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Executive Summary
of

More Jobs, Less Tax Evasion, Cleaner Environment

Options for Compensating Reductions in the Taxation of Labour - Taxation of Other Factors of Production, commissioned by the

European Commission

This executive summary and the full version are both available in the internet at http://www.jarass.de, directory publications.

June 1999

The study gives a cross-country comparison

- of the effective taxation of
  labour income, including social security contributions;
  capital income and of capital property;
  natural resources, in particular energy resources, and of environmental goods;
- for Denmark, Germany, the Netherlands, Spain, the United Kingdom and for Japan, Switzerland and the USA;
- for the period 1980 to 1996/7.

It contains substantiated proposals for conceivable improvements:

- a tax shift of close to 4 % of GDP to reduce the gross cost of labour;
- elaboration of ideas about an efficient, fair and easily administrable European tax system.

The paragraphs (1) to (7) describe the main ideas and results of sections I to VII of the main report.

(1) This study investigates the economic structure of the tax system, at the present stage for the 5 EU countries Denmark, Germany, Netherlands, Spain and United Kingdom, and for the 3 EU competitors Japan, Switzerland and USA, for the period 1980 - 1996/97. Based on the comparison of the countries investigated conveivable changes and their impact are discussed; the problems to be examined are:

- How could tax incentives for increased employment of labour be created by a reduction of the gross cost of labour?
- In particular: how could the system of social security be relieved from some of the burden that employed labour has to bear for the benefits of the entire population?
- In which way can taxes be used as an economic instrument for environmental improvement?
- What are the possibilities and the effects of an increased taxation of property?
- With respect to financial capital: can tax avoidance be reduced and some of tax evasion be prevented by improved methods of collection?

The concept of social costs and their potential reinternalization serves as a guiding line for the direction and the volume of conceivable changes of the tax base and the tax rates.

Simplicity and efficiency of collection with respect to taxes on enterprise surplus is the principle of proposed changes in the mode of taxation and the definition of the tax base ´capital´.

(2) This study is built on concepts of neoclassical economics; its basis is the well-established and empirically proven correlation between relative factor prices and relative factor deployment and the signal effect of foreseeable changes of factor prices.

In order to demonstrate the effects of taxes on factor prices the study develops a methodology to disaggregate tax statistics (EU and OECD) and reassign the actually paid taxes (´effective taxation´) according to the economic factors of production: labour, capital, natural resources & environment, and of consumption.

Taxes on labour are further disaggregated into taxes in the strict sense and social contributions, taxes on capital into those on capital income and property, taxes on natural resources & environment into taxes on transport and other; taxation on energy is paid special attention to.

Borderline cases are discussed and delineated.

(3) Effective taxation is shown in fig. 3.1 as actually paid taxes per gross domestic product. The results are disaggregated according to production factors and their subcategories *(cf. main report, fig.s 3.2, 3.3 and 3.4)*.

The most striking feature can be seen very clearly: Throughout all the years the countries under study can be grouped into two quite distinct classes:

