

Moving Towards a European Tax Burden



Hannu Kaseva
Researcher
ETLA



Pentti Vartia
Managing Director
ETLA

An active tax reduction program would boost economic growth and lower unemployment. Finland has a greater need than its competitor countries, as well as the resources, for tax reform encompassing a substantial reduction in taxes on earned income.

Greater economic integration since the 1980s has changed the Finnish business environment in a fundamental way. World trade has grown faster than GDP for many years now. International direct investment flows have increased at twice the pace of world trade. Transnational corporations have led to increased competition by penetrating into national markets. Finland has also been involved in this process, and so far the results have been positive. The rise in Finland's standard of living has been largely based on the success of the country's export industries in the EU and the rest of the world.

Even though Finland's competitiveness is strong by international comparison, there is still much room for improvement on many fronts. Indeed, "hard" measures of competitiveness reveal that Finland's competitiveness is not as strong as commonly believed (see Rouvinen and Vartia, 2002).

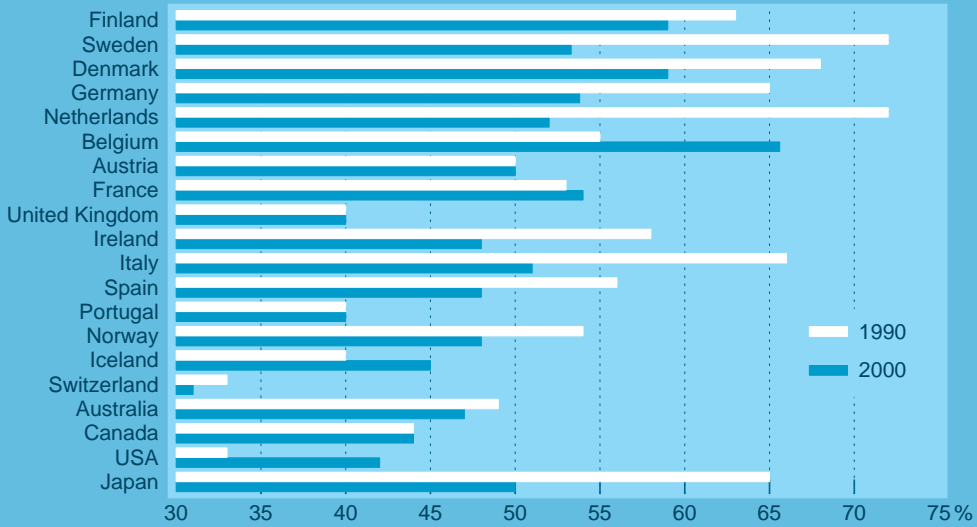
Tax Competition Has Increased

Acquiring new markets and achieving competitive size have become important factors determining the location of production facilities. Already in the 1980s and 1990s production was shifted closer to growing markets through in-

ternational mergers and acquisitions. Selecting the location of production facilities is also affected by many other factors, such as wage costs, the quality of infrastructure and research, the functionality of administration and, of increasing importance, international differences in taxes levied on labor, capital and corporate profits. At the same time, corporate management and high-skilled labor, such as key product development personnel, can move easily to countries with lower taxes on earned income and capital income.

For this reason, national governments are concerned about the heightened level of tax competition. Many OECD countries have reacted to this trend by lowering taxes on labor, capital and corporate profits, to maintain their attractiveness as a destination for production companies. This holds regardless of the size of the country or the level of its taxation. Keep in mind that the Southeast Asian "little tigers" are planning tax reforms. For example, Singapore, where taxes as a percentage of GDP are only 20 percent, is planning to further reduce corporate and personal income tax rates. With this measure, Singapore is striving to meet the challenges posed by China's strong economic growth and maintain its attractiveness as a destination for large corporations.

