Società italiana di economia pubblica

XV CONFERENZA

DIRITTI, REGOLE, MERCATO
Economia pubblica ed analisi economica del diritto

Pavia, Università, 3 - 4 ottobre 2003

RATIONALE AND OPEN ISSUES OF EUROPEAN TAX RADICAL REFORMS

LUIGI BERNARDI

Dipartimento di economia pubblica e territoriale

Università di Pavia

XV Conferenza SIEP - Pavia, Università, 3 - 4 ottobre 2003

pubblicazione internet realizzata con contributo della

COMPAGNIA di San Paolo

1. Introduction[*]

From the early 1990s European fiscal systems were requested to achieve more and conflicting aims. Maastrich's and Stability Pact's targets required to raise revenue. On the other side the European declining growth and employment rates called for a reduction of fiscal pressure. Tax rates and structures were affected by the different reactions of each country to an increased fiscal competition. However the purpose of improving the efficient working of the single market called for more simple taxes, neutral and harmonised on European scale. The result has been a twisted stop and go of tax cuts and tax increases, of continuous shifts from a tax to another one and of repeated minor tax codes updates. As an unavoidable consequence, most 1990s European countries' tax changes were namely narrow in size and limited in scope.

It looks me very hard to claim that such changes were the most suitable fiscal reforms for the basic present needs of European countries. On the contrary one should start from three current key factors which heavily impinge on European tax systems and any future changes hoped for. First, several years of tax competition and harmonisation efforts have failed up to now to set out a basic common framework for an "European" tax system, *i.e.* a system improving the efficiency of the single market, by making moving of people, goods and capitals really free from fiscal distortions. Second, the current European growth rates' decrease seems almost endless, while prospects for future recovery are continuously postponed. Might fiscal reforms really contribute to enhancing economic growth and further matching the decreasing growth rate by increasing fairness? Finally, the rebuilding of the European institutional setting is just starting out and it goes on very slowly. The speed of its steps is historical in nature: advances and stops alternate. However common historical heritage of Federal States leads to predict maybe not close but inevitable future deep changes in allocation of taxing and spending powers among government tiers'.

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

---

[*] Department of Public and Environmental Economics - University of Pavia, Italy: Eunice@unipv.it This paper owns much to an extended version published in Bernardi, L. and P. Profeta (eds.) (2003), *Tax System and Tax Reforms in Europe*, London, Routledge. I gratefully acknowledge Routlege's permission to take up again some materials from this book. A previous version has been presented to Banca d'Italia, 5th Public Finance Workshop, devoted to "Tax Policy" and held in Perugia, 3-5 April 2003. Thanks are also due for comments and suggestions to G. Arachi, M. Bernasconi, C. Bronchi, M.C. Guerra, I. Joumard, A. Majocchi, P. Profeta, R. Puglisi and A. Zanardi.

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

From the early 1970s to the late 1990s (Eurostat, 2000) total European fiscal pressure increased in the average by about 10 points (from 33.5 to 42.2 percent in terms of GDP)[1] (Eurostat, 2000), thus leaving well behind both that of Japan (27.9 percent) and of the US (28.3 percent). Rinhe countries (France, Germany, The Netherlands) were close to the average increase, the Anglo-Saxon ones (Ireland and The United Kingdom) were far less, while the Mediterranean Italy and Spain were far over[2]. Thus the wide tax levels' dispersion among European countries, already apparent at the early of the 1970s, essentially continued to hold firm.

Total average increase was given mainly by direct taxes (four points, form 8.9 to 13.7 percent, coming almost all from personal income tax) and social contributions (3.8 points, from 11.7 to 15.5percent). Less than one point (from 13.0 to 13.9percent) was the increase of indirect taxes. It is commonly believed that tax increase was pulled up (six points) by a social expenditure growing essentially during the 1970s (van den Noord and Heady, 2001) and by a final rise due to the need to fulfil Maastricht Treaty's requirements (1.8 percent in the 1990s). After the peak of 1997, just some minor and scattered tax cuts were adopted[3]. The forces of Stability Pact were and continue to be at work, forcing European member countries to keep up fiscal pressure (for example, De Novellis and Parlato, 2003).

