European Commission

EUROPEAN SEMESTER THEMATIC FICHE

TAXATION

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1 Introduction

A well-designed tax system allows to raise sufficient revenues to finance socially-desired public expenditure and support growth, jobs, and investment. To work properly, the system needs to be accepted by taxpayers, which requires among others a fair treatment among taxpayers. EU Member States currently face several categories of tax policy challenges. These include: promoting high-level of employment and making the tax structure more growth-friendly; encouraging productive investment; addressing tax fraud, tax evasion and tax avoidance to ensure fairness and allow Member States to collect the tax revenues due.[1]

This fiche first outlines tax policy challenges in EU Member States in these areas. Second, it presents policy levers which could help make tax systems more-job and investment friendly while ensuring a fair contribution from all taxpayers. Third, it discusses tax reforms in the Member States and also highlights some examples of good practices.

2 More growth-friendly and fair tax systems

The section is organised along two main challenges that are the composition of tax revenues and growth and the distributional impacts.

2.1 The composition of tax revenue and growth

EU Member States have wide differences in levels of total taxation. In 2016, the (esti-mated) tax-to-GDP ratio[2] is expected to vary between 26.7% in Romania and 45.7% in

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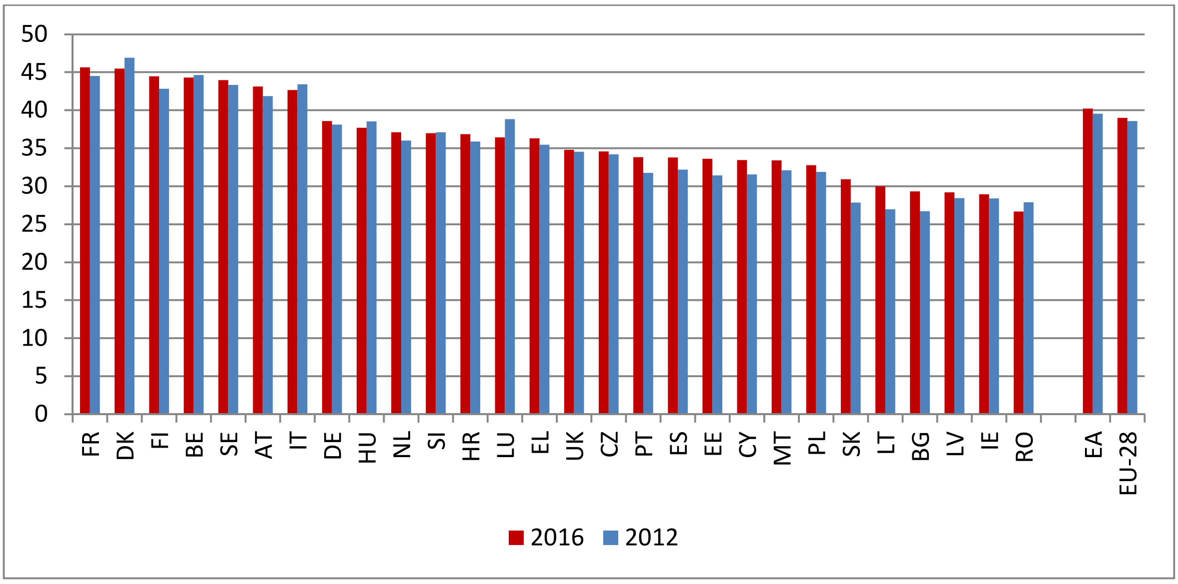
[1] More information on the issues raised in this document can be found in the 2015 Tax Reforms in EU Member States and in other Taxation Papers published by the Directorate-General for Taxation and Customs Union on Reforms of Tax Systems since the launch of Europe 2020, notably Taxation paper no. 49.

[2] This measure includes social security contributions actually paid, but does not consider deemed contributions paid by some governments for civil servants by imputing them.

France (Figure 1).

Figure 1:

Total tax burden in EU Member States in per cent of GDP, 2012 and 2016



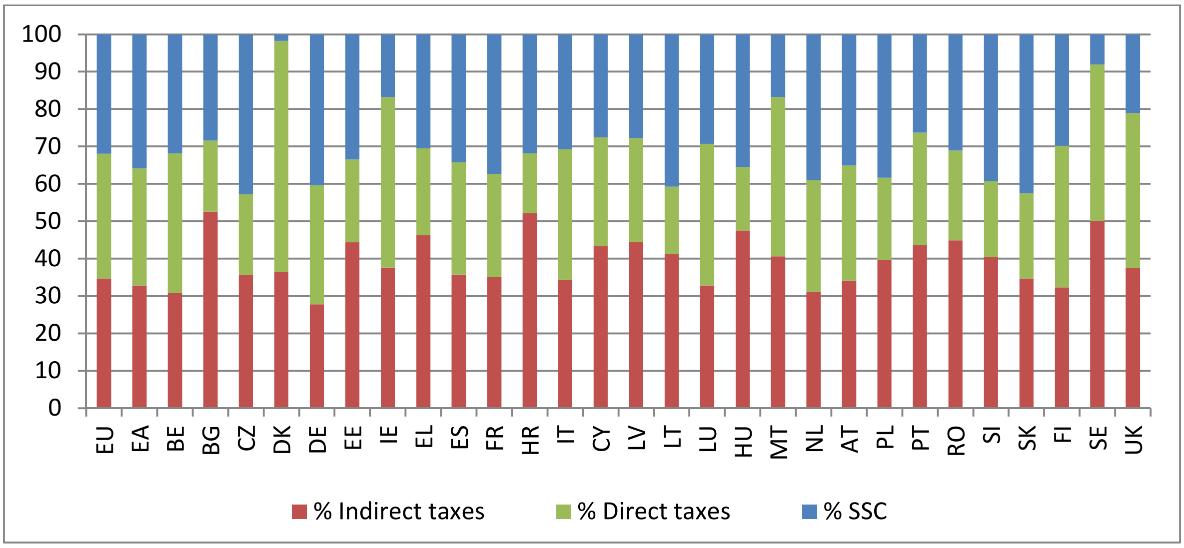
Source: European Commission, Ameco.

