imposed nationally.

This is not so when the public good is national in scope, as with defence. Then, localising decisions about tax contributions will lead to under-spending, with the voters of each sub-region hoping to freeride on the voters in the others.

So the first reform required by my Frax proposal is to locate decisions about how much to spend on public goods at the level of government – national, state, district, etc. – closest in size to the scope of the public good concerned, and to collect the taxes that pay for it from the same area.

Some public goods have a supra-national scope; as the aforementioned example of nuclear deterrence does. This provides a case for funding them from a tax set at the EU level, if only the EU could set taxes. Carbon taxes aim at delivering a public good that is global in scope: namely, a climate hospitable to human life. They should be set at a global level. Lacking the legal apparatus for global tax collection, however, they should be set by the taxing agency with the widest scope, which, for citizens of European countries, would be the EU – again, if only the EU set taxes.

Aside from these public goods and the provision of law (but not police), I can think of no public good whose scope is larger than the level of government I will call a district: that is, the level two steps down from the national government. Some public goods are yet smaller in scope: street lighting and rubbish collection, for example. If they can be funded at a lower level of government, that's all well and good, but let's not over-complicate things here.

I have said that a local democracy will do a better job of satisfying local preferences than a national democracy will. And so it will. But voting at the ballot box is of secondary importance under Frax. It is the prior and subsequent voting with feet that causes local fiscal policies to correspond to the preferences of locals. That's because people who don't like the reigning fiscal arrangement will move out, and people who do like it will move in. When people vote with their feet, they form voluntary "fiscal communities": that is, communities of people who broadly agree about the best tax-and-spend deal.<sup>4</sup>

Of course, even when these communities are small, they aren't perfectly formed. Moving homes still has some costs, especially if none of the nearby options suits your fiscal preferences. Many dissatisfied people would stay put. Nevertheless, with free movement between lots of smaller tax districts, more people will live under a fiscal arrangement that suits them better than the one they live under now. Fiscal communities will be well-formed, if not perfectly formed.

### Private Goods and Transfers

The "scope of goods" rationale for Frax also explains why governments should not supply private goods. Since the scope of a private good is the individual consumer, the individual should decide how much to spend on, as well as bear the cost of it. Alas, most governments do supply private goods, such as healthcare and education. And I cannot be sure that Frax would overcome this bad habit. After all, one of the best (approximate) examples of voluntary fiscal communities involves education. In the United States, many people with school-aged children move into neighbourhoods with high property taxes and well-funded public (state) schools and then move out of them when their children leave school.

If local governments supplied private goods under Frax, that would be regrettable. Still, they will do a better job of it than national or regional governments, for the reasons already mentioned. Foot-voting makes politicians act more like suppliers competing for willing customers, regardless of whether they are supplying public goods or private goods. Under Frax, they will be more responsive to the preferences of locals about the cost and nature of those goods.

<sup>4</sup> Tiebout, C., "A pure theory of local expenditures," *Journal of Political Economy* 64 (1956): 416-424.

Among the private goods that governments now supply is income insurance, such as unemployment benefits and incapacity benefits. The logic of funding private goods privately may seem to apply here too. Each individual should be left to decide for himself how much he wants to spend on protecting himself against an unexpected loss of income. So, as with education and healthcare, if these things must be supplied by governments, they should be supplied by the smallest and most local government possible.

But this decision is too rash. A good argument for the government supply of income insurance is that it remedies a market failure (in the sense of a failure of a market to exist). Some people have “cosmic misfortune”: they are born with diminished prospects in life, perhaps because of their genetic inheritance or because of the circumstances of their upbringing. Before our births, each of us might be willing to buy insurance to protect ourselves against such bad luck, the premiums being paid by those who turn out to be lucky and the pay-outs going to those who turn out to be unlucky. Alas, the yet-to-be born cannot buy anything, including insurance policies.

Tax-funded social welfare schemes can be seen as correcting this market failure. And if this is the rationale for them, then our scope of argument favours a global tax. After all, the country you are born in is as much a matter of cosmic luck (as far as you are concerned) as your height or the qualities of your parents. But with global taxes being practically impossible, we should go for the widest practical alternative scope – the EU, if citizens do not balk at the inevitable net flows from rich to poor countries, otherwise national taxation is also an option. Using the widest possible scope for funding income insurance also provides risk diversification benefits that reduce the cost of providing the cover.

On the other hand, it presents a threat to the Frax system. National politicians may try to buy votes by promising to increase the amount of income insurance pay-out and to loosen the criteria so that more voters receive them, thereby driving up national taxes. Hence the rule with which I began, that national governments within the EU may not collect more than 10% of GDP in taxation – a rule that would require serious constitutional protection. National defence and the provision of law (but not police) together consume roughly three per cent of GDP in most EU countries, leaving up to seven per cent for income insurance, which is more than EU countries now spend on unemployment and incapacity benefits combined.

(Of course, EU national governments now spend much more than this on state pensions. But retirement is an entirely predictable event and pensions are not income insurance. So they are not covered by the “cosmic luck” argument and should be left to districts or, better, to private providers.)

## Political Feasibility

Frax is a large departure from typical tax arrangements in the EU. But that is not a serious objection to it, since any significant improvement of taxation in the EU would be a large departure. And large departures do sometimes happen in taxation – not overnight, perhaps, but over historically short periods of time. In 1910 the federal government collected less than a third of all tax in the U.S., while states and municipalities collected the rest. By 1960, the federal government collected two-thirds. In New Zealand, in just a few years in the mid-1980s, the top rate of income tax was reduced from 66 per cent to 33 per cent, import tariffs were all but eliminated (having been very high) and a sales tax was introduced.

A better objection is that Frax could be adopted only with the backing of national governments – which is a turkeys-voting-for-Christmas proposal. Why would a national politician want to diminish his power, and his ability to use tax revenues to buy votes, by devolving tax-and-spend authority to districts? Many won't, of course. But some European politicians might see it as a way of solving a problem they face.

Many people claim that politicians are “out of touch”. This complaint often has a regional character. National politicians are accused of living in an elite metropolitan bubble, with no understanding of the concerns of those who live in the provinces – or, worse, no concern for them. Where regional populations have an independent “identity”, as in Scotland and Catalonia, separatist movements are thriving. In this respect, national politicians are in competition with regional politicians. But not with district politicians. Lombardy politicians might plausibly campaign to become an independent country (in league with some of their Northern Italian neighbours, perhaps), while Milanese politicians could not.

By devolving tax-and-spend powers to districts, national politicians would render regional governments largely irrelevant. Separatist politicians could not complain about the burdens placed on them by the aloof national elite. And they could make spending promises only by proposing to take over the powers of districts. But, under Frax, they could do that only by leaving the EU, which few would want to do.

In short, while diminishing the importance of current EU nation states, Frax would protect them from separatist movements. This might already strike some Spanish national politicians as a good deal. The rise of populist discontent across the continent should make national politicians in other countries favour it too.

Many Europeans have strong feelings of national allegiance. So long as it is an affection for their language, cuisine, sports teams, cultural heritage and so on, it is harmless. But it should

not be translated into the nationalisation of fiscal decision-making and tax collection. That gives national politicians great power over captive taxpayers, whom they can burden with very wasteful government spending and inefficient tax collection before driving them away. Even the most ardent French nationalist should lament the centralisation of fiscal arrangements in France, just as many American nationalists regret the shift of fiscal responsibility from states and municipalities to the federal government. The national government isn't the nation.

Ardent Europhiles should also favour Frax. For just as it would help to defuse tensions between nation states and the regions within them, it would help to defuse tensions between the EU and its member states. If the "deal" Europeans were dependent not on their nation but on the district they live in, "taking back control" would no longer be an argument for national withdrawal. People who can move between small fiscal communities and vote in them would already have more control than nationalist separatists could offer them.

The European Union was conceived as a way of avoiding the harms that can be done by nationalism. Those who still cherish this goal should embrace Frax.

# Post-Pandemic EU Tax Reforms for Economic Growth

Prajwal Pandey

## Outline of Policy Recommendations

1. Restructure labour income tax rates to a flat marginal rate of 30%.
2. Make the payable rate of corporate income tax a negative function of the rate of profit reinvestment through an investment tax credit.
3. Reform corporate income tax to a flat rate of 20%

## Introduction

The ongoing pandemic has posited numerous problems for fiscal policy makers: aggregate economic growth of the EU is expected to shrink by 7.4% in 2020,<sup>1</sup> global inequality has worsened significantly, and total factor productivity has declined to striking levels. The task for governments across the EU is to optimise tax schedules to facilitate economic recovery, without compromising other macroeconomic objectives such as social welfare maximisation and equity. Therefore, I present tax reforms that fit these criteria for a post-pandemic EU.

## Labour Income Tax

Taxation on labour income is undoubtedly a vital aspect of all countries' tax schedules; in the OECD, revenue from labour income tax constitutes 23.5% of total revenue.<sup>2</sup> Being such an important component of tax systems, it is natural that this tax is utilised greatly for budgetary revenue accumulation. However, with an increase in this tax for generating more revenue, a number of trade-offs need to be considered.

Firstly, there is a trade-off with labour supply and, by extension, labour input productivity. This is because, as per the widely accepted theory of the Laffer Curve, excessively high marginal tax rates disincentivise workers from working and providing labour supply.<sup>3</sup> Not only does this reduce labour productivity, but it also reduces government revenue, due to total taxable income decreasing with labour supply. Another trade-off to be considered is with social welfare. Since all non-lump sum taxes cause market distortions and interfere with economic agents maximising social welfare, a deadweight loss is incurred.