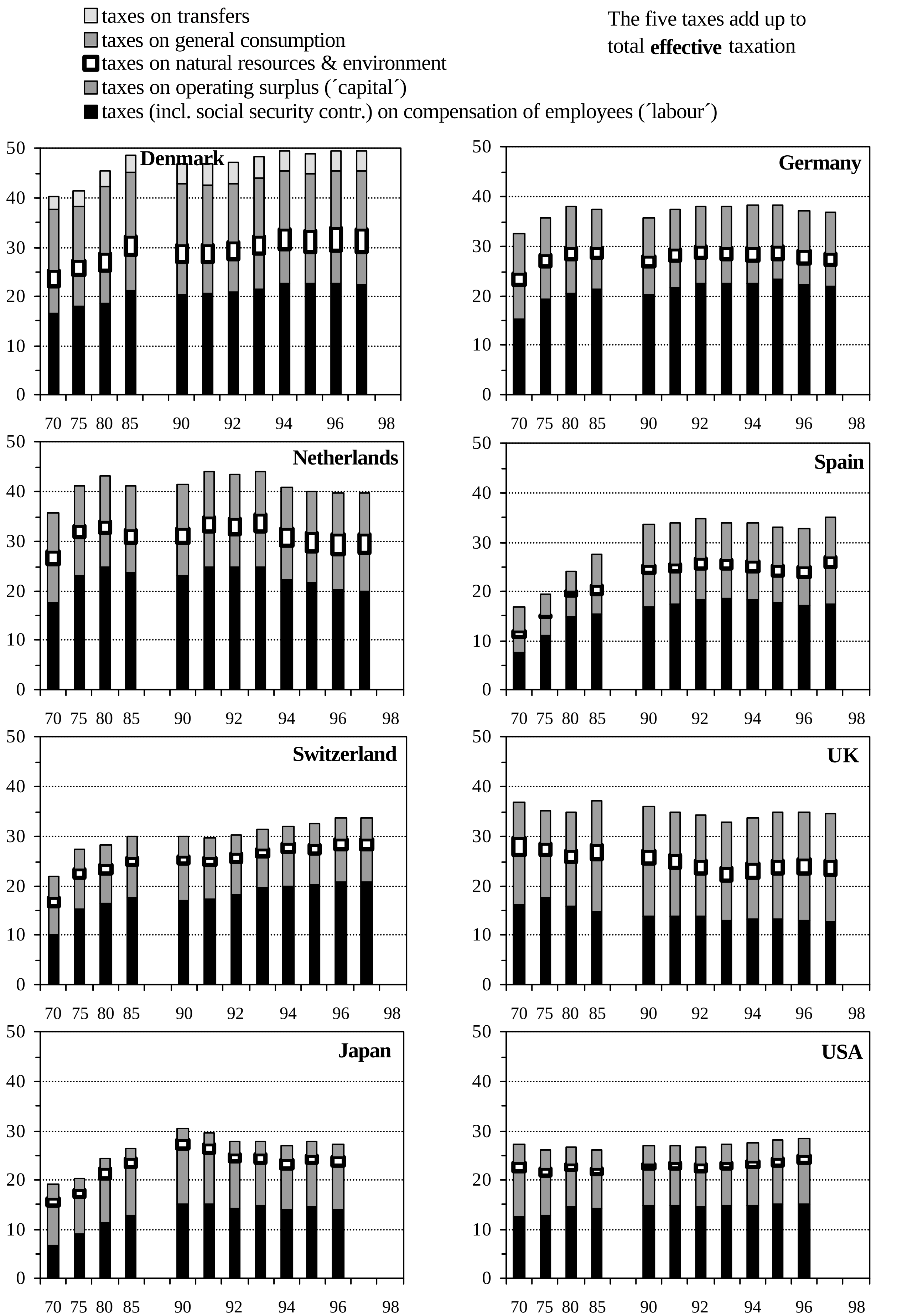
- In the ´High Load on Labour´ countries (i.e. the continental EU Member States Denmark, Germany, the Netherlands and Switzerland), where taxes & contributions on labour are around 22 % of GDP, whereas those on capital have been decreased to around 7 % of GDP, in Germany below 5 % of GDP.
- In the ´Low Load on Labour´ countries (Japan, UK, USA), the total load on labour was below 15 % of GDP, whereas taxation of capital has remained at around 9 % of GDP (after strong decreases in Japan and UK).

Taxes on natural resources and environment have yielded around 3 % of GDP and more in only 3 countries: Denmark, Netherlands and UK; in all countries sofar they have been increased, if at all, only very little between ´90 and ´95.

All taxes on consumption amount to roughly 30 % of all taxes in the EU countries, to hardly 20 % in the others *(cf. main report, fig. 3.5)*.

The allocation of factor taxes to receiving levels of government shows the wide variation of traditions with respect to centralization/decentralization of government *(cf. main report, fig. 3.6)*.

Fig. 3.1 from main report : Taxes on Labour, Capital, Natural Resources & Environment, General Consumption, Transfers [% of GDP]



(4) Effective tax rates confirm, by and large, the classification of countries into ´High Load´ and ´Low Load on Labour´, corresponding to ´Low Load´ and ´High Load on Capital´, respectively.

Fig.s 4.1, 4.2 and 4.3 of the main report show the effective tax rates paid on the production factors ´labour´ and ´capital´ and on ´energy´. The method to estimate the numbers that enter into the respective figures is described in sec. II.3 of the main report:

- for labour (cf. § 36): paid ´taxes & social contributions on compensation of employees´ divided by

  ´compensation of employees´;
- for capital (cf. § 37): paid ´taxes on capital income & on property´ divided by ´operating surplus´;
- for energy (cf. § 38): paid ´energy taxes´ divided by ´energy cost´.

The ´High Load on Labour´ countries Denmark, Germany, Netherlands, Spain and Switzerland

- have converged to an effective tax rate (incl. social contributions) on labour income at around 40 % (Switzerland 35 %);
- tax capital income at an effective rate of 30 % (Denmark), 20 % (Netherlands) and 15 % (Germany, Spain);
- in addition taxation of property contributes around 5 %, in Denmark 10 %.