Differences in the total level of taxation reflect differences in social preferences for public goods. So far, strong evidence is lacking on the impact of the overall level of taxation on economic growth. There is, however, a better understanding of how individual components of the tax system affect growth through the channels of total factor productivity, the growth of the capital stock or labour supply. Better outcomes can be achieved by improving the incentive effects of specific taxes or of the structure of taxation overall.

Member States display considerable differences in the composition of taxation between direct taxes, indirect taxes, and social security contributions (Figure 2). Most Eastern EU Member States have a lower share of direct taxes than the average. In Denmark, social security is mainly financed through direct taxes, which explains their high share in total revenue.

Figure 2:

Structure of tax revenue by major types of taxes, 2016 (Ameco forecast)

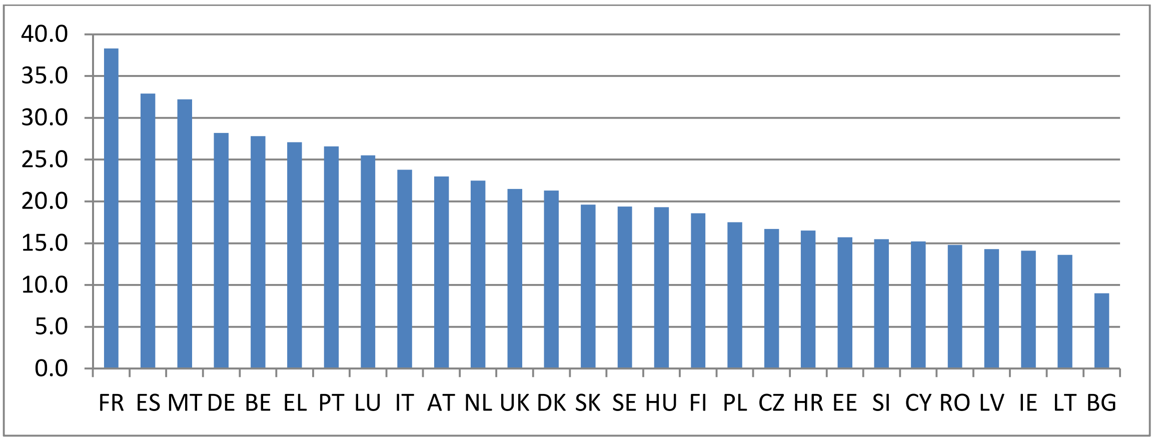


Note: data are not corrected for imputed social security contributions (see footnote 2). Source: European Commission.

Taxes on corporate and personal income have an impact on growth and investment. Corporate income taxes affect the location of businesses and can decrease domestic and foreign direct investment. Tax rates, the definition of the base, and aspects of compliance are important determinants of the economic effects of taxation. The tax treatment of different sources of financing, the design of fiscal incentives and the time spent by businesses on tax compliance can influence productive investment. Differences in corporate income taxes can trigger shifting of reported profits by multinational companies from high to low tax countries.

Figure 3:

Effective average corporate tax rates of EU Member States in per cent, 2015



Note: The effective average corporate tax rate measures the taxes paid by corporations on infra-marginal investments that produce profits above the normal return to capital.
Source: ZEW (2015), Effective Tax Levels Using the Devereux/Griffith Methodology.

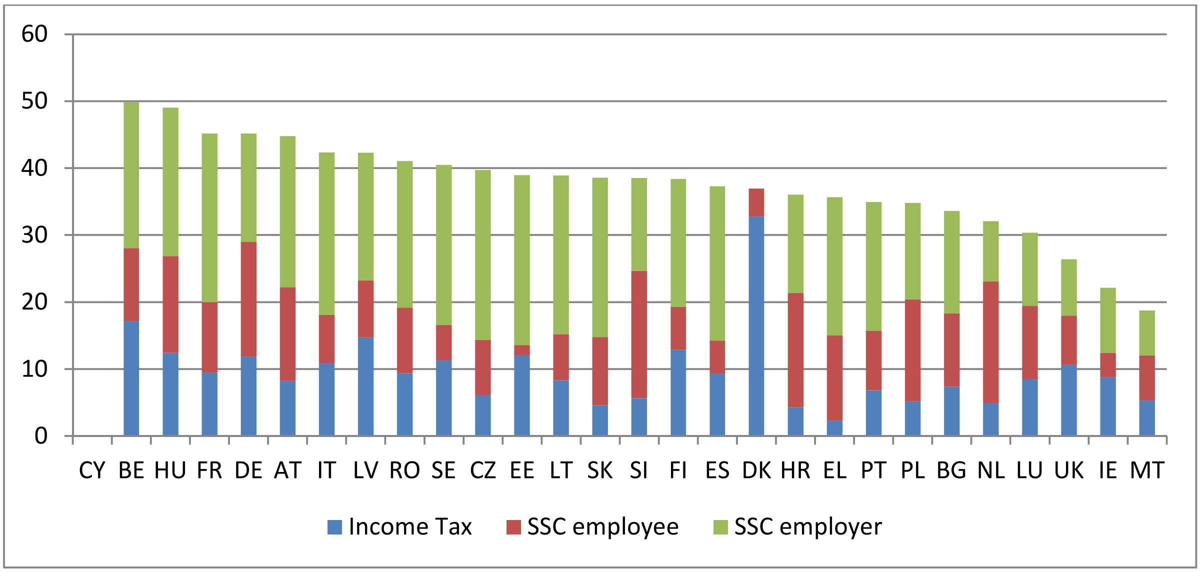
Labour taxes affect both individuals' decisions on whether and how much to work (labour supply) and employers' decisions to hire workers as they increase the cost of labour (labour demand).[3] The labour supply of some groups of the population (low-skilled workers, youth, elderly and second earners) is particularly sensitive to taxes and social security contributions.[4] The composition of the tax wedge – consisting of personal income tax, and employers' and employees' social security contributions – is important in the short run as it can have an impact on labour demand and supply. Decreases in social security contributions for employers can foster labour demand. For low-wage earners, social security contributions paid by employers are highest in 2014 (latest available data) in France, Estonia, the Czech Republic, and Italy (Figure 4).