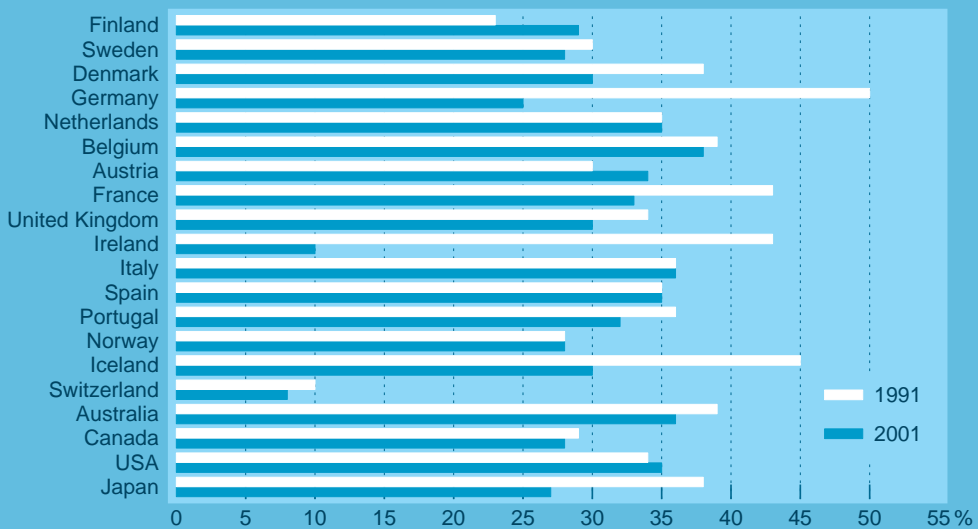
Highest Marginal Tax Rate on Earned Income in OECD Countries, 1990 and 2000



Source: OECD.

ETLA S02.2/f56

Corporate Tax Rates in OECD Countries, 1991 and 2001



Source: OECD.

ETLA S02.2/f57

Pressure To Lower Taxes in All OECD Countries

The ongoing tax competition is an indisputable reality also in the EU. Attempts to harmonize source taxes on capital income and value added taxes within the EU have not been successful. Deviating from common tax agreements is beneficial for a small country because it has very little to lose, yet much to gain, from having relatively lower taxes. A good example of this is Ireland, which offers foreign companies a low, 10-percent corporate tax rate.

Fiscal and tax policies in Finland have, with a few exceptions, been in line with those of industrial countries. Labor taxes have been eased, but capital income and corporate taxes have been raised.

Fiscal policy, being recommended also by the EU presently to member countries, is based on the principle of prudent fiscal housekeeping. Specifically, during cyclical upturns, taxes as a percentage of GDP should rise automatically to dampen demand and inflation. During economic downturns, growth in tax revenues should automatically slow, and when appropriate income taxes can be lowered in a discretionary

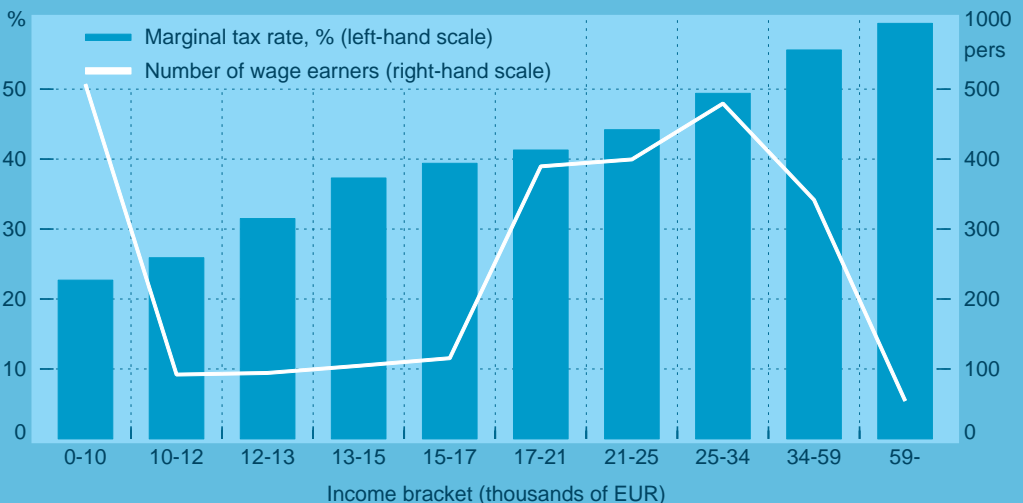
fashion, helping to offset the decline in employment and income.