Naturally, both of these effects have a negative impact on economic growth. This is especially important when looking at how post-pandemic tax schedules can be optimised in EU countries. Whilst the government must maximise revenue for repayments to creditors as well as for various other state programmes, governments must ensure that these distortions are minimised to facilitate the recovery of markets.

Firstly, in order to determine the optimal tax schedule for post-pandemic recovery, we must consider the shape of the tax schedule. Out of the 27 EU member states, 22 have progressive taxes,<sup>4</sup> where the burden of taxation increases with income. This structure causes a lot of inefficiency, as households devote large sums of money in compliance to the complicated progressive tax system, as opposed to consumption and savings. We can see this in Germany, where costs of income tax compliance are estimated to be as high as €7.2 billion.<sup>5</sup> The logical solution to this problem would be to reform to a perfectly flat rate, as this would eliminate administrative and compliance costs indefinitely. However, since low ability individuals are taxed at the same rate as high ability individuals, this defeats the sole purpose of social planners; to tax high ability individuals more, so as to redistribute to low ability individuals, thereby maximising aggregate utility and social welfare.

Instead, we can draw upon the foundational work of Mirrlees (1971) in optimal income tax theory.<sup>6</sup> The results of his model demonstrate a tax schedule which is close to being linear. This demonstrates how, in Mirrlees' model, labour-discouraging effects outweigh the positive effects brought about by taxing higher ability individuals. This fits with the context of a post-pandemic EU, since labour input productivity has decreased by 12.5% between Q4 2019 and Q2 2020.<sup>7</sup> This exemplifies the need for fiscal policy measures that prioritise increasing labour productivity for economic recovery. Since the high marginal rates of progressive taxes discourage worker productivity, it would seem unwise to continue with this structure. Instead, EU countries should adopt Mirrlees' proposed structure of a flat marginal tax rate.

<sup>1</sup> European Commission. 2020. „Autumn 2020 Economic Forecast, Institutional Paper 136.“

<sup>2</sup> „OECD ILibrary | Revenue Statistics 2020“. 2020. <https://doi.org/10.1787/2522770x>.

<sup>3</sup> „Laffer Curve Definition“. 2020. Investopedia. <https://www.investopedia.com/terms/l/laffercurve.asp>.

<sup>4</sup> „Economic And Monetary Developments“. 2007. [https://www.ecb.europa.eu/pub/pdf/other/mb200709\\_focus10\\_en.pdf](https://www.ecb.europa.eu/pub/pdf/other/mb200709_focus10_en.pdf).

<sup>5</sup> Blaufus, Kay, Sebastian Eichfelder, and Jochen Hundsdoerfer. 2013. „Income Tax Compliance Costs Of Working Individuals“. *Public Finance Review* 42 (6): 800-829. doi:10.1177/1091142113488162.

<sup>6</sup> Mirrlees, J. A. 1971. „An Exploration In The Theory Of Optimum Income Taxation“. *The Review Of Economic Studies* 38 (2): 175. doi:10.2307/2296779.

<sup>7</sup> „OECD Economic Outlook No. 106 (Edition 2019/2)“. 2017. *OECD Economic Outlook: Statistics And Projections*. doi:10.1787/8aa5bebb-en.

As for the magnitude of this tax rate, it would be unwise to continue with Mirrlees' model. Mirrlees makes modelling assumptions that simply do not apply in real life to EU countries. For example, Mirrlees' utility function has properties that do not truly reflect consumer behaviour.<sup>8</sup>

Therefore, instead, we can turn to more recent numerical models that rectify these imprecisions. Saez (2001), building upon the work of Mirrlees, created a linear elasticity-based model for estimating optimal top marginal tax rates.<sup>9</sup> Since we have established that a linear single-bracket flat rate is the optimal tax structure, we can apply Saez's equation for the top marginal tax rate which calculates the optimal rate above a given income level.

$$\tau = \frac{1 - \bar{g}}{1 - \bar{g} + \zeta u + \zeta(\alpha - 1)}$$

Hence, let us evaluate approximations for each of the relevant variables.

### Social Marginal Utility of Top Income Bracket Earners ( $\bar{g}$ )

This parameter conveys the government's preference in how much of the utility of top tax bracket payers they intend to consider. Many may argue that this should be given as 0, corresponding to a situation where the government is only wishing to maximise revenue, without regard for the welfare of these taxpayers. This is because the ongoing pandemic has exacerbated existing income inequality drastically, as can be seen by IMF projections estimating a worsening of the global Gini Coefficient to 42.7% (the same level as during the 2008 global recession).<sup>10</sup> Due to macroeconomic equity goals needing to be met by revenue accumulation amongst taxpayers for redistribution, it therefore would seem only natural that the government's increased redistributive tastes are reflected in this parameter being minimised.

However, conventional wisdom conveys that higher marginal income tax rates on earnings will discourage economic growth. Taxpayers will be left with less disposable income if their welfare is ignored and taxes are increased, resulting in substitution effects where work-effort, savings and investment decreases. Hence, economic growth will suffer. This is evidenced empirically by numerous regression analyses that endogenise the effect of income taxes on economic growth. Through this method, Poulson and Kaplan (2008) found that as much as 30% of the statistical variance in GDP growth can be explained by the aforementioned income tax-created substitution effects.<sup>11</sup>

Additionally, it is vital that governments leave tax-paying workers with more money wages, since this will encourage a recovery in consumption levels, which decreased by an unprecedented 2.9% in the EU during Q1 2020.<sup>12</sup> Since consumption constitutes 66% of aggregate demand<sup>13</sup>, governments encouraging consumption by accounting for the welfare of taxpayers will ensure a demand-side boost to economies.

Hence, for the purpose of our model, it is important that we place heavy weightage on the welfare of taxpayers, since post-pandemic economic recovery depends on their disposable income levels being maintained. Thus, let us consider this variable as having a range of values several magnitudes greater than that of the original estimates made by Saez (which was  $0 \leq \bar{g} \leq 0.25$ ).

$$0.5 \leq \bar{g} \leq 0.65$$

### Uncompensated Labour Supply Elasticity ( $\zeta u$ )

This parameter measures the responsiveness of labour supply to a change in net wage rates. This variable is of paramount importance when considering post-pandemic labour income tax rates; if governments do not consider trade-offs between labour supply and tax revenue, then labour market participation rates will remain low. This will culminate in decreased labour input productivity and, by extension, worsened economic growth from supply-side factors.

Empirical estimates of this parameter are subject to much contention. Therefore, to estimate this variable with greater accuracy, we can turn to the work of Evers, et al (2008) who conducted a meta-analysis of studies looking at uncompensated labour supply elasticity for European countries.<sup>14</sup> They find that this value is around 0.5 for women, and 0.1 for men. Therefore, by finding the weighted average of these two values (by placing the relevant weights for male/female labour market participation rates) we get:

$$\zeta u = 0.2836$$

### Compensated Labour Supply Elasticity ( $\zeta c$ )

This parameter is a Hicksian labour supply function that estimates the responsiveness of labour supply to a change in gross income (holding utility constant). Both substitution and income effects of taxation are captured in this variable, making it of great importance for our purpose. If governments ignore this, then workers will substitute labour for leisure (as leisure is a normal good) and behavioural effects that decrease productivity and revenue will be magnified.

<sup>8</sup> Saez, E. 2001. „Using Elasticities To Derive Optimal Income Tax Rates“. *The Review Of Economic Studies* 68 (1): 206. doi:10.1111/1467-937x.00166.

<sup>9</sup> *Ibid.*, p212

<sup>10</sup> „World Economic Outlook, October 2020: A Long And Difficult Ascent“. 2020. <https://www.imf.org/en/Publications/WEO/Issues/2020/09/30/world-economic-outlook-october-2020>

<sup>11</sup> Poulson, Barry W, and Jules G Kaplan. 2008. „State Income Taxes And Economic Growth“. *Cato Journal* 28 (1): 53-71.

<sup>12</sup> „Non-Financial Sector Accounts For The First Quarter Of 2020“. 2020. <https://ec.europa.eu/eurostat/documents/2995521/11146677/2-28072020-AP-EN.pdf>.

<sup>13</sup> „Pre-Budget Report, Investing In Britain's Potential: Building Our Long-Term Future“. 2006. [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/272403/6984.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/272403/6984.pdf).

<sup>14</sup> Evers, Michiel, Ruud De Mooij, and Daniel Van Vuuren. 2008. „The Wage Elasticity Of Labour Supply: A Synthesis Of Empirical Estimates“. *De Economist* 156 (1): 25-43. doi:10.1007/s10645-007-9080-z.