A set of macro-indicators of fiscal convergence from 1970 to 1997 is depicted in Table 1. Broadly speaking they confirm that fiscal convergence has been up to now far from being complete among European countries. The convergence process (by competition or harmonisation) seems to have impinged upon direct[4] and still more indirect taxes[5] but neither on total taxes nor social contributions. The classification by economic function (Eurostat 2000) points out strong evidences of convergence for

---

1 Do not forget to be careful when compare international fiscal data sets, mainly when welfare provisions and financing show different institutional arrangements. One should take account, *inter alia*, of the spread between gross and net social expenditure and of fiscal pressure's reduction due to the existing tax expenditures (Adema, 2001). Eurostat (2002) data suggest that total (public+ private) welfare demand and supply is very close to a common figure within European countries.

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

3 Italy, The Netherlands and, at a very low extent, Germany and Ireland, reduced total fiscal pressure up to 2001, the remaining ones' did not cut or increased their taxes (OECD 2002a).

4 This has been mainly due to the income tax, whose amount is largely prevailing inside this category. See below for corporate and capital incomes taxes.

5 Do not forget that in 1970 a true income tax was still not in existence in many European countries and VAT was in force only in France.

TAB. 1 – *Some descriptive statistics of fiscal systems in European countries 1970-1997*

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

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

consumption and more narrow for capital[6]. Convergence for labour and total fiscal burden seems to have been very limited. Finally implicit rates (Martinez - Mongay, 2000) show that taxation on labour increased by almost 50 percent and at the same time diverged, heterogeneous capital was affected by a stable rate converging taxation, and about the same happened for consumption.

These persisting tax systems' divergences may prevent the efficiency of the single market, as to the free movements of goods, people and capitals without fiscal interference. Notice further that the only process of convergence under way to this day seems have been due to the growth of the income tax, the harmonisation of VAT and some tax competition on the most mobile capital.

3. Further on tax systems convergence: micro issues

It is commonly recognised that from the 1980s onwards corporations' statutory "all-in" tax rates decreased markedly, by about 15 points in the EU average (from less than 47 to near 32 percent during the years 1980-2003 - forecast figure) (Cnossen, 2002). This should have been the result of a greater fiscal competition, due to the increasing degree of real and financial markets' integration (Bretschger and Hettich, 2002). The tax burden decrease is however not confirmed for backward effective (= implicit) rates. This outcome has been attributed also to the broadening of the bases that usually matched rates cuts (Devereux, Griffith and Klemm, 2001). The final result might have been of no-incentive-investments reforms, as is suspected by Keen (2002) for the German case and might be also true for its Italian mirror like project (Bernardi 2002b).

During the last decade EU's average tax rates on interests unambiguously decreased by about ten points (from nearly 46 in 1990 to slightly less than 37 percent in 2000), but this has been mainly due to the substitution of final withholdings for the inclusion of interests in the income tax bases. The reduction of dividends' rates was far less and statistically insignificant. The whole system of capital income taxation seems to be become more diverging and less neutral (Gorter and de Mooij, 2001). The widespread shift to low rate withholdings on interests enlarged the distortional spread with dividends' taxation[7], while national models of interests' taxation became more uneven (Joumard 2001; van de Noord and Heady 2001). Up to mid January 2003 non

---

6 Be aware that "capital" here means all the heterogeneous incomes which constitute operating surplus in national accounting.

7 This bad result somehow could be avoided by adopting a "true" "Dual income tax system" which should tax any kind of capital income at the same rate. As 1998 this solution was however not adopted by all the same Nordic countries which were the proponent of the system. (van de Noord and Heady, 2001).

residents were generally exempt even if this was not formally the case in Greece and Portugal.