[3] These decisions also depend, among others, on available social benefits received when not working, or working part-time. On further determinants of the impact of tax-benefit systems on labour supply, see the different indicators available through the Joint European Commission-OECD Tax & benefits indicators database.

[4] See e.g. Costas Meghir and David Phillips (2010), Labour Supply and Taxes, in Institute for Fiscal Studies (ed.), The Mirrlees Review: Dimensions of Tax Design, Oxford: Oxford University Press, pp. 202-274.

Figure 4:

Tax wedge of low wage earners by components as percentage of total labour costs in EU Member States, 2014



Note: The tax wedge is shown for singles with no child earning 67% of the average wage. No data for Cyprus.

Source: Joint European Commission - OECD Tax & benefits indicators database

2.2 Redistribution

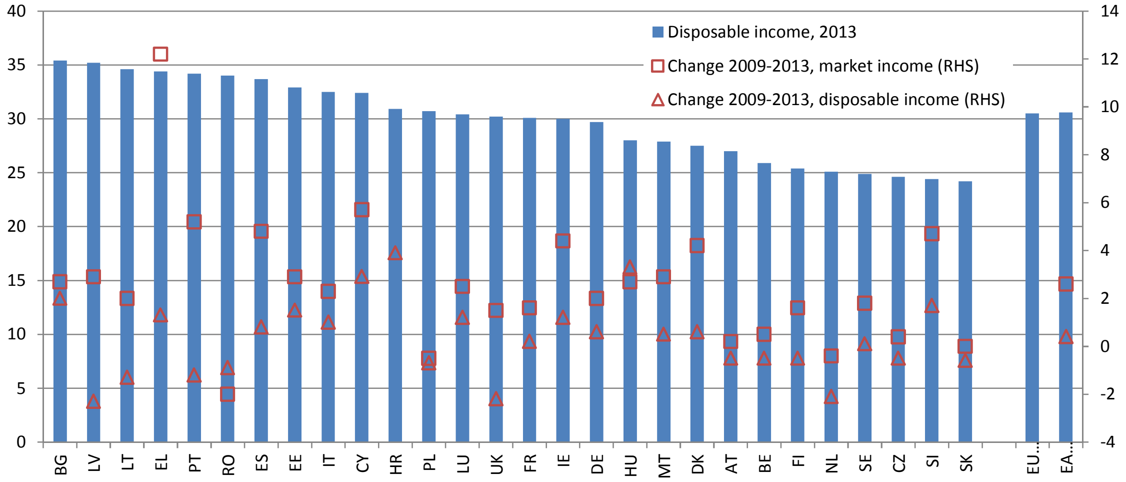
The relationship between income inequality and economic growth is complex. Market income inequality is reduced by different elements of countries' tax-benefit systems. The most commonly used instruments are progressive personal income taxes, targeted tax schemes for low-income households, and specific social programmes providing benefits. The degree of redistribution achieved by the tax-benefit systems varies across EU Member States. Striking the balance between social equity and economic efficiency in line with citizens' preferences is a national prerogative.

Depending on the inequality of market income distribution and the characteristics of national tax-benefit systems, Member States address the inequality of disposable household income to different degrees (Figure 5). Between 2009 and 2013, inequality in disposable income has increased in more than half of EU Member States, but national tax-benefit systems were to a considerable degree able to cushion the increase in market income inequality.[5]

[5] The Gini coefficient is the most commonly used inequality measure. It varies between 0, when each unit has an identical share of the total, and 1, when a single unit has all.

Figure 5:

Gini coefficient of disposable household income, 2013, and change in the Gini coefficient of household market income and disposable income 2009-2013 in EU Member States



Note: Income data are adjusted for household size (equalisation). Left axis: Gini coefficient (scale from 0 to 100. The value 0 corresponds to perfect equality (same income to everybody) while 100 corresponds to maximum inequality (all income distributed to only one person and all the others have nothing)). Right axis: change in Gini coefficient, in percentage point.

Source: Eurostat.