Saez suggests that this value is around 0.25. However, economists have argued that this underestimates the total dead-weight loss of such a high tax, due to behavioural responses like shifting income into non-taxable forms and tax evasion not being accounted for in the long-run. Saez acknowledges this limitation in his paper, and admits that estimates of this variable as high as 0.5 are justified. Furthermore, similar results have been found in oft-cited papers, such as by Ziliak et al (2005) in the Journal of Labor Economics, who estimate compensated elasticity to be around 0.3.<sup>15</sup> Thus, in order to account for all of the range of estimates in the literature on this topic, let us consider this Hicksian labour supply function as taking a value such that:

$$0.3 \leq \zeta_c \leq 0.5$$

### Pareto Parameter (a)

This value determines how ability is distributed in the economy, assuming that ability follows the shape of a Pareto distribution. This is of significance because the objective of social planners is to redistribute a large portion of tax revenue from high-ability individuals to low-ability individuals. The number of individuals at each respective ability level is determined by the shape and magnitude of the ability distribution. This will

determine the volume of necessary transfers and, by extension, additional tax revenue that is needed to maximise the government’s utilitarian social welfare function (as low-income workers receive greater utility from these transfers, but at the cost of higher earners being taxed at higher rates and receiving less utility).

In the context of post-pandemic fiscal policy, this is especially important as the global Gini Coefficient has worsened to 2008 levels, demonstrating the increased need for considering equity goals in tax policy. Hence, it is vital that this variable is estimated with accuracy.

Saez estimates this value to be between 1.5 and 2.5 for the US. However, he notes that this value is likely to be higher for European countries. Due to the nature of ‘ability’ being difficult to quantify (with the best estimates being derived by using income as a proxy for ability), it would be worthwhile considering a larger range of values for this parameter. Thus, taking Saez’s observations into account and allowing for a larger range of values:

$$2 \leq a \leq 3.5$$

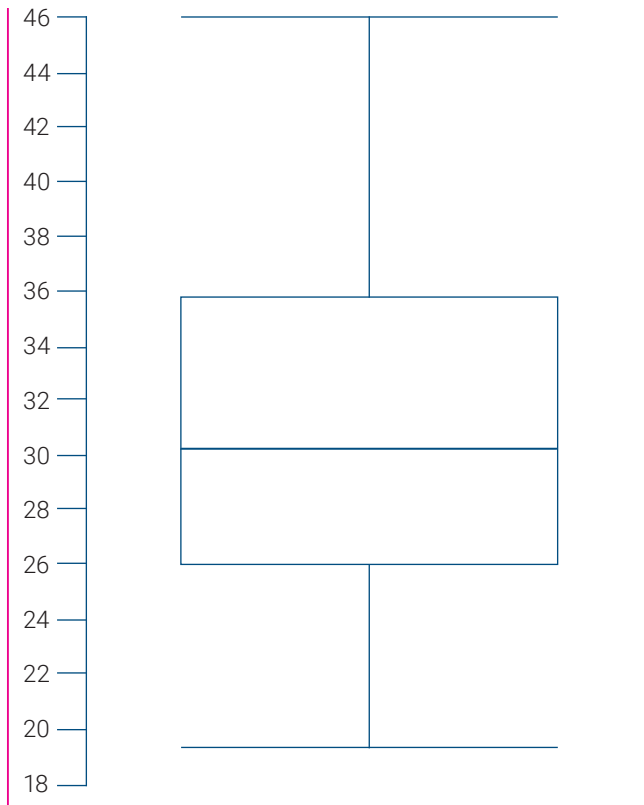
Therefore, I present the results of this linear model below.

### Compensated Labour Supply Elasticity ( $\zeta_c$ )

		0.3	0.35	0.4	0.45	0.5
Social Marginal Utility ( $\bar{u}$ ) = 0.5	a = 3.5	33	30	28	26	25
	a = 3	36	34	32	30	28
	a = 2.5	41	38	36	34	33
	a = 2	46	44	42	41	39
Social Marginal Utility ( $\bar{u}$ ) = 0.55	a = 3.5	30	28	26	24	23
	a = 3	34	31	29	28	26
	a = 2.5	38	36	34	32	30
	a = 2	44	42	40	38	36
Social Marginal Utility ( $\bar{u}$ ) = 0.6	a = 3.5	28	26	24	22	21
	a = 3	31	29	27	25	24
	a = 2.5	35	33	31	29	28
	a = 2	41	39	37	35	34
Social Marginal Utility ( $\bar{u}$ ) = 0.65	a = 3.5	25	23	21	20	19
	a = 3	28	26	24	23	21
	a = 2.5	32	30	28	27	25
	a = 2	37	36	34	32	31

<sup>15</sup> Ziliak, James P., and Thomas J. Kniesner. 2005. „The Effect Of Income Taxation On Consumption And Labor Supply“. Journal Of Labor Economics 23 (4): 769-796. doi:10.1086/491611.

We can represent this data as a box plot diagram, given below.



The median is 30.5%, indicating that the optimal magnitude of labour income tax rates should be around 30%. The range of the income bracket at which this flat rate should apply will differ from country to country due to heterogeneity in distributions of ability, average income level, Gini coefficients, etc. Hence, I propose policy recommendation 1.

### Corporate Income Taxation

Corporations have suffered from supply chain shocks and draconian lockdown measures reducing productivity and output. In Europe, this has resulted in 70% of firms reporting having received less revenue, due to the ongoing pandemic. On a global scale, we can see the effect of this with the IMF's projection of a \$9 trillion loss in global cumulative output.<sup>16</sup> Therefore, in a post-pandemic Europe, corporate income tax needs to be reoptimized to encourage a 'V' shaped recovery in markets, whilst still maintaining revenue.

Important trade-offs to be considered when deciding corporate income tax rates include distortions to levels of investment; if taxes are high then firms will have less net profit for investment. Another important consideration is potential 'Laffer Curve' effects where firms are incentivised to engage in tax evasion and avoidance at higher rates of taxation, thereby reducing tax revenue. Moreover, governments need to account for the negative effects of higher corporate taxes on unemployment and wage rates for workers, since firms will be left with less funds to maintain their workforce and wages if taxes are increased. Finally, on the global scale, corporate taxation discourages Foreign Direct Investment (FDI) inflows and causes firms to move operations to foreign countries with lower corporate taxes in the long-run, resulting in worsened economic growth.

### Laffer Curve Effects

The first consideration in any tax policy should be to ensure that the rate of taxation does not exceed the point of revenue maximisation, as any rate higher than this point will not only cause excessive market distortions, but will also garner less revenue. In the context of corporate income taxation, excessively high rates of taxation cause firms to shift reported profits and operations to other countries, and causes firms to engage in tax evasion and tax avoidance. Empirical analyses of OECD countries between 1980 and 2005 have found that the revenue maximising rate is at 26%.<sup>17</sup> There is a general consensus around this figure, and, therefore, for the purpose of EU tax reform, we can say that the corporate income tax rate should not be higher than 26%. It should be noted that this is not the optimal rate, since distortionary effects are not accounted for.

### Distortions to levels of investment and Foreign Direct Investment

The European Central Bank has reported that the demand from businesses to take out long-term loans for investment has fallen by 15% in Q1 2020.<sup>18</sup> Furthermore, Chief Europe Economist at Capital Economics, Andrew Kenningham, predicts that European business investment will fall by 24% over the course of 2020, resulting in a 12% contraction in output.<sup>19</sup> Evidently, it can be seen that substantial weightage needs to be given to any potential distortions to levels of investment in government fiscal policy, since it is essential that investment levels recover in order to facilitate a recovery in economic growth.

<sup>15</sup> Ziliak, James P., and Thomas J. Kniesner. 2005. "The Effect Of Income Taxation On Consumption And Labor Supply". *Journal Of Labor Economics* 23 (4): 769-796. doi:10.1086/491611.  
<sup>16</sup> Gopinath, Gita. 2020. "The Great Lockdown: Worst Economic Downturn Since The Great Depression". <https://blogs.imf.org/2020/04/14/the-great-lockdown-worst-economic-downturn-since-the-great-depression/>.  
<sup>17</sup> Brill, Alex, and Kevin Hassett. 2007. "Revenue-Maximizing Corporate Income Taxes: The Laffer Curve In OECD Countries". American Enterprise Institute Working Paper 137.  
<sup>18</sup> "The Euro Area Bank Lending Survey – First Quarter Of 2020". 2020. [https://www.ecb.europa.eu/stats/ecb\\_surveys/bank\\_lending\\_survey/html/ecb.blssurvey2020q1~17a1b2b7d2.en.html#toc1](https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/ecb.blssurvey2020q1~17a1b2b7d2.en.html#toc1).  
<sup>19</sup> Romei, Valentina. 2020. "European Investment Plunge Raises Fears For Future Growth". *Blog. Financial Times*. <https://www.ft.com/content/4c279e4c-05af-4c59-be90-48bf3228c92f>.



In order to observe the effects of corporate taxation on levels of investment, we can turn to the works of Djankov et al (2009), who demonstrated that a 10% increase in 1st year effective tax rates (corporate tax payment divided by pre-tax earnings) results in a 2.2% decrease in corporate investment and a 2.3% decrease in FDI.<sup>20</sup> In terms of the effect of raw tax rates, a 1% decrease in corporate tax increases investment by 4.7% of installed capital.<sup>21</sup> Assuming that these effects are linear, it can be seen that, for the purpose of maximising investment for post-pandemic economic recovery, the optimal corporate income tax rate would be 0%.

However, this is neither politically possible to implement, nor is it optimal for the government’s other macroeconomic objectives that require tax revenue from corporation tax to finance. Instead, the next best alternative would be to reform to a flat corporate tax rate.