For the ´Low Load on Labour´ countries Japan, UK and USA

- the effective tax rate (incl. soc. contributions) on labour is around 25 % in all countries;
- capital income is taxed at an effective rate of 20 - 25 %;
- in addition taxation of property contributes around 15 %.

Particularly striking here is the comparison between the nominal rates (´expected factor revenue´) with the effective rates (´obtained factor revenue´):

- For labour the nominal rates for typical earned income are not very much different from the effective rates: around 40 % in the ´High Load on Labour´ countries, around 25 % % in the ´Low Load on Labour´ countries.
- For capital the comparison is quite complex, but for many forms of capital income at least, like corporate income, dividends and interest, nominal tax rates range between 30 % and 50 %, whereas effective rates on capital (incl. taxes on property) yield well below 30 % in the ´High Load on Labour´ countries (15 % in Germany and Spain ´96), but up to 40 % in the ´Low Load on Labour´ countries: This is the phenomenon of tax erosion, which in particular the continental Member States have not been capable to prevent and counteract against.

Fig. 4.1 from main report : Taxes (incl. social security contributions) on Compensation of Employees divided by Compensation of Employees [%]

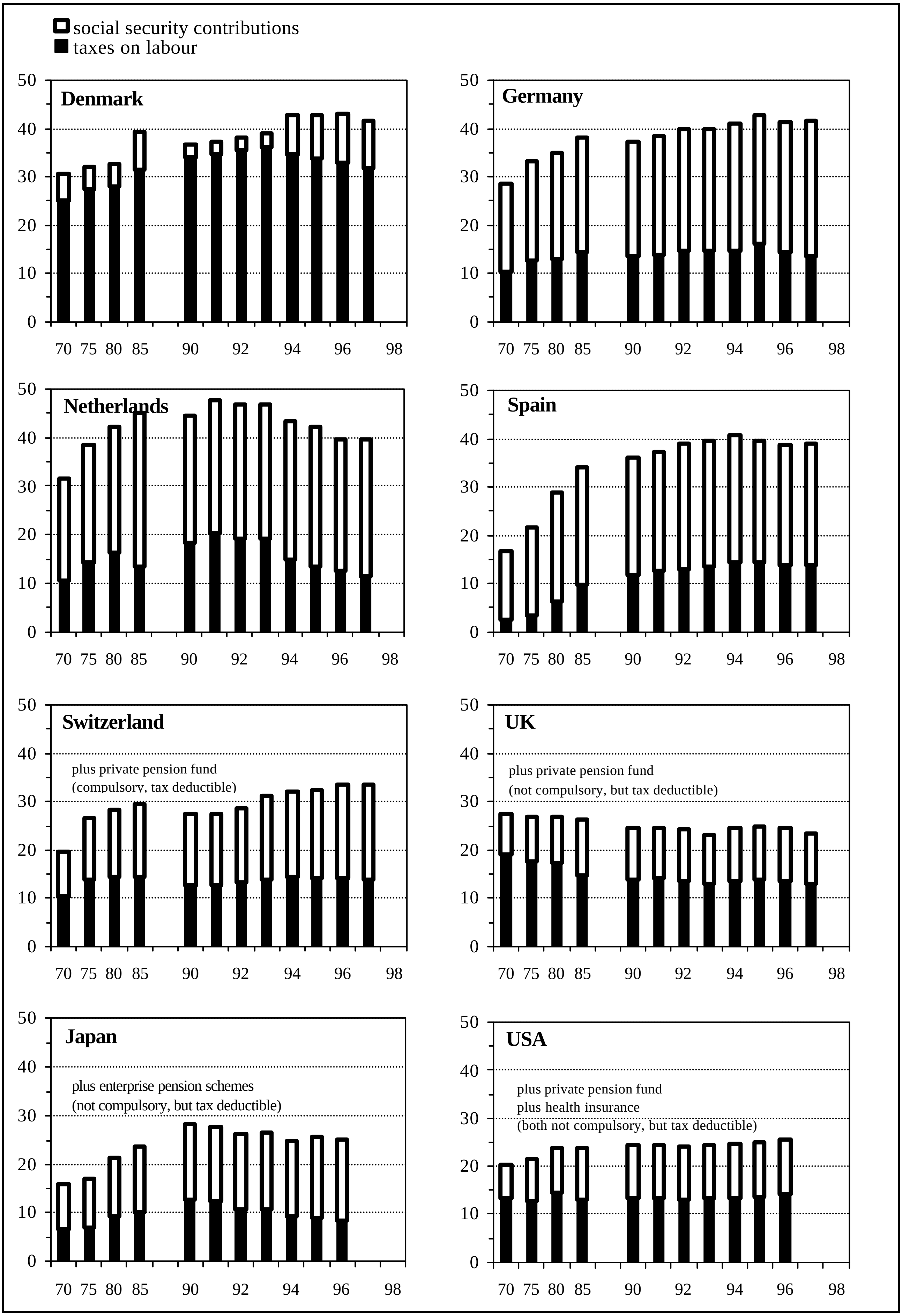
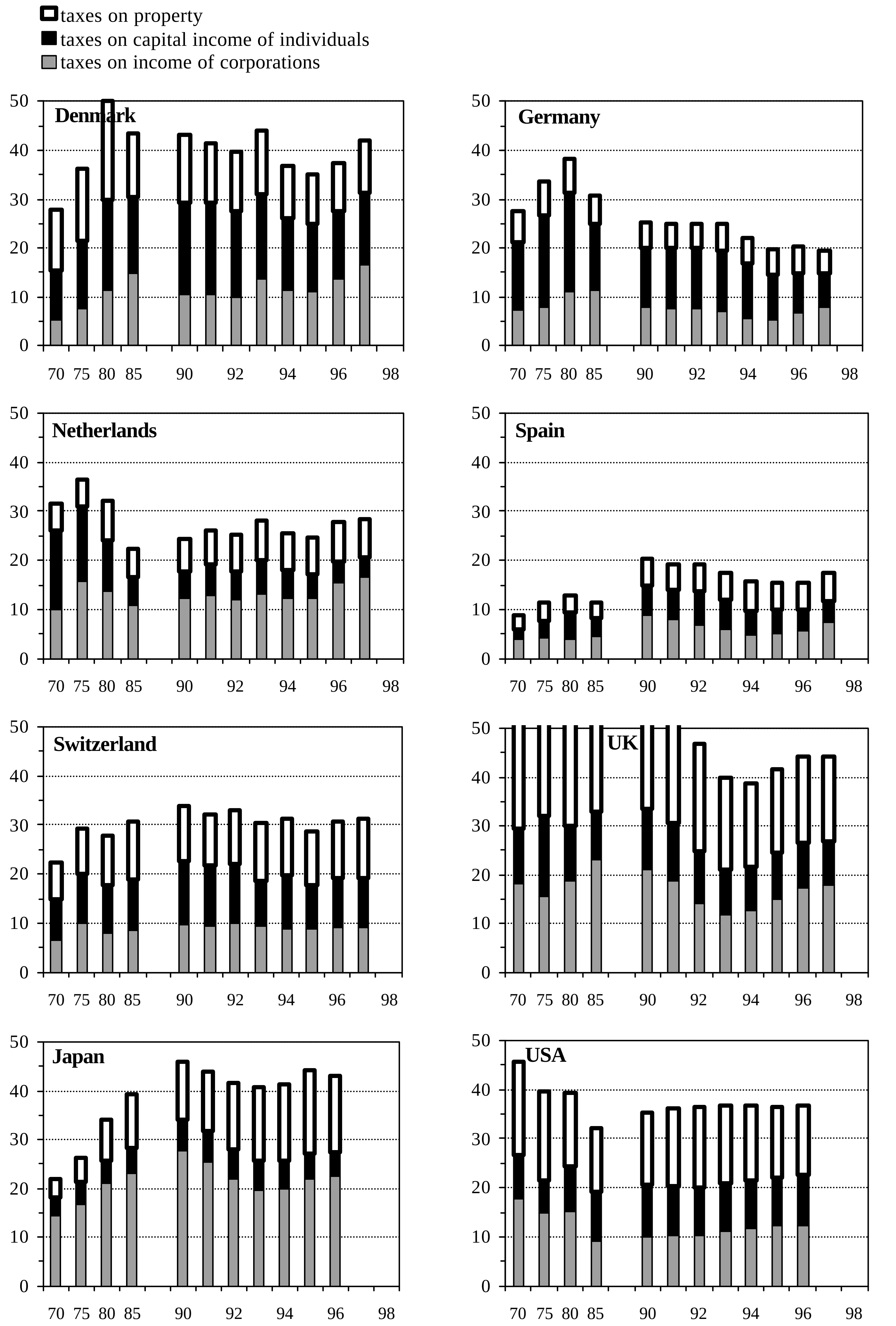

social security contributions
taxes on labour
Denmark
Germany
Netherlands
Spain
Switzerland
plus private pension fund
(compulsory, tax deductible)
UK
plus private pension fund
(not compulsory, but tax deductible)
Japan
plus enterprise pension schemes
(not compulsory, but tax deductible)
USA
plus private pension fund
plus health insurance
(both not compulsory, but tax deductible)
0 10 20 30 40 50
70 75 80 85 90 92 94 96 98

