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Will the Consolidation of National Budgets Work? Do We Need an EU Tax?

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1. Will the consolidation of national budgets work?
2. Do we need an EU tax?
3. What does the consolidation of national budgets have to do with an EU tax?

The consolidation of national public budgets MUST work!

- **A high level of public debt may dampen economic growth**
  => Reinhart/Rogoff 2010: critical debt level 90% of GDP
- **Public debt may have negative distributionary consequences**
- **Public debt causes budgetary restrictions**
  => EU27 2010 -> 2011:
  - interest expenditure/GDP 2.8% -> 3.1%
  - interest expenditure/total expenditure 5.5% -> 6.1%
  - interest expenditure/tax revenues 11.5% -> 12.3%
  - danger of debt spirals for some countries

  => long-term perspective
  - European Commission Sustainability Report: EU27 sustainability gap by 2060 6.5% of GDP
  - European Commission Ageing Report: EU27 age-related costs by 2060 +4.7% of GDP

The consolidation of national public budgets WILL work, if…

- … experience from past budget consolidation episodes is taken into account
- … potential negative macroeconomic effects can be avoided („non-Keynesian“ effects cannot be expected automatically!)

Conditions for successful budget consolidations – stylised facts:

- Expenditure-based consolidations are more promising than primarily revenue-based ones.
- Cuts in public wages and social expenditure are particularly effective.
- The more difficult the initial budgetary conditions, the larger is the probability for success.
- A large consolidation package („cold shower") is more likely to be successful than a gradual consolidation approach.
- Institutional framework and political conditions are important.

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Macroeconomic effects of budget consolidations – theoretical approaches

Taxonomy	Main underlying assumptions	Definition	Value of the multiplier
Traditional Keynesian Multiplier	Slack in productive capacity; fixed price; static model.	Increase in income following exogenous increase in public expenditure or tax cut.	Positive and greater than 1.
Weak Keynesian	Productive capacity close to full use; market interest increase; exchange rate appreciation.	Partial or full crowing-out side-effects of budget changes limit the size of the multiplier.	Between 1 and 0.
Ricardian equivalence	Intertemporal Optimisation; forward looking agents; no liquidity constraints.	Precautionary behaviour of economic agents fully offsets fiscal policy changes.	Multiplier equal to 0.
Non-Keynesian	intertemporal Optimisation; large fiscal imbalances; risik premium on interest rates; credible fiscal consolidation.	Prompted by a credible fiscal consolidation, agents' expectations about future fiscal policy and future income improve.	Negative or close to 0.

Source: Briotti 2005.

„Non-Keynesian" effects of budget consolidations – empirical results

=> Surveys by Briotti 2005, Afonso 2006

- Econometric studies show that under certain conditions budget consolidations (structure, size, timing) may have short-run non-Keynesian effects
- Altogether, results non clear-cut and unambiguous
- Number of expansionary budget consolidations may be overestimated due to endogeneity problems or because accompanying monetary regime is neglected (Prammer 2004)

Guidelines for successful budget consolidations (1):

- Consolidation is not the only priority; coherent strategy is needed
- Communicating the goal and the strategy including a vision is important
- A proactive component is needed
- Fair burden sharing and equity considerations are important
- Consolidation should be growth-sensitive and underpinned by structural reforms

Guidelines for successful budget consolidations (2):

- Consolidation should be demand-sensitive
- Expenditure-based consolidation is more likely to be successful
- Boosting domestic demand specifically in countries with external surplus is required
- The structure of expenditure cuts matters
- The structure of tax increases matters

First (preliminary) evaluation of European budget consolidation plans (1)

- Almost all countries rely on mix of expenditure- and revenue-based measures
- Expenditure cuts seem to have a larger weight than revenue increases
- Revenue increases almost exclusively consist of tax increases (privatization revenues an exception – Greece)

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First (preliminary) evaluation of European budget consolidation plans (2)