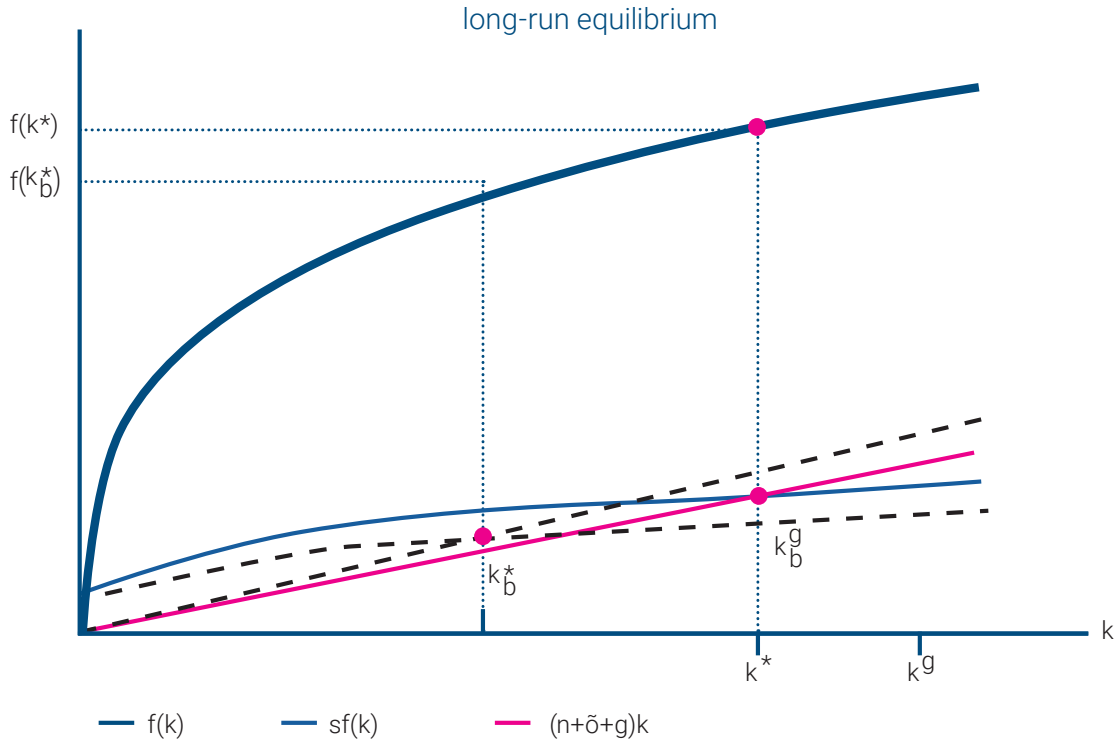
The intuition behind the flatness of the tax schedule is that it would help eliminate costs of compliance, which are as high as £1.3 billion in countries like the UK.<sup>22</sup> This will allow firms to divert funds from tax accounting to investment, innovation and growth. Furthermore, such a tax schedule has been proven in widely accepted literature to be beneficial for promoting efficiency, due to the simplicity of the flat rate. Hence, this reform would enable an investment-driven recovery in economic growth in a post- pandemic EU.

Another way in which investment can be encouraged by a corporate tax is if the rate of taxation is made a negative function of the rate of profit reinvestment through an investment tax credit. Although some member states already have tax credits for small firms or for investment in renewable energy, these generous tax credits should be extended to all corporations, resulting in a greater proportion of funds being used for reinvestment. In this way, more multinational corporations will move operations and profits to member states, thereby increasing investment and FDI inflows for post- pandemic recovery.

We can see the effect of these reforms through the lens of a standard Solow Swan neoclassical growth model.<sup>23</sup>

$$k'(t) = sk(t)\alpha - (n + g + \delta)k(t)$$

As higher levels of investment will be able to be financed, technological innovation (g) will increase. Additionally, for the same reason, capital intensity (k) will increase. Therefore, by adjusting the relevant variable functions from baseline, we can observe on the diagram below that the long-run steady state output equilibrium will increase from  $(k^*)$  to  $f(k^*)$  due to these reforms.



<sup>20</sup> Jankov, Simeon, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer. 2010. „The Effect Of Corporate Taxes On Investment And Entrepreneurship“. American Economic Journal: Macroeconomics 2 (3): 31-64. doi:10.1257/mac.2.3.31.  
<sup>21</sup> Ohrn, Eric. 2018. „The Effect Of Corporate Taxation On Investment And Financial Policy: Evidence From The DPAD“. American Economic Journal: Economic Policy 10 (2): 272-301. doi:10.1257/pol.20150378.  
<sup>22</sup> Collard, David, and Michael Godwin. 2005. „Compliance Costs For Employers: UK PAYE And National Insurance, 1995-96“. Fiscal Studies 20 (4): 423-449. doi:10.1111/j.1475-5890.1999.tb00020.x.  
<sup>23</sup> Solow, Robert M. 1956. „A Contribution To The Theory Of Economic Growth“. The Quarterly Journal Of Economics 70 (1): 65. doi:10.2307/1884513.  
<sup>24</sup> Swan, T. W. 1956. „Economic Growth And Capital Accumulation“. Economic Record 32 (2): 334-361. doi:10.1111/j.1475-4932.1956.tb00434.x.  
<sup>25</sup> Chen, Daphne, Shi Qi, and Don Schlagenhauf. 2018. „Corporate Income Tax, Legal Form Of Organization, And Employment“. American Economic Journal: Macroeconomics 10 (4): 270-304. doi:10.1257/mac.20140103.

## Effects on Consumers and Workers

Corporations pass on the burden of taxes onto consumers and workers (the extent to which depends on the Price Elasticity of Demand). This results in consumers paying higher prices and workers being made redundant. Therefore, the magnitude of the optimal rate should minimise this effect.

Chen et al (2018), in the American Economic Journal, proposed a theoretical framework to observe this effect.<sup>24</sup> They created a dynamic stochastic occupational choice model, which measures the extent to which higher employment is incurred by corporate tax decreases. Furthermore, they presented the effect of various rates in their endogenous model on other factors like capital and Gini coefficients (thus capturing the aforementioned trade-offs with investment and revenue respectively).

They found that a rate of 20% decreases unemployment by 3.3% and increases both capital and consumption by 1.1%. Additionally, this is the lowest rate at which the Gini coefficient decreases (-0.2%), further demonstrating the positive impacts of this rate of taxation on the government's other macroeconomic objectives. Therefore, we can say that the magnitude of the flat corporate tax rate should be 20% so as to facilitate both the government's equity and growth objectives.

Thus, to complete this section, I propose recommendations 2 and 3.

## Concluding Remarks

Discourse surrounding tax policy is fraught with ideological fervour and a disregard for scientific empiricism. Although the ongoing pandemic has had devastating effects on economic growth in the EU, sound fiscal policy approaches should ensure this is minimised in the long-run. Currently, an overwhelming body of both empirical and theoretical evidence points towards the aforementioned policy recommendations. Therefore, regardless of political alignment, governments should adopt the above unprecedented recommendations into tax policy, since unprecedented ideas are needed to solve unprecedented crises.

**'Ideas shape  
the course of history'**

John Maynard Keynes

# Counterproductive Production Taxes Must End

## Nicolas Marques

### Introduction

In today's frightening Covid-19 context, it is reasonable to wonder what type of leverage can be used to overcome the historic economic crisis now confronting Europe. We must quickly attain a level of economic development enabling us to halt and then offset the destruction of wealth and employment that has been such a sad occurrence.

It is also vital to meet social expectations while avoiding the pitfalls of protectionism. The Covid-19 crisis is boosting support for protectionist arguments in Europe.

Opinion leaders of every stripe, from the far left to the traditional right, are outraged that the production of various items (protective masks, drugs, ventilators, etc.) has been offshored, challenging Europe's self-reliance and its ability to react to the crisis. Their narrative suggests that this is the result of unfair competition from low-cost countries and that it requires protection through tariff or regulatory barriers.

Many people have spoken out in favour of bringing back part of the necessary production to Europe, whether to reduce our dependency in a few strategic areas or to promote shorter, more resource-efficient supply channels.

To imagine that these goals can be met without a significant cut in production taxes is simply a delusion. These taxes work against European production and serve as a subsidy to imports. A top fiscal priority should therefore be to dismantle production taxes.

Rather than erecting protectionist barriers, the real need is for decreases in European taxes, more particularly production taxes, that penalise the unemployed, wage earners and consumers.

### Production Taxes: What are We Talking About?

Taxes are commonly divided into three categories: (1) taxes on factors of production, which is our focus in this essay; (2) taxes on products; and (3) taxes on income or wealth.

These three categories of taxes are paid on an "unrequited" basis, setting them apart from social contributions (Zoom 1).

These three forms of taxation affect businesses differently.

**1. Production taxes** come into play during the production process, upstream from operating accounts, long before sales occur or profits are realised. They cover production factors or even turnover and added value. They represent an advance charge for producers, who need to provide cash up front.

#### Zoom 1: Production taxes in European accounting (SEC 2010)

Other production taxes (D29) cover production facilities. In particular, they tax factors of production ranging from the use of land, buildings and other assets to the employment of workers.

They differ from taxes on products (D21) such as VAT and import duties. These two tax categories (D29 & D21) are grouped in an aggregate covering production taxes and imports of goods and services (D2).

They are distinct from income and wealth taxes (D5), consisting of taxes on the income (D51) of natural persons (D51A, taxes on individuals or households) or legal persons (D51B, taxes on the income or profits of corporations) and of so-called current taxes calculated on other bases (D59).