It is increasingly recognised that tax policy measures aimed at equity do not necessarily come at the expense of efficiency. Tax reforms that are both growth-friendly and mitigate income inequality include addressing specific tax measures that mainly benefit high-income taxpayers (such as specific tax expenditures, tax breaks on stock options, bonuses and carried interest, and low capital gains taxes). Reshaping the tax structure to less growth-distortive taxes – in particular away from labour and corporate income taxes towards consumption – could also improve incentives to work, save and invest. However it might be regressive since consumption represents a larger share of low-income households' expenditure. Transfers targeted at lower income groups can be used to alleviate this trade off. The fight against tax fraud and evasion might also help improve the the fairness of tax-benefit systems.

3 Policy levers to address the tax policy challenges

The section presents three main policy areas to make the tax systems more growth-friendly and fairer: by shifting taxes away from labour, by designing tax systems promoting productive investment and by fighting tax fraud, evasion and avoidance.

3.1 Shifting taxation away from labour

Reforms targeting labour tax reductions should be intensified to help restore employment, as tax burdens on labour remain high in many EU economies. Shifting taxes away from labour should be a priority for several EU Member States, in view of its positive impacts on labour supply and demand. EU Member States may want to reduce their level of labour income taxation in a budget neutral way, implying a shift towards tax bases that are less harmful to growth while taking into account redistributive effects and impacts on social security systems. At the macroeconomic level, recurrent property taxes, consumption taxes, and environmental taxes are found to be the least detrimental to growth.

The potential room for a tax shift depends on the existing tax structure. High levels of labour taxation together with a relatively low tax burden on consumption taxes, recurrent property taxes, or environmental taxes indicate room to shift taxes away from labour. Other avenues to finance a decrease in labour taxes are the strengthening of progressivity in the personal income tax (PIT), including the taxation of capital income of individuals, and revenues from fighting against tax fraud, tax evasion and aggressive tax planning. This would have the merit of fairly spreading the burden across the population and to overcome potential constraints (i.e. institutional, distributional and competitiveness concerns) in the field of indirect taxes.

3.2 Tax systems promoting productive investment

Many factors influence companies' investment decisions. Tax is one of such factors as it increases the cost of capital of companies and can create high compliance costs when tax systems are complex, uncertain and intransparent. Taxation influences both domestic and foreign investment, and can reduce the number of entrepreneurs. Tax reforms play a role in removing barriers to financing and creating an environment supportive of investment and innovation including for smaller and young companies. Encouraging alternative sources of financing, designing better fiscal incentives for entrepreneurial initiative and cutting compliance costs for entrepreneurs are among tax policy means that could help stimulate productive investment.

3.3 Fighting tax fraud, evasion and avoidance

Tax fraud, tax evasion and tax avoidance lead to considerable revenue losses for EU Member States. Tax fraud and tax evasion are illegal practices. Aggressive tax planning, although not necessarily illegal, also artificially erodes tax bases in EU Member States. Tackling these challenges is necessary not only to regain revenue lost to fraudsters but also to make sure that taxes are paid where they are due, as a matter of fairness. In addition, tax evasion, fraud and avoidance create distortions that impede the proper functioning of the internal market.

4 Cross-examination of the state of play

4.1 Shifting taxation away from labour

Targeted labour tax cuts have been a predominant feature of tax reforms during the latest phase of the crisis in order to stimulate employment. Combined with tax increases for higher earners, these measures have also contributed to increasing progressivity. In 2014-2015, near half of Member States reduced the overall level of taxation on labour. A few of them reduced labour taxes for low-wage earners and specific groups, while increasing labour taxes for higher income groups. However, there was no clear indication that the tax burden has been shifted to taxes less detrimental to growth such as consumption taxes, environmental taxes and recurrent housing taxes.

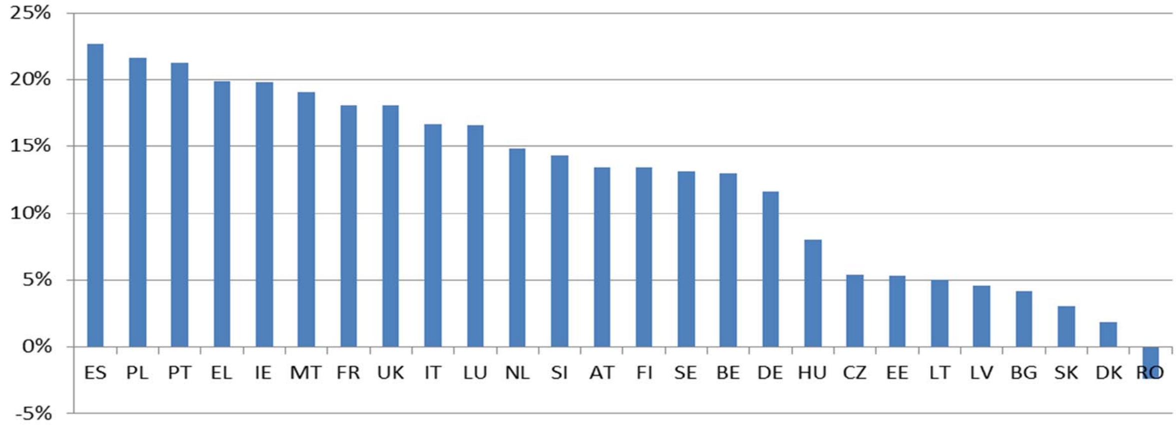
Consumption taxes

By the size of the base, consumption taxes can raise larger revenues in contrast to property taxes and environmental taxes for which the base is relatively smaller. It would not even be necessary to increase the standard VAT rate, if the tax base were broadened.