When assessing the effects of lowering taxes it is important to remember that changes in taxation are a significant channel for countercyclical policy as well as an important tool for addressing structural policy issues. Taxation affects the demand side of the economy as well as its supply side.

High Income Taxes Reduce Incentives To Work

The negative effects of high income taxes have gained increasing attention particularly in the labor market. High taxes reduce labor supply and increase demand for leisure. If the average income earner is allowed to keep only half of the extra income he or she earns, it becomes obvious that this poses a significant barrier to attaining higher output growth. A middle-income wage earner making 28,000 euros a year still faces a marginal tax rate of 50 percent this year. There are around 800,000 wage earners, in other words around one-fourth of all employees, facing this and higher marginal tax rates in Finland. High and sharply increasing

Number of Wage Earners and Marginal Tax Rates by Income Bracket in 2002



Source: Finnish Tax Administration.

ETLA S02.2/f58

marginal tax rates tend to reduce the incentives of those persons with the burden of paying for the welfare state to increase earned income. For the same reasons, those persons having fallen dependent on the social security system do not have sufficient incentives to move off of welfare.

Fiscal Surpluses Should Be Used To Finance Tax Cuts

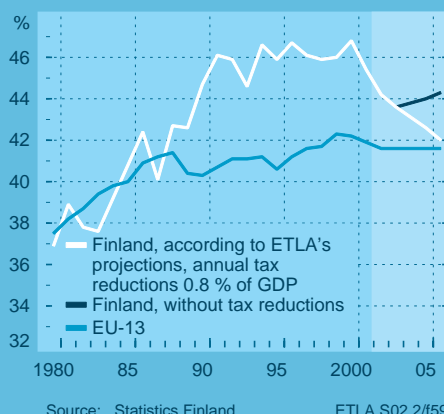
According to ETLA's medium-term forecast extending to 2006, presented in this issue, Finland's export-led growth is slowing from the rapid 5-percent average pace recorded in 1996-2000. Our projections point to average annual GDP growth of around 3 percent in the medium term. Slower growth will mean that the public sector budget deficit will remain more or less unchanged at its current level and that the unemployment rate will decline only slowly.

The risks associated with the economic outlook are greater than before. For example, there are many uncertainties regarding the growth prospects of the rapidly globalized electronics industry. The technology sector is currently shifting operations to regions offering lower labor costs and corporate taxes, for example China and Mexico. If our forecast for average annual output growth in the electrical equipment and electronics industry of 7 percent proves to be too high, then average Finnish GDP growth could decline from 3 percent to 2.5 percent per annum during the medium term.

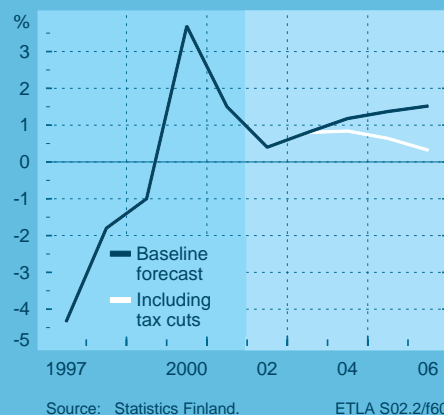
In any case, our latest projections show Finland's fiscal position starting off from a strong level. Thanks to the favorable decision on nuclear power, there will be more room to maneuver in fiscal policy and it is possible to cut taxes while keeping the central government balance from moving into deficit. The general government structural surplus will remain well in surplus at around 3.5 percent of GDP until 2006. In our baseline alternative, we assume that the only changes in taxation starting in 2004 are the inflation adjustments made to the tax rate tables. In this case, the tax burden would settle at 44 percent. Without further tax cuts, the central government would record a surplus of 1.5 percent of GDP in 2006.

This surplus provides the opportunity to implement an ambitious tax reduction program.

Taxes as a Percentage of GDP in Finland and the EU



State and Local Government Balance, % of GDP



State taxes on earned income could be reduced starting in 2004 so that taxes as a percentage of GDP would fall to 42 percent, i.e., the current EU level, by 2006. This would imply tax reductions amounting to around one billion euros annually, including the inflation adjustments. The central government budget would nevertheless remain in surplus, and at a better level than the aggregate Euro Area budgetary position.