The EU agreement of 21 January 2003 is based mainly on monitoring and exchanging information to allow taxation in the country of residence (except for Austria, Belgium and Luxembourg). The results of this solution however are somewhat reduced by the increasing exclusion of total interests' income from progressive income tax bases and the continuous moves to flat tax rates for all capital incomes. Further one must hope that there will be strong cooperation in monitoring and information exchanging and that strategic behaviours will not dominate the fixing of national withholdings rates. Needless to say tax regimes for dividends and capital gains are still more fragmented than for interests. The same claimed "general" shift away from the imputation system (whatever are its doubtful merits) up to now has been realised by a minority of European countries (van de Noord and Heady, 2001).

At the early 1990s the European average tax wedge on labour had already reached the level of about 50 percent. The implicit rate was near 35percent, some ten points above the US level (EU Commission, 2000; Cnossen, 2002). This spread was largely suspected to have something to do with the different pattern of growth and employment then observed in the two areas. The suggestion to reduce taxes on labour, particularly non skilled labour, was from then repeatedly raised both by the OECD and also by the UE Commission: it became mandatory for the Union Member States at the Lisbona's Council of 2000.

Notwithstanding these authoritative and mandatory statements, from the early to the late 1990s the average European implicit rate on labour was increased by about two further points (Martines-Mongay, 2000). Not much before than the turn of century small cuts were introduced in social contributions, by no more than a few points, especially at the lower end of the wage scale (Gandullia, 2003). Cuts in rates of the income tax have been similar during last years, but usually they were extended also to the top rate. The burden for the (most dense) central income classes kept generally relatively unchanged. The total redistributive effect thus has not been particularly relevant.

The enlargement of exemptions looks certainly welcome, mostly as much as producing higher equity, than for the alleged but uncertain incentives on the labour supply. The exempt threshold should have been enlarged up to a level enough high to cover the equivalent households' income of poverty. This was rarely been achieved especially for the households with many dependents, and the mistake (see par. 4.2) of adopting poor equivalence scale was largely diffused.

The reduction of income tax's top rates is neither easy to be explained on the grounds of efficiency nor clear to be understood on political economy grounds (Profeta, 2003). One is thus forced to see this change as an ideological signal on the lines of though which allege the existing of some "natural" or "implicit constitutional" limits to the power to tax. This stream of thinking about fiscal and social justice is however very questionable (for example, Bernardi 2002a) and certainly not new. It has been revived by the recent diffusion of right-wing ideas inside European governments.

Not surprisingly and as almost always horizontal equity was largely forgotten. Usually changes did not cross the traditional border of adjustments of households' and different workers' tax treatment (Gandullia, 2003). However a widespread innovation were the more favourable regimes granted to the aged and disabled people. The allowances for dependent parents were also widely augmented but the increase was limited in almost all countries. The excess burden on single worker households remained almost anywhere under-corrected, the exception being France's well known case.

4 Tax reforms for the recovery of European economy

Reducing rates and broadening bases in order to make tax systems supply friendly was the well known buzz rule of action of the tax reformers of the 1980s, but the results were not as positive as expected (for example, Bosworth and Burtless 1992, with reference to the paramount US case). The taxation-to-growth link then became a topic of an endless discussion.

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

Neoclassical exogenous growth models do not help very much, behind pointing up the common sense advise to take off taxes as much as possible from investments and savings. Endogenous growth models claimed to be able to provide much more robust and targeted prescriptions. However empirical checks showed that the general level of average and marginal fiscal burden has just a limited impact on the rate of growth (Myles 2000). Specific allowances should however be allowed to physical and human capital accumulation (Tanzi and Zee, 1997). Once more the linking figure does not seem clear-cut (Besley, 2001). Last, the so called "New theory of economic growth" stresses the need for taxes (for example, Tanzi, 2002; Jones, 2002) and institutions

8 This for instance means that a tax cut which can raise net wage by 10 percent will increase labor supply just by 1.5 percent.