Like all taxes, these are "unrequited" payments. The payments are called unrequited because the government or EU institution provides nothing in return for the payment (something-for-nothing).

They differ from social contributions (D61, net social contributions), which encompass contributions from employers (D611, D612) and households (D613, D614) and provide something in return.

**2. Value added tax (VAT)** is levied when a final product is sold to another business or to a household. Its assessment base is linked to the surplus created by the seller in the course of a transaction. Economists regard this type of tax as relatively neutral for businesses insofar as it is levied at each stage in line with the added value created. Even so, VAT does have some effects. When it is borne by the final purchaser, final prices rise in proportion to the tax. This may alter purchasing behaviour based on relative elasticities in demand for goods and services<sup>25</sup> and potential differences in VAT rates between substitutable products. When it is borne by the producer, it can reduce the incentive to offer goods or services.

<sup>25</sup> Conlon Christopher and Rao Nirupama. 2017. "Discrete Prices and the Incidence and Efficiency of Excise Taxes", Industrial Organization Society session of the Allied Social Science Associations annual meeting, January 7, Chicago, IL.  
Besley Timothy and Rosen Harvey. 1999. "Sales Taxes and Prices: An Empirical Analysis", National Tax Journal, No 52(2): 157-178.

**3. The tax on profits, the corporate income tax**, comes into play closer to the bottom line on the balance sheet once a transaction is completed. Its base, directly linked to a company's wealth creation, moves in tandem with profits. Some economists consider that it does not alter production costs and raises a company's break-even point.<sup>26</sup> However, a high tax on profits necessarily penalises activity by reducing incentives to undertake projects and to direct resources to investing and innovating.

### Production Taxes are Especially Problematic for the Economy

Production taxes force entrepreneurs to make economically inefficient decisions, causing declines in production, revenues and value creation.<sup>27</sup> Establishing production taxes thus alters choices to the detriment of quality and productivity, thereby reducing production efficiency.<sup>28</sup> Their key flaws are the following:

- **These taxes cause distortions between factors of production.**

Production taxes create distortions in the choices made by entrepreneurs. They lead to changes in the choice of production factors by altering the use of capital or labour in response to tax levels on these factors of production. In addition, this form of taxation affects choices of whether to produce something internally or to use an outside contractor or partner. It also interferes with choices on whether to source inputs domestically or import them.

In the absence of a distorting tax, these decisions depend on the quality of a purchased good and the resulting productivity. They are guided exclusively by trade-offs in the relative economic efficiency of a given strategy compared to another one. This provides for greater productivity and competitiveness, ensuring companies with higher revenues and profits.

- **These taxes reduce the ability of companies to survive.**

By affecting results higher in the operating account, production taxes tend to raise the threshold beyond which companies are profitable, meaning that fewer of them will survive.

Unlike the corporate income tax, based on profits, this form of taxation does not reflect a company's performance or its ability to pay. Production taxes are decoupled from wealth creation inside the company. They do not decline when performance is weaker, making these taxes "insensitive to a company's financial position".<sup>29</sup> This poses a significant danger to low-margin businesses, which are the primary victims of production taxes (Zoom 2).

### Zoom 2: Production taxes, a danger for low-margin activities

The case below shows the effect of production taxes in two countries, one with no production taxes and the other with high production taxes, citing in both instances a high-margin business (9%) and a low-margin one (3%).

It can be seen that production taxes:

- fail to take account of the ability to pay off businesses that, in each country, are subject to the same production taxes, regardless of differences in profitability;
- reduce earnings after corporate income tax in the country with high production taxes;
- routinely cause the low-margin business in the country with high production taxes to run at a loss, at the risk of forcing it to close and raising unemployment

	Country without production tax	Country with high production tax (4% of revenues)
<b>Activity A (with 9% margin before production taxes)</b>		
<b>Revenues</b>	<b>100 €</b>	<b>100 €</b>
Production taxes as %	0%	4%
Production taxes in €	0 €	4 €
After-tax margin (as %)	9%	5%
After-tax margin in € (pre-corporate tax)	9 €	5 €
Corporate income tax as % (20%)	20%	20%
Corporate income tax in €	1,8 €	1,0 €
<b>Earnings after corporate income tax in €</b>	<b>7,2 €</b>	<b>4,0 €</b>
Effects on activity	<b>Developing+++</b>	<b>Developing++</b>
<b>Activity B (with 3% margin before production taxes)</b>		
<b>Revenues</b>	<b>100 €</b>	<b>100 €</b>
Production taxes as %	0%	4%
Production taxes in €	0 €	4 €
After-tax margin (as %)	3%	-1%
After-tax margin in € (pre-corporate tax)	3 €	-1 €
Corporate income tax as % (20%)	20%	20%
Corporate income tax in €	0,6 €	0,0 €
<b>Earnings after corporate income tax in €</b>	<b>2,4 €</b>	<b>-1,0 €</b>
Effects on activity	<b>Developing+</b>	<b>Closed/layoffs-</b>
<b>Economies as a whole (Activities A+B)</b>		
<b>Long-term activities and jobs</b>	<b>100%</b>	<b>50%</b>
Long-term revenues	200 €	100 €
Long-term margins	12,0 €	5,0 €
Earnings after long-term corporate tax	9,6 €	4,0 €

<sup>26</sup> In principle, the taxation of profits does not affect prices. Profits are not a component of the cost price; they are the difference between the market price and the cost price. See, for example: Lauré Maurice, Babeau André and Louit Christian. 2001. Les impôts gaspilleurs, 17-20. Paris: PUF Quadrige.

<sup>27</sup> Crawford Ian, Keen Michael and Smith Stephen. 2010. "Value Added Tax and Excises", in Dimensions of Tax Design, Sir James Mirrlees (ed) and al., 275-422, Oxford University Press.

<sup>28</sup> Diamond Peter and Mirrlees James. 1971. "Optimal Taxation and Public Production I: Production Efficiency", American Economic Review, No 61(1): 8-27.

Heady Christopher. 1993. "Optimal Taxation as a Guide to Tax Policy: A Survey", Fiscal Studies, No 14(1): 15-41.

<sup>29</sup> Guerini Mattia, Guillou Sarah, Nesta Lionel, Ragot Xavier, Salies Evens. 2018. "Impôt sur les sociétés : état des lieux et effets différenciés de la réforme", OFCE Policy Brief, No 38 October 16: 1.

• **These taxes create adverse cascading effects.**

Unlike other taxes, production taxes have effects that spread and grow throughout the production process. They favour vertical integration by encouraging players to source internally as a way of limiting tax stacking, or they promote imports.<sup>30</sup>

In concrete terms, a production tax borne by a company high on the production chain will have effects on other companies all the way down the chain; this is known as the “cascade effect”. This tax cascade is especially clear with taxes on revenues, levied each time a good is sold to a company for use in its production process. The initial good is taxed and then retaxed each time it changes companies until it becomes a final good.

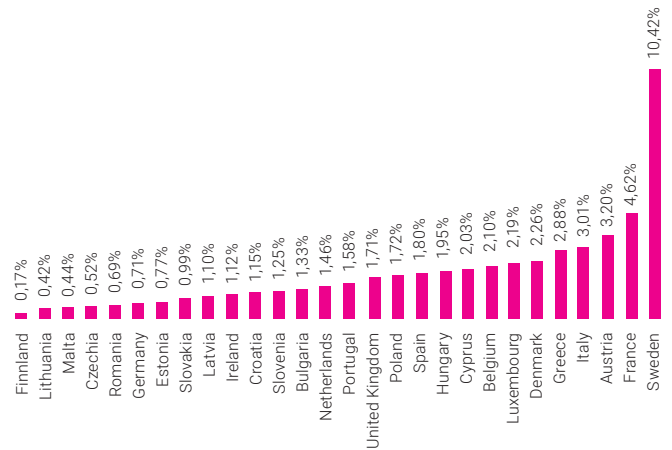
The greater the number of production steps and the more the economy is intertwined, the more the product will be taxed.<sup>31</sup> It then becomes preferable to integrate an activity vertically and/or to turn to imports, even if these solutions are less productive when taxes are not an influencing factor.

• **These taxes are harmful to society, even in small doses.**

Production taxes, even when they seem low, can have significant effects on economies with long production chains, especially where there is strong international competition. A production tax has three direct negative impacts: weaker productivity and competitiveness, lower revenues and higher imports. To this is added a direct negative impact on consumers: the tax leads to uneven price increases, depending on the number of steps in the production of a good and on the elasticity of demand. This forces consumers to alter their choices and reduces their satisfaction.

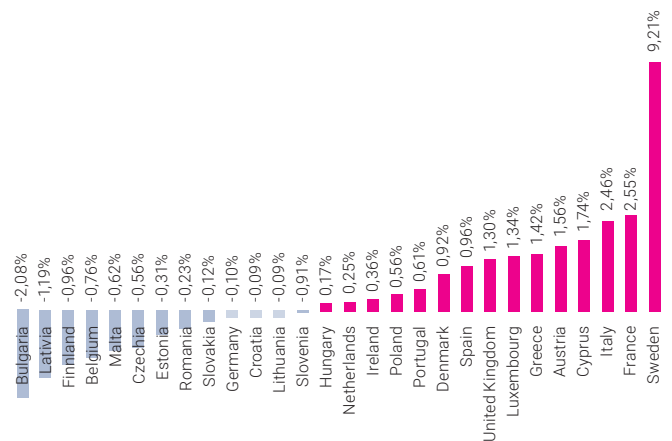
Production taxes act as import subsidies. In response, many governments have established production subsidies (D39) that reduce these harmful effects, meanwhile introducing other distortions that skew competition in some cases. In countries where subsidies to producers are heavily criticised, there have been calls for the re-establishment of trade barriers in the form of import duties or regulatory constraints. Eliminating production taxes would reduce the appeal of these calls.