Empirical economic analysis[6] suggests that VAT should be levied on a broad base minimising revenue losses from exemptions and reduced rates. The extensive use of VAT reduced rates is generally not the most suitable instrument for pursuing policy objectives, particularly for ensuring redistribution to poor households, and leads to economic costs (including compliance costs) and distortions. Forgone revenues due to reduced rates and exemptions (and disregarding non-compliance) are estimated at up to 23% of theoretical revenues at standard rates in the case of Spain (Figure 6). However, redistributive effects of removing reduced VAT rate should be taken into account (for instance through properly designed transfers to the poorest households).

Figure 6:

VAT actionable policy gap (reduced rates and exemptions) as per cent of theoretical revenue in EU Member States, 2013



Note: measure of "actionable policy gap" defined as the sum of the rate gap and the exemption gap net of imputed rents, financial services and public goods. No values are available for Croatia and Cyprus. The negative value for Romania derives from the fact that input VAT of the exempted 'non-actionable' sectors is bigger than their potential output VAT. Therefore, removing exemption would lead to a VAT revenue loss as the VAT paid would become deductible.
Source: CPB/CASE (2015): Study to quantify and analyse the VAT Gap in the EU Member States. 2015 Report.

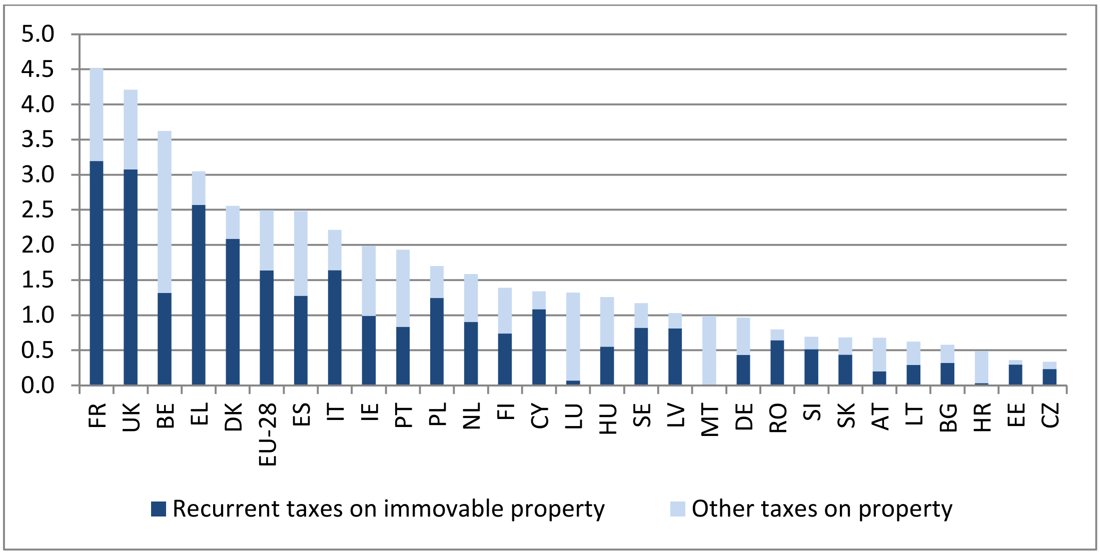
Housing taxation

Property taxes and recurrent taxes on immovable property specifically are among the taxes least detrimental to growth. Taxes on immovable property include both recurrent and transaction taxes. Housing transaction taxes tend to discourage transactions, allocation efficiency, and labour mobility. In contrast, recurrent property taxes have the advantages of a stable, immobile, and visible tax base, which makes evasion more difficult and induces fewer economic distortions. As a result, a labour tax shift towards recurrent property taxes should be preferred. As current systems of housing taxation rely heavily on transaction taxes (Figure 7), an internal shift from transaction taxes towards recurrent taxes could also bring efficiency gains. In many countries, cadastral values are not regularly updated. Bringing cadastral values of housing in line with market values may increase revenues while improving equity aspects.

6 See e.g. Copenhagen Economics (2007), Study on reduced VAT applied to goods and services in the Member States of the European Union, European Commission, Directorate-General for Taxation and Customs Union, Taxation Papers no. 13.

Figure 7:

Revenue from property taxes in EU Member States in percentage of GDP, 2014



Note: Data does not include personal income tax on imputed rents.
Source: European Commission (2015), Taxation Trends in the EU 2015, Brussels.