Fig. 4.2 from main report : Taxes on <u>Operating Surplus</u> divided by Operating Surplus [%]



(5) What have governments done *(cf. main report, fig. 5.1)*, seen through the eyes of the subjects of the economy? Gross domestic product has grown, with variations in time, but more or less equally in all countries by 2 %/a and by 3 %/a in Japan. Growth there has been, but how and for whom? The data show that neither the allocation nor the distribution of this growth was optimal:

- Allocation: From ´80 to ´95 employers in the ´High Load on Labour´ countries have seen the real gross cost of labour (i.e. the compensation per employee) increase by 10 % to 15 % from a high to an even higher level: a permanent disincentive against the deployment of labour.
- Distribution: Employees in these countries, however, had their real net wages hardly increased, in some cases even decreased below the ´80 level, while total employment has grown very little in these countries and even decreased in UK: The predictable and visible outcome is political polarization and even destabilization.

In this situation, with returns from capital investments taxed ever less, labour-saving rationalization investments are actually enforced by tax policies - unemployments grows, driving contributions even higher: a vicious circle.

Finally producers and consumers realize, cf. fig. 1(c), that taxes on natural resources & environment have hardly been increased, real prices for raw material and environmental goods are lower than ever: a permanent incentive for the careless squandering of these resources.

(6) General result: the ´High Load on Labour´ countries Denmark, Germany, Netherlands, Spain and Switzerland grant preferential tax treatment to those who are ´having´ (property owners, well off pensionists etc.), the ´Low Load on Labour´ countries Japan, UK, USA to those who are ´doing´ (labour, entrepreneur capital etc.).

Conceivable tax shifts in favour of labour and environment include, for the EU-countries investigated, slight tax increases for non-transport energy, for cars, for capital income, and for property. Efficient methods of collection, in particular for taxes on capital income, would have to be introduced. The following table *(cf. main report, table 6.3)* summarizes the conceivable additional revenue.

Tab. 6.3 from main report : Conceivable Additional Revenue for the Continental EU-Member States [% of GDP]

non-transport energy, if DK level:	+ 1 %
car tax, if DK/NL level:	+ ½ %
capital income, if UK/CH/JAP/USA level:	+ 0.5 to 1.5 %
capital property, if approaching UK/USA level:	+ 1 %
total:	+ 3 to 4 %

Of this additional revenue one half could serve to pay basic social benefits to non-contributors, thus decreasing the load on labour due to social contributions; the other half to reduce the wage tax for low and moderate incomes.

Within each country improved efficiency of capital taxation would allow somewhat lower nominal tax rates and thus further reduce the temptation for tax evasion. Within the European Union as a whole the loss of revenue resulting from capital mobility might be decreased.

(7) Taxation in a Global Economy faces obvious problems:

- The use of global financial instruments facilitates and favours tax avoidance which is often transformed into tax evasion with, among other factors, the aid of bank secrecy.
- Tax residents and domestic business are, in many countries, increasingly discriminated in comparison to tax foreigners and international business. Double taxation agreements, the EU parent-subsidiary and the merger directives as well as the practiced system of transfer pricing favour this discrimination.
- The situation is aggravated by socalled ´tax-competition´, which, as practiced, should rather be called ´tax dumping´ or ´unfair tax practices´ between EU Member States (Owens/OECD).

The study proposes, in agreement with recent publications by EU-, OECD- and national experts, some principles and instruments to overcome these problems. The basic concept is:

- The producer of a surplus must be made the entity that is obliged to pay taxes on all forms of retained and distributed surplus;
- That way he has a self-interest to pay and report taxation of distributions correctly in order to avoid overvaluation of his profits and resulting overtaxation.
- Bank secrecy does not enter, if the taxes collected on distributed surplus are transferred to government anonymously, i.e. without the name of the beneficiary.

The impact is discussed for three cases:

- Application by one country alone: the producers or distributors of surplus in this country can be made to collect and - anonymously - pay to tax authorities, irrespective of the tax residence of the beneficiary.
- Application by an action group of EU-Member-States: application of the same concept to all producers, distributors and beneficiaries with tax residence within the action group; insofar bilateral agreements are replaced by group actions.
- Application by the EU: this would provide EU-wide ´taxation at the source´ - a flat rate enterprise tax without imputation and a flat rate withholding tax on distributed surplus that can be credited against the beneficiaries´ personal income tax. That way an efficient, simple and fair tax system could be established.