Figure 1: Gross production taxes (as % of GDP, 2018)



Note: Rates calculated by taking the amount of production taxes (D29). Source: Eurostat, GDP and main components [nama\_10\_gdp].  
Extracted 01/09/2020

Figure 2: Net production taxes (as % of GDP, 2018)



Note: Rates calculated by subtracting production subsidies (D39) from production taxes (D29). Source: Eurostat, GDP and main components.  
Extracted 01/09/2020

<sup>30</sup> Keen Michael. 2013. "Targeting, Cascading, and Indirect Tax Design." IMF Working Paper No. 1357. International Monetary Fund, Washington, DC.

<sup>31</sup> Keen Michael. 2009. "What Do (and Don't) We Know about the Value Added Tax? A Review of Richard M. Bird and Pierre-Pascal Gendron's The VAT in Developing and Transitional Countries." Journal of Economic Literature, No 47(1): 159-170.

Smart Michael and Bird Richard. 2009. "The Impact on Investment of Replacing a Retail Sales Tax with a Value-Added Tax: Evidence from Canadian Experience", National Tax Journal, No 62(4): 591-609.

Bengle Matt, Pallot Marie and Slack Hamish. 2013. "Possible Lessons for the United States from New Zealand's GST", National Tax Journal, No 66(2): 479-498.

## Production Taxes Can Be Replaced

Given the diversity and magnitude of their negative effects, production taxes appear to be inefficient.<sup>32</sup> It is better to tax final goods and income to avoid distortions in production decision.<sup>33</sup> For this reason, economic studies, whether empirical or theoretical, conclude that the corporate income tax and VAT are superior to production taxes.<sup>34</sup>

### • Eliminating production taxes automatically boosts corporate tax revenues

A decrease in production taxes generates an increase in corporate taxes. Even without any change in the level of activity, this measure would raise operating income and earnings. Through a ricochet effect, the corporate tax base would grow, leading also to an increase in corporate income tax revenues.

Each country that dismantles its production taxes can expect to see an increase in corporate tax revenues equivalent to the proceeds from the eliminated taxes, based on the average corporate tax rate.<sup>35</sup>

### • Eliminating production taxes causes other tax and social revenues to rise

Companies would become more competitive and would be able to boost their production, resulting in:

- an increase in the use of factors of production, especially employment, generating higher government revenues linked to (i) additional social contributions; (ii) lower social spending on unemployment benefits; (iii) higher income tax revenues; and (iv) higher consumption and VAT revenues;
- an increase in profits, leading to a further rise in corporate tax revenues.

In some cases, removing taxes on production could quickly be self-financing. This is the conclusion presented in a forthcoming study that quantifies the outcome of an alignment of French production taxes with the European average. This result, obtained from an econometric analysis covering the EU countries and the multiplier coefficients used by French government statisticians (Table 1 page 9), is in line with the intuition of Arthur Laffer, according to which taxable income changes in response to changes in the rate of taxation.

Table 1 : Expected effects of lower production taxes in France

Impact of lower production taxes after two years (billions of euros or jobs)	Businesses households	Public finances
Decrease in production taxes	- €35 billion	- €35 billion
Increase in revenues at French companies	+ €156 billion	
Increase in compensation (job creation and pay raises)	+ €42 billion	
Increase in employment	753,000 jobs	
Surplus employer and employee social security contributions		+ €15 billion
Savings in public spending due to lower unemployment		+ €11 billion
Surplus income tax revenues		+ €2 billion
Surplus VAT revenues		+ €1 billion
Surplus corporate tax revenues (mechanical effect plus surplus activity)		+ 7 billion
<b>Overall net impact on public finances</b>		<b>Self-financing</b>

For a country such as France, the challenge lies not in establishing new forms of taxation to offset the shortfall caused by the decrease in production taxes but rather in persuading local communities, which benefit from production taxes, to abandon this resource in exchange for receiving a share of corporate tax or VAT revenues.

### • If the reduction in production taxes is not totally self-financing, the VAT could replace production taxes.

In countries where forecast-based analyses showed that the cut in production taxes would not be self-financing, the VAT could be used instead of production taxes.<sup>36</sup>

This form of taxation was originally conceptualized in Germany<sup>37</sup>, the United States<sup>38</sup> and then in France to do less economic damage than traditional taxation. It has the great advantage of being "neutral with regard to the methods and organisation of production; neutral regardless of the form and number of intermediaries in the distribution channels; neutral also irrespective of the choices made by consumers with regard to products of the same type."<sup>39</sup>

<sup>32</sup> Heady Christopher. 1993. "Optimal Taxation as a Guide to Tax Policy: A Survey", Fiscal Studies, No 14(1): 38

<sup>33</sup> Martin Philippe and Trannoy Alain. 2019. "Taxes on Production: The Good, the Bad and the Ugly", Les notes du conseil d'analyse économique, No. 53 June 2019: 5.

<sup>34</sup> Blundell Richard and Preston Ian. 2019. "Principles of Tax Design, Public Policy and Beyond: The Ideas of James Mirrlees, 1936-2018", Fiscal Studies, Vol 40(1): 5- 18.

<sup>35</sup> OECD. 2020. Corporate Tax Statistics, Second edition: 54

<sup>36</sup> Smart Michael and Bird Richard. 2009. "The Impact on Investment of Replacing a Retail Sales Tax with a Value-Added Tax: Evidence from Canadian Experience", National Tax Journal, No 62(4): 591-609.

<sup>37</sup> Von Siemens Carl Friedrich. 1919. Veredelte Umsatzsteuer, Siemensstadt.

<sup>38</sup> T.S. Adams. 1921. "Fundamental Problems of Federal Income Taxation," Quarterly Journal of Economics, No 35:4: 527.

<sup>39</sup> Delorme Guy. 2000. De Rivoli à Bercy : Souvenirs d'un inspecteur des finances 1952-1998, Paris: Institut de la gestion publique et du développement économique.



## Conclusion: An Opportunity for Households

One of the obstacles to replacing production taxes lies in the often mistaken belief that the burden of production taxes is borne by business, whereas the burden of other forms of taxation such as the VAT is borne by households. It has become common to contrast taxes supposedly borne by companies or their shareholders, such as production taxes or taxes on profits, with taxes supposedly paid by consumers, such as the VAT.

In actual fact, economic reality is far more complex. Analysis of tax incidence<sup>40</sup> shows that the tax burden is borne by consumers, wage earners and shareholders in proportions that depend on the respective power of the various players, regardless of what the tax is called and the official entity in charge of collecting it.

In the late 1820s, Jean-Baptiste Say noted that *"the tax the producer is required to pay is part of his production costs... And since he can continue producing only as long as all his production costs are defrayed, he must raise the price of his products; in this way, he must pass on at least a significant portion of the tax to his consumers."*<sup>41</sup>

Shifting taxation onto consumers is not always possible, especially in highly competitive markets. Arnold Harberger showed in the 1960s that taxes may also penalise shareholders and wage earners.<sup>42</sup> According to his reasoning, corporate taxes have the greatest impact on the least mobile factors, which have the fewest alternatives. If we find ourselves in a configuration in which products and capital are more mobile than wage earners, the latter will bear a significant portion of corporate taxes, as shown in a significant number of analyses.<sup>43</sup>

This applies beyond the corporate income tax. It applies to production taxes and even to taxes on products such as the VAT. In many instances, it is harder to shift production taxes onto consumers or shareholders than onto wage earners due to the highly competitive nature of markets for products and capital. Just as consumers are not prepared to accept a quality-price ratio debased by production taxes, investors are not prepared to accept lower long-term returns. The dismantling of production taxes would be good news for European households and in particular for wage earners and the unemployed.

<sup>40</sup> "Exploring tax incidence involves going beyond appearances in seeking the "real" loser or winner from an additional tax or a change in its rate. Statutory incidence means the tax is borne by the person paying it. Economists note, however, that in a market economy where product prices and factors are flexible, varying in keeping with the law of supply and demand, prices can adjust to tax changes. Price shifts caused by tax variations lead to changes in the distribution of income, profits and well-being. This is the ultimate outcome of tax incidence." Simula Laurent and Trannoy Alain. 2009. "Incidence de l'impôt sur les sociétés", Revue française d'économie, 2009/3 Vol XXIV: 3-4.

<sup>41</sup> Say Jean-Baptiste. 1840. Cours complet d'économie politique pratique, Bruxelles : Société Belge de librairie, 507. Full excerpt: "The tax that a producer is required to pay is part of his production costs; it is a difficulty that he encounters along his way and that he can overcome only by paying a certain amount. And since he can continue to produce only as long as all his production costs (including his penalty) are defrayed, he has to increase the price of his products; and in this way he has to pass on at least a significant portion of the tax to his consumers."