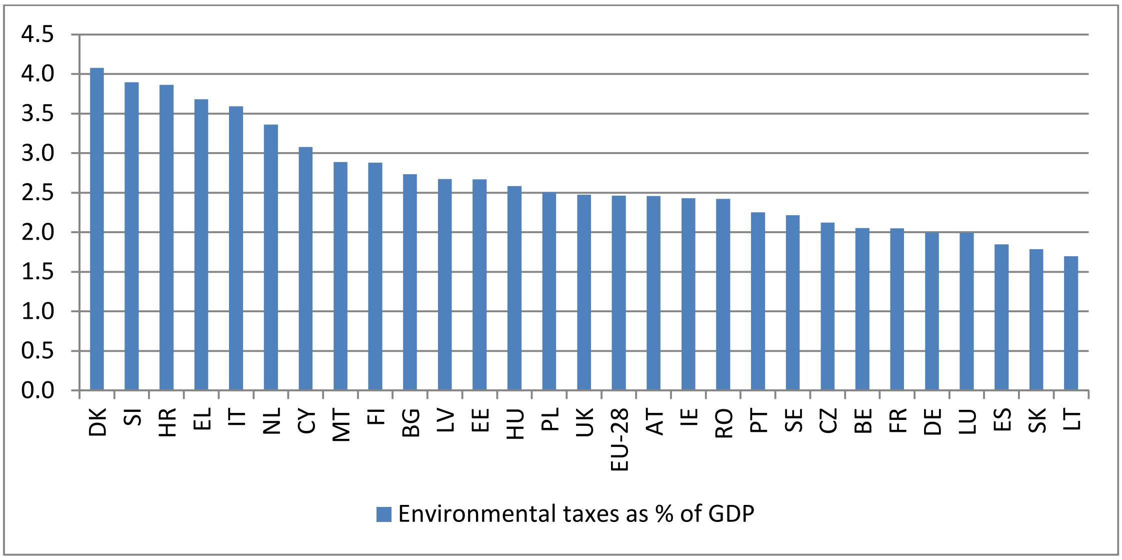
Environmental taxes

Environmental taxes remain underdeveloped in many EU Member States: such taxes provide revenue of about 2.5% of GDP on average and below 4.5% even in the Member States with the highest revenue relative to GDP, notably Denmark, Slovenia and the Netherlands (

Figure 8). Still, many EU Member States have some potential to raise further revenues not only through tax rate increases but also by removing environmentally harmful subsidies.

Figure 8:

Environmental tax revenue in percentage of GDP in EU Member States, 2014



Source: European Commission (2015), Taxation Trends in the EU 2015, Brussels.

4.2 Tax systems promoting productive investment

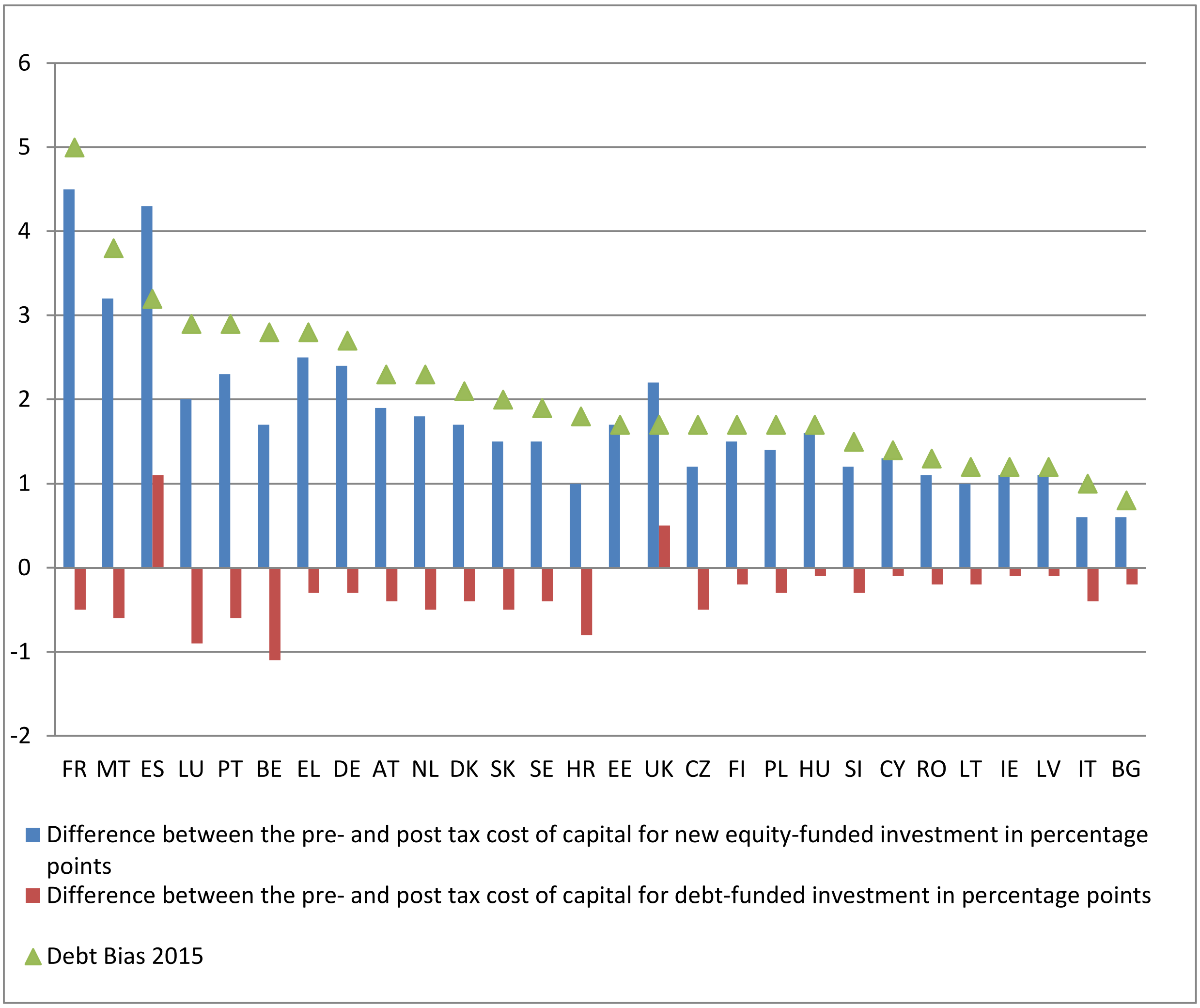
Stimulating investment has been an important priority in recent tax reforms in particular in countries affected strongly by the crisis. Efforts were also made to simplify the business environment in relation to taxation. However, Member States can do more to boost investment through tax policy means. Most tax systems still favour debt at the expense of equity. Tax incentives can be better designed to stimulate investment in the real economy and to represent good value for public money. Tax environment need to be modernised and simplified as part of efforts to improve the investment climate.