(going back to North, 1990) not hindering or meddling with economic transactions induced by the market. However up to now the list of specific prescriptions is still short and selective (for taxes) or somewhat vague (for institution).

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

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

Wide and selective tax shifts thus become the last option to check out. The candidates are labour and corporate taxes to be reduced by a huge extent: a rough estimate may fix the needed cuts of corporate tax and social contributions near about at one third of their present burdens if not just marginal effects should be achieved. The total figure reaches near six points in term of GDP. Income tax on labour should instead not to be dramatically changed to preserve vertical equity (see par. 5). On the contrary tax burden on consumption, rents and externalities (= environment) should become substantially heavier. These two latter may produce an additional yield of not more than about two-to-three points of GDP[10]. Thus an increase in consumption taxes of the size of three-to-four points should be required at the end. It must come from VAT which has a wider base and lower rates than excise duties. Inflationary effects have not to be overestimated. Higher consumption taxes should substitute social contributions, *i.e.* an item of cost of labour at least in part already passed on prices.

Reducing tax burden on labour by increasing consumption taxes is really effective for enhancing growth? Obviously, the traditional textbook equivalence of taxation on

---

9 Making the Pact more rational and less binding is also suggested, by substituting debt to deficit as the target for budget consolidation.

10 They could arrive from an increase of these taxes from present European average to the level of the countries more taxing immovable property (United Kingdom, 3.5 percent of GDP) and environment externalities (The Netherlands, 1.7 percent) (Eurostat data).

labour income and consumption in a life-cycle framework has still some good arguments (for example, Cnossen 2002), but is increasingly open to question, mainly due to its lacking empirical frame (Carone and Salomaki 2001)[11]. Further, the old idea that heavier taxes on consumption may increase savings and investments still holds. Finally, interesting econometric estimates have recently been performed by using the EU Commission's Quest II model. GDP 1 percent shift from corporate to consumption tax would raise GDP by 1.6 points and wages by 2.1 points from the average European baseline levels. The same amount of shift but from labour to consumption taxes should increase employment by 0.6 and GDP by 0.7 points (Leibfritz *et al.* 1997)[12].

Thus we are tempted to conclude that in real world wage and consumption taxes are not perfect substitutes and that shifting burden from the first to the latter effectively may enhance growth. However Profeta (2003) introduces more than one *caveat* concerning the political feasibility of a the tax shift of the amount and the nature here proposed. The main bottleneck comes for this shift is almost entirely going from dependent workers to all the consumers. Thus some parts of the workers' contributions to their PAYG pension schemes should be charged on other tax-payers-voters. A not trivial escape route could however be suggested (see also par. 6). The financing of an universal social security safety net including also minimum pensions could be charged on general taxes. This share of total treatments can thus be subtracted from the funding through workers' social contributions.

5. Tax reforms for social fairness

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

Tax reforms may first help by making taxation reliable and sure, by impeding tax amnesties, by heavily fighting against evasion and corruption and by inducing tax

[11] EU taxes on consumption have a basis one third higher than labor income taxes. Tax basis for capital is half than that for labor.

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

Administration to be efficient and correct with tax-payers. I recall these obvious fine tax systems features just because they in fact are largely absent in some European countries, especially the Mediterranean ones'.

The aim of vertical equity, *i.e.* the redistributive purposes of tax systems should be empowered and not dismantled for more than one reason. First, the common argument that redistributive targets can better be reached through the expenditure side of the budget (for instance: EU Commission, 2002) is very questionable. Ultimate demonstrations for an already long time have been given (for example, Goodin and Le Grand, 1987) according to which welfare and other public services are mostly captured by the middle class. The redistributive impact should then be due mainly to social protection and particularly to public pensions. However these estimates look single generation ones, which do not consider in a proper life-cycle horizon also the effects of PAYG social contributions. These are commonly considered proportional when they lower net wages or even regressive if are passed on prices in non-competitive markets.