<sup>42</sup> Harberger Arnold. 1962. "The Incidence of the Corporate Income Tax", Journal of Political Economy, Vol. 70 No 3: 215-240.

<sup>43</sup> See, for example, Simula Laurent and Trannoy Alain. 2009. "Incidence de l'impôt sur les sociétés", Revue française d'économie, 2009/3 Vol XXIV: 36-37 for a review of the literature with, in particular: Arulampalan Wiji, Devereux Michael and Maffini Giorgia estimating that an additional \$1 tax on profits reduces wages by 92 cents in the long term (2008. The Direct Incidence of Corporate Income Tax on Wages, Oxford university Centre for Business Taxation); Felix R. Alison estimating that a 10% increase in the corporate income tax reduces gross annual salaries by 7% (2006. Passing the Burden: Corporate Tax Incidence in Open Economics, University of Michigan); Hassett Kevin and Mathur Aparna concluding that a 1% increase in the corporate income tax rate is associated with a 1% decrease in the wage rate (2006. Taxes and Wages, American Enterprise Institute, working paper 28); Aus dem Moore Nils and Kasten Tanja showing that a \$1-per-employee increase in the corporate income tax results in a wage decrease of between \$0.80 and \$1.17 (2009. Shifting the Burden? The Direct Incidence of Corporate Income Taxation); Desai Mihir, Foley Fritz and Hines James finding that between 45% and 75% of the corporate income tax is paid by labour, with the rest borne by capital (2007. Labor and Capital Shares of the Corporate Tax Burden: International Evidence, Harvard University).

# Fiscally Responsible Economic Growth Through Full Taxation

## Thomas Spencer

### Introduction

The prevailing wind of the European Union's attempts to revive the economy post Covid-19 has, somewhat understandably, been blowing towards spending. However, to maintain stable budgets with large rises in spending we must also look to raise revenues in order to finance that investment. The question we must, therefore, ask ourselves is what is the best way to raise tax revenues in a way that has minimal contractionary effects on economic growth?

The following shall make the case for full taxation. This is where a state's value added tax (VAT) rate is applied indiscriminately to all stages of production. By removing a state's ability to zero-rate and apply lesser rates of VAT to their goods and services, the substantial welfare losses under the current approach will be eliminated, thus helping to facilitate growth. The reason for this is the current approach is significantly distortionary in that it heavily affects consumer and business decisions and encourages inefficient practices to be facilitated.

By adopting full taxation, there will be a significant growth in government receipts which can help to provide the fiscal breathing room necessary to pursue the expansionary tax cuts, as well as investments necessary to create the economic growth needed to escape the crisis Covid-19 has left the economy in.

### The Current Regime on Value Added Tax

The EU's law on VAT is defined in numerous directives. The most relevant ones for the purposes of this essay are the 6th directive<sup>44</sup> and the 2006 directive.<sup>45</sup> The 6th directive remains the most important source of the EU's approach to VAT, thus it is important to discuss that first, and then the changes made in 2006.

The 6th directive's importance initially was that it made significant changes to the rules relating to the base of the tax. Under this directive, Article 28(2) gave states the ability to maintain *"reduced rates and exemptions... which are in force on 31 December 1975 and which satisfy the conditions stated in the last indent of Article 17 of the second council directive of 11 April 1967"*.<sup>46</sup> The problem with this is that Article 17 is rather vague. This states merely that *"exemptions maintained for clearly defined social reasons and for the benefit of the*

*final consumer"* are permissible.<sup>47</sup> This was problematic given any tax reduction could be construed as beneficial to those involved in the industrial process, as well as for the consumer. Therefore, any interpretation of the meaning of this directive will naturally lend itself to all goods and services.

### Box 1 – Mandatory Exemptions under the 2006 VAT Directive

#### Public Bodies (Article 13)

States, regional and local government authorities and other bodies governed by Public Law.

#### Activities in the Public Interest (Article 132)

Public postal services, hospital and medical care, welfare and so-cial security work, protection of children, children's education, private tuition, religious or philosophical institu-tions, subscriptions based political or religious organisations, sport , cultural services, public radio

#### Other Activities (Article 133)

Insurance, Credit, Deposit and Current Account transactions, currency, share transactions, special investment funds, postage stamps, gambling, land.

However, over time this was strengthened and made into the standard we see today. This involves an exhaustive list of goods where exemptions are mandatory.<sup>48</sup> These are displayed in box 1 above. This shows that large exceptions were provided to member states to continue zero rating of some goods. For example, even today children's clothing is zero rated within the UK.

The most significant impact of the 6th directive was Article 117. This meant that no Member State could introduce a new zero rate. This has been a significant restriction on a nation's abilities to narrow its VAT base, however, exceptions have been made for items such as women's sanitary products in the United Kingdom.<sup>49</sup> However, it is fair to say that this still provides member states, particularly Ireland and the Netherlands, significant abilities to use VAT to a much lesser extent

<sup>44</sup> Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment

<sup>45</sup> Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax

<sup>46</sup> Article 28, Sixth Council Directive

<sup>47</sup> Article 17, Ibid.

<sup>48</sup> Council Directive 92/77/EEC of 19 October 1992 supplementing the common system of value added tax and amending Directive 77/388/EEC

<sup>49</sup> European Council Press Release 143/16, European Council Conclusions 17-18 March 2016.



than their European neighbors. This raises issues given that “tax harmonization” is a key factor that has led to the EU’s regulation of member states’ VAT.<sup>50</sup> Indeed, the Commission explicitly recognizes this argument.<sup>51</sup> Therefore, in order to facilitate the aim of harmonizing tax rates across Europe, more needs to be done on value added taxes to prevent states needlessly ducking their obligations by offering excessively thin VAT bases.

## Welfare Costs and Collection Efficiency

VAT is, for the most part, an extremely well-designed tax. As value is added at each stage of production, it leaves an obvious paper trail for states to follow. Indeed, this is the main benefit it holds above a retail sales tax, as used in places like the United States.<sup>52</sup> It is, therefore, very difficult to avoid or evade. Furthermore, it is slightly progressive.<sup>53</sup> This means that it will have positive impacts on equality by helping to reduce wealth in an equitable way.

The main benefit, for the purposes of this essay, is its minimal contractionary impacts on aggregate demand, therefore limiting the negative impacts that taxes inevitably have on economic growth. A 2019 IMF paper revealed that where VAT is increased, it increases the ability to make other tax cuts that ultimately lead to more growth.<sup>54</sup> This tells us that when receipts need to grow, such as during a pandemic, a fantastic way to justify expansionary fiscal policy is to increase VAT, rather than other taxes.

This presents a better method of raising revenues, contrary to the way the EU aims to fund its €750bn ‘Next Generation EU’ scheme. Here, one of the proposals involves a consolidated corporate tax based on revenue, not profit. Alongside the obvious problems with taxing revenues,<sup>55</sup> there are additional problems with this in that high corporate taxes are unusually problematic for economic growth.<sup>56</sup> This is because they tend to disincentive capital and productivity investment, which are necessary ingredients for delivering economic growth. Therefore, when aiming to recover from a recession they’re not a sensible way to raise additional revenue.

New Zealand is an excellent example of how VAT should work; here, nearly all goods are taxed at a uniform rate of 12.5%. This has led it to having a C-efficiency, the amount of the departure of the VAT from a perfectly enforced tax levied at a single rate on all goods, of 0.95, which is significantly better than the mere 0.52 that the EU experienced in 2016. The reason we want to keep C-efficiency as high as possible is correctly emphasized by Crawford in the Mirrlees Review; he argues that by breaking the chain of output taxes and input

credit, they work as a de-facto production tax.<sup>57</sup> Although, the EU rate is slightly better than the OECD average (0.50) the example of New Zealand tells us that there is still a lot to be desired.<sup>58</sup>

Copenhagen Economics analysed the impacts of adopting a similar approach to New Zealand in the EU, and their results broadly support the argument of this essay. They looked at six key sectors that permit low rates under the 6<sup>th</sup> directives (cultural activities, education, health care, garbage collection, postal services, and radio and television broadcasts). From this change there would be an efficiency gain of 0.34% of GDP.<sup>15</sup> Whilst, this may not sound significant, for developed nations like those inside the EU, these gains can be substantial in improving the welfare of their citizens. It is also substantial when you consider the huge hit that has now been taken to European GDPs due to the Covid-19 outbreak. This is particularly important when you consider the expansionary policy that could be adopted with the additional receipts, such as tax cuts and strategic investments.

This conclusion is supported by research conducted by the Institute for Fiscal Studies. They found that an increase in reduced rates (5% in the UK) to the level of the standard rate will result in a welfare gain of 3.5% of total VAT receipts. Given, VAT receipts were £132bn in the 2018/19 financial year this amounts to £4.62bn. Additionally, if the reduced rate was eliminated altogether and invested entirely into cutting the standard rate, then this would still create a welfare gain per household of over €1 per week.<sup>59</sup> It is, therefore, clear that broadening the VAT base is supported by a volume of evidence, each showing that it would create substantial welfare gains for the EU, without having an excessive impact on economic growth.

The analysis of the literature above supports a single conclusion; a highly differentiated VAT base, like the one currently permissible in the EU, imposes significant welfare costs and collection problems onto states. Directing member states to broaden their VAT bases will have substantial benefits for their people and provide additional revenue necessary for sound governance. Given the dip to European GDPs this has made the adoption of full taxation, not just a favourable policy goal, but a necessity if the EU wishes to recover and prosper post-Covid 19. The remainder of the essay shall focus on the financial and public sectors of the economy; analysing the microeconomic impacts of the current approach. This analysis shall reveal how beneficial full taxation would be to these sectors of the economy, and help support the case for its implementation.