Encouraging alternative sources of financing: debt-equity bias

In most corporate tax systems, interest payments on debt are tax-deductible, while the return on equity is not. This results in a bias in favour of debt leading to overindebtedness of companies which makes them more fragile and above certain level can act as a drag on economic growth. Addressing this tax bias would encourage more equity investments and create a stronger equity base in companies.

A measure of the debt bias is the difference between the post- and pre-tax costs of capital for new equity- and debt-funded investments. The countries where the difference calculated by this indicator is greatest are France, Malta, Spain, Luxembourg and Portugal (Figure 9).

Figure 9: ***The debt-equity tax bias in corporate financing in EU Member States, 2015***



Source: ZEW (2015) and Commission services

To eliminate the distortion in tax treatment of debt and equity, tax systems could remove interest deductability (CBIT), provide a tax deduction for return on equity (so-called allowance for corporate equity or ACE) or introduce the same rate of capital allowance for both sources of financing (ACC). The Italian ACE has been introduced with a clear goal of stimulating growth and investment. The tax benefit applies to the new equity and includes anti-avoidance measures.

Designing well-targeted fiscal incentives

Tax incentives for entrepreneurial initiative – such as tax incentives for R&D expenses and for young and innovative companies – could help stimulate R&D investment and innovation, but they have to be well designed. For example, the design may prevent start-ups and small companies from fully benefitting from these incentives. A total of 26 Member States are currently using fiscal incentives to encourage investment in R&D.

A 2014 study carried out for the European Commission identified a number of good practices for R&D tax incentives[7]. The effectiveness of tax incentives in promoting R&D could be improved by ensuring that young and small companies are able to benefit from these incentives, by simplifying and regularly evaluating their impact. France's tax credit for young innovative companies has been benchmarked as best practice in the study.

Cutting tax compliance costs for entrepreneurs

Efficient tax administration, legal certainty, stability, and simplicity of tax rules matter for business and investors' decisions. Complexity of tax systems and high costs of compliance with tax rules take up productive resources and act as a barrier for business and investment (Figure 10). The high tax compliance costs are likely to be felt in particular by SMEs.[8]

To enhance the business environment, tax systems could be reformed along three lines: 1) simplifying and reducing tax obligations especially for smaller businesses, 2) broadening the range of e-services and make them available in one-stop shops, 3) raising awareness, informing and coaching business taxpayers to help them comply with tax rules by various channels, including social media. For instance, Latvia is implementing an Action Plan for Improvement of the Business Environment with specific measures to simplify tax compliance requirements for micro- and small enterprises. Another example comes from Poland which, as part of a larger tax administration reform, is providing guidance and assistance to new entrepreneurs when dealing with taxes.

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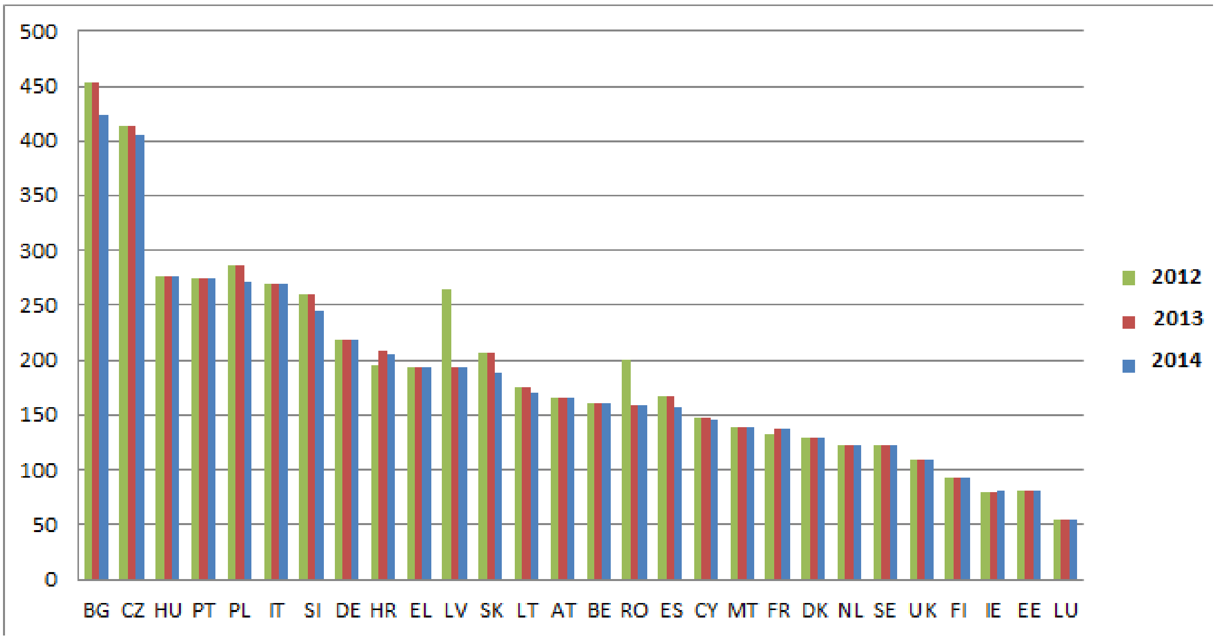
[7] See "A Study on R&D Tax Incentives". Taxation working paper N. 52 - 2014

[8] See "A review and Evaluation of Methodologies to Calculate Tax Compliance Costs". Taxation Paper N. 40, European Commission - 2013.