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

Vertical equity has also been eroded by the decreased burden on capital incomes due to fiscal competition. The Nordic "Dual income tax system" has then been viewed as a good compromise between equity and contrasting capital flights (Cnossen, 2002). Really it is so only when income and wealth are evenly distributed and highly correlated. This may be the case in some European countries, but not in all[15]. Furthermore, an even level of capital income tax rate is required but this is not the case in many European countries. Just as one example, for the middle 1990s Joumard (2001) reports rates on interests incomes ranging from 12.5 percent (Italy) to 30.0 percent (Sweden, not surprisingly).

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

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

[15] For the early 1990s Wagstaff *et al.* (1999) report Gini coefficients on *ex ante* incomes ranging from 0.25 (Germany) to 0.41 (The United Kingdom).

A large room for improving fairness can be found on the ground of horizontal equity. The modern "welfare view," restricting the need of allowances for dependent parents only to low-income families, is now contrasted by a (reversed) renewal of the old "optimum size view," induced by the worries of a European declining population. According to this view, allowances should be extended also to the middle-to-high incomes and should reach a huge amount in order to work effectively. A true fairness further should extend the concept of horizontal equity at least in two directions.

First, the tax system should contribute to make the social justice principle of equal opportunities effective. For instance, taxing human capital formation is not only inefficient, but is also unfair. Similarly, inheritance taxes should be empowered and not written off, as it is largely occurring. Second, the old fashioned qualitative discrimination among incomes (traditionally in favour of dependent work) should be enlarged and extended to encompass more features of the ability to pay, also from the point of view of the social evaluation of different types of income and wealth[16]. Thus the market distortions at the individual income levels (due to rents, information failures and under evaluation of social value of some activities) should be compensated by the fiscal system. To give just some speculative examples, lawyers and football players should be taxed more, whereas less taxes should be charged on teachers and long term care nurses.

6. Tax reforms for the changing European institutional and policy setting

The outlining of tax reforms should be aware of EU institutional trends and not conflicting with them, difficult as they are to be precisely foreseen. Due to this uncertainty, here we will not go beyond a brief discussion of some (personal) broad guesses. The EU present institutional setting is made up of no less than five tiers of government: Union, National countries, Regions, Local governments, the last usually split into counties and municipalities. A widespread opinion suggests that the National governments will not disappear at all but will result in being the losers, overwhelmed by the need to enlarge Union powers and the enforcement of subsidiarity's principle at the lower (Regional+Local) tier.

The prevailing literature seems to favour an enlargement of the EU powers from time to time, provided that Europe government has been made democratically accountable. A largely shared proposal suggests to gradually extend allocation function to encompass defence, research & development and the European transport network, besides the current activities in the fields of single market and agriculture policy.

---

[16] Notice some likeness with Atkinson's (1996, cap. 15) *Participation Income Scheme*.

Further, a due emphasis should indeed be devoted to the recurrent proposal of making EU declared aims of social protection really effective, whereas up to now they merely consisted of high-sounding statements of rights[17]. New pressures to change may arrive by the incoming European Constitution, which most likely will adopt the Tobin's principle of "Specific Egalitarianism" as endorsed by the Nice 2000 "Charter of European Union's fundamental rights"[18].

The reason (Atkinson 1992) to put in operation an "European social safety net" is twofold. Member countries' programs suffer from a severe weakness which is made evident by the about seventy millions of people (18 percent of the total) at risk of poverty who still live in the core Europe. Furthermore differences in GDP level and in budget conditions may discriminate one country from the other as to their ability to cope with social protection needs. Such a proposal should be strongly welcomed in order to implement our suggestion of tax shift from social contributions to consumption tax, particularly VAT. This means that in any European country, the "Safety net" should also cover the social security minimum pensions that in this way should be paid out from general taxation.