- Integration of budget consolidation in long-run strategic economic policy concept not visible, including proactive component (Germany as an exception!)
- Cuts in the public wage bill often across-the-board; demand-sensitive and equitable cuts targeted to higher incomes only in few countries
- W.r.t. cuts in social transfers, pensions are in the focus – majority of countries planning to dampen pension expenditures aim at securing long-term sustainability of pension systems by increasing pension age
- Only few countries intend to cut expenditure on growth drivers (among them Austria)

First (preliminary) evaluation of European budget consolidation plans (3)

- Tax increases:
  - Focus on taxes with double dividends (alcohol, tobacco, environmental taxes)
  - Some countries raise wealth taxes, top income tax rates, some tax on the financial sector
  - Bulk of increases: VAT
  - No country has addressed the question how to use additional tax revenues after consolidation

- Growing interest in international / European taxes in international / EU political debate during the last decade
  - European Commission, „Financing the European Union, Commission Report on the Operation of the Own Resources System“, 1998 and 2004
  - IMF, „A Fair and Substantial Contribution by the Financial Sector“, 2010
  - European Commission, „Innovative Financing at a Global Level“, 2010
  - European Commission, „The EU Budget Review“, 2010

1. Do We Need an EU Tax?

- International/European taxes linked to the concept of international public goods characterised by
  - non-excludability
  - non-rivalry in consumption
  - cross-country spillovers

  (i.e. economic and financial stability, environment, scientific discovery, ...)
- International/European public goods are typically undersupplied
  => coordination mechanism among benefiting nations is required (concerning provision and financing)

Economic rationale of international/European taxes

- Principle of fiscal equivalence: financing and provision of a public good should be assigned to same jurisdictional level – users of public goods should be responsible for their financing
  => supranational provision + national financing implies danger of free riding

- Fair burden-sharing between countries involved requires internationally coordinated approach

- Taxes resting on mobile bases cannot be effectively implemented without international cooperation due to danger of tax avoidance/evasion

- Level playing field, avoidance of competitive disadvantages require coordinated approach

Which taxes would be good EU taxes? (1)

- Taxes on mobile bases/activities
  => danger of relocation
  => danger of suboptimally low tax rate for Pigouvian taxes due to tax competition
- Taxes on bases/activities with cross-border negative externalities
  => danger of suboptimally low tax rate for Pigouvian taxes

Which taxes would be good EU taxes? (2)

- Taxes with short-run revenue stability
- Taxes with high long-term elasticity
- Taxes for which there is a tight link between tax base / payments and national income level
- Taxes which may negatively impact on competitiveness of individual countries

„Conventional“ criteria to evaluate potential EU taxes:

- Effects on market efficiency
- Effects on equity and income distribution
- Effects on economic growth
- Legal and administrative aspects

Options for the design of EU taxes

- Assignment of one (or more) taxes to EU, to partially replace existing revenue sources
- Candidates: carbon / energy tax, VAT, financial transaction tax, corporate income tax, taxes on aviation
- Different designs / degrees of tax autonomy for EU conceivable:
  - surcharge on given tax base; tax rate and base determined by member states
  - assignment of existing national tax(es) to EU, i.e. complete harmonization; transferring the right to set tax base and rate to EU
  - introduction of new tax; EU deciding on tax base and rate

Expectations:

- Mitigation of „net contributor debate“ – and resulting underprovision of European public goods
- More transparent system of own resources
- Better use of potential of certain taxes which cannot be effectively implemented at national level as instruments to improve market efficiency (Pigouvian taxes)

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The EU debate about „innovative finance“

- European Commission (2010)
  => international taxes to raise revenues and as regulatory instruments helping to correct market imperfections
  - financial sector: international taxes on leverage or risk-taking by financial intermediaries to secure an adequate contribution to costs of current and future crises
  - climate change: internationally coordinated taxes (carbon tax, flight ticket tax) to finance policies to stop climate change
  - development: internationally coordinated tax incentives may contribute to raise additional private funds