Figure 10:

Hours to comply with tax obligations for a medium-sized company



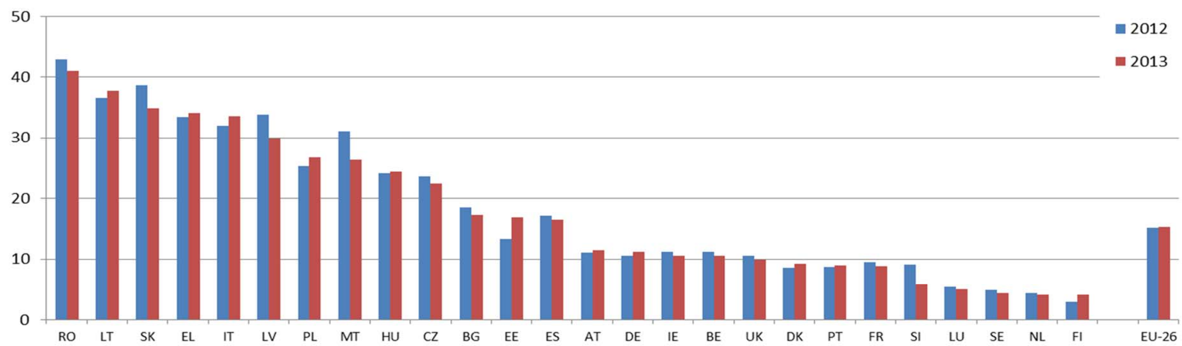
Source: World Bank (2015). Doing Business 2016. Measuring Regulatory Quality and Efficiency, World Bank

4.3 Fighting tax fraud, evasion and avoidance

The scale of tax evasion and avoidance has not yet been conclusively quantified, but there is a general consensus that it is substantial. For example, the total amount of VAT lost across the EU is estimated at €168 billion equating to 15.2% of revenue loss due to fraud and evasion, tax avoidance, bankruptcies, financial insolvencies and miscalculation in 26 Member States (Figure 11). A recent study done for the European Parliament estimates yearly losses to corporate tax avoidance to be around 50-70 billion euro for the EU.[9]

Figure 11:

VAT gap as a percentage of VAT that should be paid in EU Member States, 2012 -2013



Note: for the EU, an unweighted average is shown. No values are available for Croatia and Cyprus
Source: CPB/CASE (2015): Study to quantify and analyse the VAT Gap in the EU Member States. 2015 Report

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[9] Bringing transparency, coordination and convergence to corporate tax policies in the European Union - Assessment of the magnitude of aggressive corporate tax planning. Research paper by Dr Robert Dover, Dr Benjamin Ferrett, Daniel Gravino, Professor Erik Jones and Silvia Merler for the European Parliamentary, September 2015.

To support the fight against tax fraud, evasion and avoidance, Member States need to work along various axes. Public authorities need to promote a climate of trust and mutual respect between the administration and taxpayers. Taxpayers should get quality service from public bodies and, most importantly, see that tax money is put at good use. Member States could make taxpayers' life simpler, taking as a starting point that most taxpayers wish to comply. For instance, Italy has made filling personal income tax returns easier for millions of citizens, by pre-filling tax forms with data they already had at their disposal. At the same time, Member States could use enforcement against taxpayers who deliberately do not comply. For instance, Bulgaria heavily relied on enforcement to reduce excise duties fraud. In 2014, its tax authority started 168 audits and more than 400 checks to address the problem. Enforcement proved useful: it prevented as much as BGN 100 million of losses to the state's budget.

Furthermore, corporate tax rules need to be reviewed to address the issue of aggressive tax planning. Companies that artificially shift their profit to minimise their tax contribution threaten the social contract between governments and citizens who perceive that the tax burden is unfairly shared. They also put at a competitive disadvantage companies that pay their fair share of tax. In January 2016, the Commission published a study on "Structures of Aggressive Tax Planning and Indicators". The study reviews tax rules and practices of all EU Member States in the light of a set of indicators (i.e. factors that are critical to the setup of aggressive tax planning structures). The study reviews among others the absence of some anti-avoidance rules across Member States. Among the findings is the lack of controlled foreign corporation (CFC) rules in half of the Member States, while such rules may be effective in countering aggressive tax planning structures. Another finding relates to the widespread lack of anti-abuse rules to counter "hybrid entity" mismatches (i.e. mismatches in qualification of an entity for tax purposes).

A multilevel, coordinated approach - with synergies between actions to improve tax compliance at the national, European and global level - is essential to reduce aggressive tax planning, tax fraud and tax evasion. As an example, Romania cooperated recently with other Member States to target its enforcement actions on cross-border VAT carousel fraud, taking part to four joint inspections together with other Member States' tax authorities. Several initiatives have been and will be taken at EU level, which include the Action Plan for a more effective EU response to tax evasion and avoidance; the Transparency package and the Action Plan for fair and efficient corporate taxation in the EU, the Anti Tax Avoidance Package[10] and the Action Plan on VAT aiming at delivering an efficient and fraud-proof VAT regime.[11]

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[10] See http://ec.europa.eu/taxation_customs/taxation/company_tax/anti_tax_avoidance/index_en.htm

[11] See http://europa.eu/rapid/press-release_MEMO-16-1024_en.htm