At the moment the EU budget (Laffan 1997) is not (and must not be) higher than 1.27 percent of Union's GDP, i.e. close to 85 billions of euro. This plentiful amount of money comes from custom duties on extra Union imports (about 15 percent of total resources), a share of member countries' VAT (about 35 percent), and, as to the remaining, from countries' contributions in accordance with their GDP. About half of these resources are absorbed by the Common agricultural policy alone. One third goes to the so called "Structural actions," i.e. to regional development and other cohesion initiatives. The small rest is almost lost, being dispersed among many minor items.

Now we can go back to the discussion of tax reforms, by integrating it with the previously outlined proposal of enlargement of EU's central powers. When (and if) fully implemented, such proposal would require resources near to ten percent of GDP at Federal level. Going on with this parable, we can now speculate that EU existing resources should be increased up to near three points of GDP. Individual countries' contributions based on GDP will be eliminated and the revenue losses will be more than

---

17 During the 1970s and 1980s EC's Acts basically took up the 1945 UN "Charter of human rights." In 1989 the "Charter of fundamental social rights" was adopted by the Community (although with the United Kingdom dissenting). Its aims were confirmed by the Social protocol annexed to the Maastricht Treaty (United Kingdom still dissenting). The central idea was to extend social protection to wider cohorts of beneficiaries and specifically target it to fight against poverty.

18 Specific guarantees are stated regarding the right to: free mandatory education (art. 14); satisfactory, regular employment (art.15); getting high protection of health (art.35); being admitted to social protection and services, "in case of motherhood, sickness, labor accidents, dependency and old age, besides that in case of loosing the job, *according to Union's and national laws*" (italics our).

compensated by allocating total revenue accruing from VAT on imports from outside the Union to the EU budget together with the yields from the (increased) environmental levies.

The new additional financial tools should be outlined according with sound criteria of tax design and fiscal federalism. Our choice is twofold, and seriously takes into account the previously outlined requirements about tax reforms growth and fairness enhancing. First, for the working of a government that appears to be so distant from its citizens, a part of new revenues should be highly visible and keep politicians for their use. This task may be better performed by a EU's VAT rate, that is made explicit to consumers, than by a sharing to income tax revenues, which on the contrary is largely hidden in the withholdings on labour incomes.

The second leading principle should be to directly attribute to the EU level those taxes that most require highly puzzling (for example, Keen, 1996; Haufler, 1999) coordination, i.e. corporations[19] and capital income taxes. The rate should be fixed at about the same rate, in the order of 20 to 25 percent. This rate should be applied to any kind of capital incomes (interests, dividends, capital gains) via a flat rate inside income tax, which is a good and easy tool to reduce evasion on other kinds of incomes. Thus an acceptable "Dual income tax system" would be realised. In fact, among European countries income tax average rates (Wagstaff et all 1999) range from nine percent (France) to 33 percent (Sweden), and the average European un-weighted rated is at about 15 percent.

7. Conclusions

European countries' tax reforms adopted from the 1990s introduced some improvements, mainly by streamlining existing systems, but they have been mostly narrow both in size and as to the aims. Sound fiscal choices that are targeted at Europe's basic needs should instead be more radical.

Many years of common market, the single market, and then the monetary union, together with the harmonisation efforts of the European government had not up to now the consequence to realise a very high degree of tax systems' convergence, which is instead required for the EU's single market efficiency.

Before any further analysis, basic common sense suggests that (average) tax wedges on labour at around 45 percent and implicit rates over 30 percent for corporations have something to do with the European declining growth rate and

[19] The proposal to shift Corporation tax at EU's level is certainly not new (for example, Albi *et al*. 1997) and recently has been authoritatively brought in again (Cnossen 2002).

increasing unemployment. Theoretical hints and empirical data suggest that tax reforms could help, but only if burden taken off from labour and corporate capital can be pushed to a relevant extent.