<sup>50</sup> COM (2003) 397 final, 23 July 2003

<sup>51</sup> European Commission, “Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee: On the follow up to the Action Plan on VAT, Towards a single EU VAT area – Time to act” COM (2017) 566 final/

<sup>52</sup> Dina Pomeranz, “No taxation without Information: Deterrence and Self Enforcement in the Value Added Tax” *American Economic Review* 105:8 (August 2015)

<sup>53</sup> Alastair Thomas, “Reassessing the regressivity of the VAT”, OECD Taxation Working Papers, No. 49, OECD Publishing Press, Paris.

<sup>54</sup> Santiago Ormaechea and Atsuyoshi Morozumi, “The Value Added Tax and Growth”, IMF Working Paper No. 19/96.

<sup>55</sup> Garret Watson, “Resisting the Allure of Gross Receipts Taxes: An Assessment of their Costs and Consequences”, Tax Foundation: Fiscal Fact No. 634.

<sup>56</sup> OECD, Tax Policy Reform and Economic Growth, OECD Tax Policy Students, No. 20, OECD Publishing, Paris.

<sup>57</sup> Copenhagen Economics, “VAT in the Public Sector and Exemptions in the Public Interest, Final Report for TAXUD/2011/DE/334.

<sup>58</sup> Ian Crawford, Michael Keen and Stephen Smith, “Value Added Taxes and Excises”, pp 275-362 in James Mirrlees and others (eds), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for Institute for Fiscal Studies

<sup>59</sup> Institute for Fiscal Studies, “A retrospective evaluation of elements of the EU VAT system”, Final Report for TAXUD/2010/DE/328.

## Impact of Exemptions on Financial Services

The 2006 VAT directive exempts financial services absolutely. In effect, this means that financial services do not pay tax on financial services, but they are expected to pay on purchases of taxable goods and services acquired in supplying the exempt services. This has an inherently distortionary impact on the running of the banks, whereby they will be incentivised to perform services in-house, rather than pay external companies, who have the benefit of specialisation, to provide the same services.<sup>60</sup> This prevents them from creating a business model that fits their ideal regulatory tax and business goals. Furthermore, the examples of financial institutions provide an excellent case summary of the excess burden that is created by VAT exemptions. Here, significant additional compliance costs are created in order to properly obey the intricacies of these rules. This is particularly prevalent for the many multinational corporations in finance who operate across multiple jurisdictions. The most problematic element of this is that the incidence is imposed mostly on consumers, and not the firms themselves.<sup>61</sup> This results in higher prices to the detriment of the consumer.

New Zealand offers a better model to address this problem. Here, services supplied to financial institutions from firms where at least 75% of their output is taxable are zero-rated.<sup>62</sup> Although, this does create the welfare loss problems described above that come with zero-rating goods and services, it is preferable to the system in place currently where financial institutions are actively disincentivised from using what would be the most efficient services. However, this is not sufficient to show that financial institutions should merely be taxed at the standard rate. Indeed, most of the evidence suggests that the receipt gains of imposing the standard rate on all financial services will be negligible at best, and at worst lead to decreases in receipts of as much as €7.6bn.<sup>63</sup> Therefore, financial institutions should remain an exception to the directive that this essay is proposing and not just remain zero rated, but have an extension into a model like that used in New Zealand.

## Impacts of Exemptions on the Public Sector

The public sector is traditionally treated as operating outside the ambit of VAT. This is done under the assumption that governments are final consumers; whereby, they are not subject to credit for tax on inputs. The logic behind this is twofold; firstly, the nature of government services is extremely varied, and it is therefore believed that they are difficult to tax properly.<sup>64</sup> Secondly, that public services are merit goods, and so there are positive externalities associated with their production. So, by not taxing these goods you will reduce the na-

tural regressivity of consumption taxes.<sup>65</sup> The latter of these arguments does not appear to hold up anymore, given most modern analyses of the progressivity of VAT that present VAT burdens as a proportion of current expenditure across income distribution finds that its regressivity is negligible and may even be slightly progressive.<sup>66</sup> Furthermore, Bettendorf and Crossen find that higher income groups benefit nearly twice as much from lower rates; therefore, we can see that the times where VAT is most regressive is where its exemptions are writhe.<sup>67</sup>

Furthermore, these defenses fail to take into consideration the considerable legal and economic problems with the current approach. Firstly, the terms of the 6th VAT directive are extremely unclear. This has led to significant litigation at the CJEU over the definitions of terms like “significant distortions to competition” and “engaged in as public authorities,” as well as to the scope of the directive. This uncertainty raises compliance costs for public sectors who must grow increasingly large civil services to work their way around overly complicated VAT regimes. Rita de la Feria correctly explains that this tells us two things; firstly, that the court is unable to reconcile the problems inherent in the current approach. Secondly, that the provisions fail to account for the modern approach to VAT.<sup>68</sup>

There are also significant economic consequences to the current approach. By creating a break in the VAT chain, it leaves the efficiency of tax collection vulnerable. As previously explained, VAT works so well, because it taxes every part of the chain of production as a percentage of value added. By creating a break in this chain, it creates accountancy errors and susceptibility for evasion. Tait highlights a worrying trend of ‘creeping exemptions’ from this. Where some goods are exempt and others are not, this creates an incentive for non-exempt products to be manipulated in a way that fits the exempt criteria.<sup>69</sup>

The model used in Australia is preferable to the system used in the EU. Here, almost all goods are taxed at the standard rate under their GST (goods and services tax) with a few exemptions such as government schools. Although, these exemptions do create distortions, they are on a much smaller scale than that seen in the EU.<sup>70</sup> Perhaps, a more implementable model is that used in Canada. This operates on broadly similar grounds to the EU, with the noticeable exception that a rebate is granted so that the input tax can help deal with the considerable compliance costs. Similar schemes have been implemented in European nations like Denmark, Sweden and Finland, but nothing of the kind has been attempted at the European level. However, this does still come with many of

<sup>60</sup> Sadya Poddar, “Consumption Taxes: The Role of the Value Added Tax, pp 345-380 in Patrick Honohan (eds). *Taxation of Financial Intermediation: Theory and Practice for Emerging Economies*, Oxford University Press for the World Bank.

<sup>61</sup> European Commission, *Value Added Tax: A Study of the Methods of Taxing Financial and Insurance Services*, Ernst and Young for the European Commission

<sup>62</sup> Marie Pallot, “Financial Services under New Zealand’s GST, 22 *International VAT Monitor* 5.

<sup>63</sup> Price Waterhouse Cooper, “How the EU VAT exemptions impact the Banking Sector”, 18th October 2011

<sup>64</sup> Pierre-Pascal Gendron, “Value Added Tax Treatment of Public Sector Bodies and Non-Profit Organisations: A Developing Country Perspective”, *Bulletin of International Taxation*.

<sup>65</sup> George Carlson and Melanie Patrick, “Addressing the Regressivity of a Value Added Tax”, *National Tax Journal* 42(3).

<sup>66</sup> Richard Bird and Michael Smart, “Taxing Consumption in Canada: Rates, Revenues and Redistribution”, *SSRN Electronic Journal*.

<sup>67</sup> Leon Bettendorf and Sijbren Crossen, “The Long Shadow of the European VAT, Exemplified by the Dutch Experience”, 71 *FinanzArchiv* 1.

<sup>68</sup> Rita de la Feria, “The EU VAT treatment of public sector bodies: slowly moving in the wrong direction”, *Intertax* 37(3).

<sup>69</sup> Alan Tait, “Value Added Tax – International Practice and Problems”, *International Monetary Fund*.

<sup>70</sup> David Snell, “GST – Revenue and Business Risk”, pp 423-430 in Kreyer and White (eds) *GST in Retrospect and Prospect*.

the problems under the current system, and so the Australian GST model would be preferable.

### Conclusions and Policy Suggestions

The nature of the EU VAT Law is extremely complicated; it imposes significant exemptions that are ill-defined and inherently distortionary. This creates considerable welfare loss and issues for businesses of both the public and private sectors who are expected to navigate through increasingly complex regulatory environments.

The main objector to significant reform of the VAT base in the EU when it was last considered in 2006 was the United Kingdom. Brexit, therefore, provides the EU a substantial opportunity to pursue an economically successful reform to VAT, that previously would have been blocked by the British Government, by implementing full taxation.

The model that the EU should aim to replicate is New Zealand's full taxation model. By applying the same rate of VAT to most goods, New Zealand offers a non-distortionary and potentially progressive approach to VAT that brings in significant revenue. Given this information, it is no wonder that the nation scores 3<sup>rd</sup> in the Tax Foundations Internal Tax Competitiveness Index.<sup>71</sup>

This would bring about a huge boost to member states' revenue with minimal contractionary effects. This would be especially significant given the current economic climate, whereby the Coronavirus pandemic has forced extensive increases in public spending to the detriment of member states' budgets. It is, therefore, increasingly necessary that for the EU to deliver additional growth in a fiscally responsible way, it must come through full taxation.

<sup>71</sup> Tax Foundation, International Tax Competitiveness Index 2020.