Recent proposals for EU taxes (1)

Tax	tax rate and base	potential or actual revenues
General financial transaction tax	0.01 percent on all financial transactions between professional traders	in 2007 up to € 94 billion Europe up to € 211 billion worldwide (estimate by Picek – Schulmeister – Schratzenstaller, 2008)
Kerosene tax	EU minimum tax rate for diesel	€ 6 to 7 billion EU (estimate by European Commission)
Flight ticket tax	country-specific progressive scales based on destination and class alternative: 1 €/km	in 2008 € 170 million for various countries (actual revenues) € 12.8 billion
Carbon tax	€ 12 / tonne CO_2 in Denmark, € 108 / tonne CO_2 in Sweden, € 20 / tonne in Finland	in 2007, 0.3 percent of GDP in Denmark, 0.81 percent of GDP in Sweden, 0.29 percent of GDP in Finland (actual revenues)

Sources: European Commission (2010), Schratzenstaller – Berghuber (2007), Picek – Schulmeister – Schratzenstaller (2008).

Recent proposals for EU taxes (2)

Tax	tax rate and base	potential or actual revenues
Value added tax	Tax on largely harmonised VAT tax base, surcharge in addition to national taxation (e.g. 1%)	About € 40 billion (estimate by European Commission)
Corporate income tax	Tax on harmonised corporate tax base, maintenance of national tax rates and introduction of a minimum tax rate, attribution of one quarter of revenues collected EU-wide to the EU	About € 50 billion (estimate by European Commission)
Financial activity tax	Profits and boni paid out by financial institutions	€ 25 billion

Source: Schratzenstaller – Berghuber (2007).

Potential EU taxes

Tax	negative cross-border externalities	mobile tax base	high short-term stability	high long-term revenue elasticity	equitable national gross burden	negative impact on national competitiveness
General financial transaction tax	x	x	-	x	?	x
Kerosene tax	x	x	-	x	x	x
Flight ticket tax	x	?	-	x	x	-
Carbon tax	x	x	x	x	?	x
Value added tax	-	-	x	x	-	-
Corporate income tax	-	x	-	x	-	x

2. Do We Need an EU Tax?

Tax	Market efficiency	Equity and income distribution	Administrative and legal aspects
General financial transactio n tax	- unclear effect on price volatility - potential negative effects on allocative efficiency of financial markets - potential stabilising effect by reducing short-term speculative transactions	Unclear unequal distribution of financial transactions can be assumed	Compatibility with free movement of capital and payments (EU Treaty, WTO)
Flight ticket tax	No incentives for using least-cost abatement opportunities (small) disincentives for consumers	Progressive effects likely	Low administrative costs
Carbon tax	-Incentives for using least-cost abatement opportunities - risk of distortive effects by uncoordinated approach in EU	May require accompanying social expenditure to address social hardships as low-income groups tend to spend higher share of their income on energy and transport services	Carbon border tax: Practical and legal concerns (WTO compatibility) and administrative costs as well as risks of trade conflicts and retaliatory measures
Kerosene tax	incentives for using least-cost abatement opportunities disincentives for consumers	Progressive effects likely	Low administrative costs

Source: black letters: European Commission (2010); red letters: own amendments.

3. Consolidation of national public budgets and EU Tax

- Prima vista no direct link between consolidation of national budgets and EU taxes, which are designated for the EU budget
- EU taxes are intended to replace, not to complement national contributions to the EU budget
  => relieve national budgets from EU contributions (contribute to consolidiation); help to make national tax systems more growth- and employment-friendly by allowing cuts in distorting national taxes in the long run
- Should EU taxes partly flow into national budgets of EU member states to support budget consolidation?
  => Pro: helps to avoid more distortionary increases of national taxes
  => Con: may stifle incentives for fundamental structural reforms within the public sector to contain expenditures in the long run