How to finance such huge tax-cuts is the subsequent puzzle. The Stability Pact prevents the reduction of fiscal pressure and takes in any workable expenditure cuts. Thus the escape route necessarily involves shifting the tax burden, from labor (mainly social contributions) and corporations to rents, environmental externalities and, mainly, consumption (VAT). Theory and evidence are in fact not thoroughly reassuring about this policy while political economy predictions warn us to beware of its electoral feasibility. To climb over this last obstacle, I propose that the heavier consumption taxes should fund an universal social security safety net, which also encompasses minimum pensions treatments.

In a world where growth rates decline, one is forced to find an additional source of welfare by increasing fiscal and social fairness. What is needed is a legitimated and transparent political process of tax voting, an equitable fiscal exchange and well behaved tax rules between state and citizens. Even better vertical and horizontal equity have to be empowered and enlarged to contribute to the society of equal opportunities.

European countries should be aware that present tax reforms are to be applied in a changing institutional setting. EU central functions will probably increase: here it is suggested that the financing should come partly from a transparent tax such as an (additional in our scheme) EU VAT rate which is visible to consumers. The remaining amount of financing can be found by attributing to the Union level both environmental levies and the two taxes which need more coordination, this being however particularly difficult, *i.e.* taxation on corporations and capital incomes at about a same and even rate.

REFERENCES

Adema, W. (2001), *Net Social Expenditure*, 2nd ed., Paris, OECD.

Agell, J., Lindh, T. and H. Ohlsson (1997), "Growth and the Public Sector: A Critical Review Essay", *European Journal of Political Economy,* No. 3, pp. 33-52.

Aghion, P., and E. Caroli, (1999), "Inequality and Economic Growth: The Perspective of the New Growth Theories", *Journal of Economic Literature*, No. 4, pp. 1615-71.

Albi, E., R. Paredes and E. Carona (1997), *Corporate Tax as a Possible Fifth Own Community Resource: How Much Harmonization Is Necessary?*, EU Commission, study XIX/BI/9602.

Atkinson, A.B. (1992), “Toward an European Social Safety Net?”, *Fiscal Studies*, No. 3, pp. 41-53.

Atkinson, A.B. (1996), *Incomes and the Welfare State,* Cambridge, Cambridge University Press.

Atkinson, A.B. (1999a), *The Economic Consequences of Rolling back the Welfare State*, Cambridge, Mass., The MIT Press.

Atkinson, A.B. (1999b), “Equity Issues in a Globalizing World: The Experience”, in V. Tanzi, K. Chu and S. Gupta (eds.), *Economic policy & equity*, Washington, D.C., International Monetary Fund, pp. 63-80.

Bernardi, L. (2002), “Imposte Giuste, Giuste Giustizie e Riforme Impossibili”, *Politica economica*, No. 3, pp. 585-96.

Besley, T. (2001), “From Micro to Macro: Public Policies and Aggregate Economic Performance”, *Fiscal studies*, No. 4, pp. 357-74.

Bosworth, B. and G. Burtless (1992), “Effects of Tax Reform on Labour Supply, Investment and Saving”, *Journal of Economc Perspectives*, No. 6, pp. 3-25.

Bretschger, L. and F. Hettich (2002), “Globalization, Capital Mobility and Tax Competition: Theory and Evidence for OECD Countries”, *European Journal of Political Economy*, Vol. 18, pp. 695-716.

Carone, G. and A. Salomaki (2001), “*Reforms in Tax - benefit System in Order to Increase Employment Incentives in EU,* European Commission, EC/160.

Cnossen, S. (2002), “Tax Policy in the European Union. A Review of Issues and Options”*, FinanzArchiv*, No. 4, pp. 1-93.

De Novellis, F. and S. Parlato (2003), *Tax Systems and Tax Reforms in Europe: Reducing Fiscal Pressure Under the Stability Pact*, SIEP WP 199/03.

Devereux, M.P., R. Griffith and A. Klemm (2001), *Have Taxes on Mobile Capital Declined*?, mimeo IFS.

EU Commission (2000), “Public Finances in EMU”, *European Economy*, No. 3, pp. 69-92.

EU Commission (2002), *The Social Situation in the European Union*, Brussels, EU Commission and Eurostat.

Eurostat (2000) *Structures of the Taxation Systems in the European Union, 1970-1997,* Brussels, European Commission.

Gandullia, L. (2003), *Tax Systems and Tax Reforms in Europe: A Comparative View of Selected European Countries,* SIEP WP, 201/03.

Gorter, J. and R.A. de Mooij (2001), *Capital Income Taxation in Europe. Trends and Trade Offs*, CPB Netherlands Bureau for Economic Policy Analysis, Publication 30.

Goodin, R. and J. Le Grand (1987), *Not Only the Poor: The Middle Class and the Welfare* State, London, Allen & Unwin.

Haufler, A. (1999), “Prospect for Co-ordination of Corporate Taxation and the Taxation of Interest Incomes in the EU”, *Fiscal Sudies*, No. 2, pp. 133-54.

Johnson, P. and H. Reed (1996), “Two Nations? The Inheritance of Poverty and Affluence”, *IFS Commentary,* No. 53.

Jones, C.I. (2002), *Introduction to Economic Growth*, 2nd ed., New York and London, W. W. Norton Company.

Joumard, I. (2001), *Tax Systems in European Union Countries*, OECD Economic Department Working Paper No. 301.

Keen, M. (1996), “The Welfare Economics of Tax Coordination in the European Community”, in M. P. Devereux (ed.), *The Economics of Tax Policy,* Oxford, Oxford University Press, pp. 189-214.

Keen (2002), “The German Tax Reform of 2000”, *International Tax and Public Finance,* Vol. 9, pp. 603-21.

Laffan, B. (1997), *The Finances of the European Union*, London, Mac Millan.

Leibfritz, W., J Thronton and A Bibbee (1997), *Taxation and Economic Performance*, OECD, Economic Department Working Paper No. 136.

Martinez-Mongay C. (2000), *The ECFIN Effective Taxation Databank. Properties and Comparisons with Other Databanks*, EU Commission Economic Paper No. 146.

Myles, G. (2000), “Taxation and Economic Growth”, *Fiscal Studies*, No. 1, pp.141-68.

North, D.C. (1990), *Institution, Institutional Change and Economic Performance*, Cambridge, Cambridge University Press.

OECD (2001), *Revenue Statistics 1965-2000*, Paris, OECD.

OECD (2002a), *Revenue Statistics 1965-2001*, Paris, OECD.

OECD (2002b), “*Fiscal Decentralization in EU Applicant States and Selected EU Member States, mimeo* OECD.

Pigou, A.C. (1929), *The Economics of Welfare*, London, Mac Millan.

Pissarides, C.A. (1998), “The Impact of Employment Tax cuts on Unemployment and Wages: The Role of Unemployment Benefit and Tax Structures”, *European Economic Review*, Vol. 42, pp. 155-83.

Profeta, P. (2003), *Tax Systems and Tax Reforms in Europe: Public Finance and Political Economics,* SIEP WP 183/03.

Rawls, J. (2001), *Justice as Fairness: A Restatement*, Cambridge, Mass., The Harvard University Press.

Tanzi, V. and H.L. Zee (1997), *“Fiscal policy and long - run growth”,* IMF Staff Papers, 44, 2.

Tanzi, V. and L. Schuknecht (1997), “Reforming Government: An Overview of Recent Experience”, *European Journal of Political Economy*, Vol. 13, pp. 395-417.

van den Noord, P. and C. Heady, (2001), "Surveillance of Tax policies: A Synthesis of Findings in Economic Surveys", OECD, Economic Department Working Paper No. 303.

Wagstaff, A. *et al*. (1999), "Redistributive Effect, Progressivity and Differential Tax Treatment: Personal Income Taxes in Twelve OECD Countries", *Journal of Public Economics*, Vol. 72, pp. 73-98.