Ingredients for a European Fiscal Revolution

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Roadmap of the talk

- **1. Euro-bonds** : the current euro zone crisis is very serious; if we do not mutualize our public debt, there is a serious risk that the euro becomes very unpopular very soon

  → new treaty & new euro-parliament
- **2. Euro-taxation**:
- **2.1. General context**: globalization, inequality ↑, low growth → we need tax justice & fiscal progressivity more than ever
- **2.2. Personal income tax**: left to member states? Ok but we need EU help, e.g. automated information exchange; so far savings directive didn't work → no more unilateral deals
- **2.3. Corporate income tax**: FTT not enough; we need EU corporate tax → no more unilateral corporate tax cuts
- **2.4. New balance between labor and capital**

  → no more unilateral repeal of wealth taxes

→ **without binding commitments (in PES platform?), local socialist parties tend to follow tax competition forces & behave like conservatives when they come to power…**

1. Getting out the crisis: eurobonds

- Euro zone countries have less public debt than US, UK, Japan... but we have a sovereign debt crisis, not them
- Europe is the richest economic area of the world: we should be able to fix our public finance pb without asking help to China or Brazil or the IMF...
- EU27: GDP 12 tril. €, pop 500m (24 000€ per capita)

  (Euro zone: GDP 9 trillions €, pop 330m)
- China GDP 4 tril. €, Brazil GDP 1,5 tril. €
- EU households own over 50 tril. € in net wealth (incl. over 25 tril. € in financial assets), i.e. 20 times more than China's reserves (2.5 tril.€), 5 times more than total EU public debt (10 tril. €)

→ **our problem entirely come from inadequate fiscal & budgetary institutions**

- US, UK, Japan pay 2% on their public debt; but Southern European countries – and maybe France in the coming months – pay 5%, 6% or more, including countries with less debt than US, UK, Japan
- Why? Because in US-UK-Japan the central bank plays its role of lender of last resort; a large fraction of the extra debt (≈10-20% of GDP) was purchased by the central bank; the ECB holds only 1,5% of GDP in public debt
- But the ECB will be able to fully play its role only if euro zone countries mutualize their public debt, which requires federal budgetary decisions, which requires a federal parliament with real budgetary power: either the European Parliament, or a new « European Senate » with MPs from national parliaments' finance commissions

2.1. Euro-taxation: the general context

- **Huge rise of income inequality** since the 1970s-1980s, especially in the US (>50% of total growth absorbed by top 1%) & in Anglo-saxon countries
- We observe the same trend in Continental Europe since the 1990s-2000s
- Tax competition tends to reduce taxes on top incomes & capital, and to exacerbate the trend
- Tax progressivity also affects on pre-tax incomes

→ so far the rise of inequality has been much less strong in the EU than in the US; but the same process is at work; this can destroy our social model; **we should react before it becomes as large as in the US**

The World Top Incomes Database

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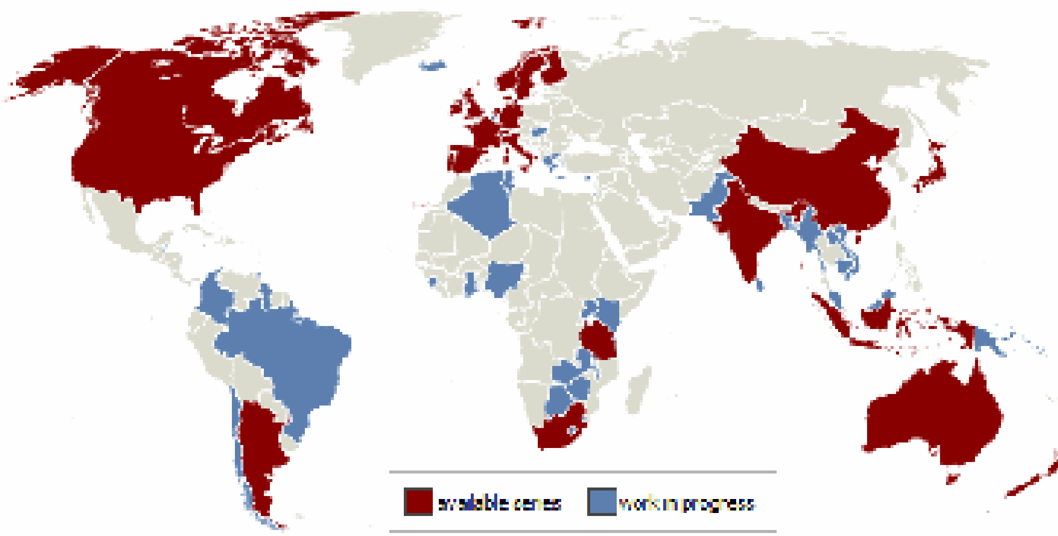


Institute for New Economic Thinking

Center for Equitable Growth

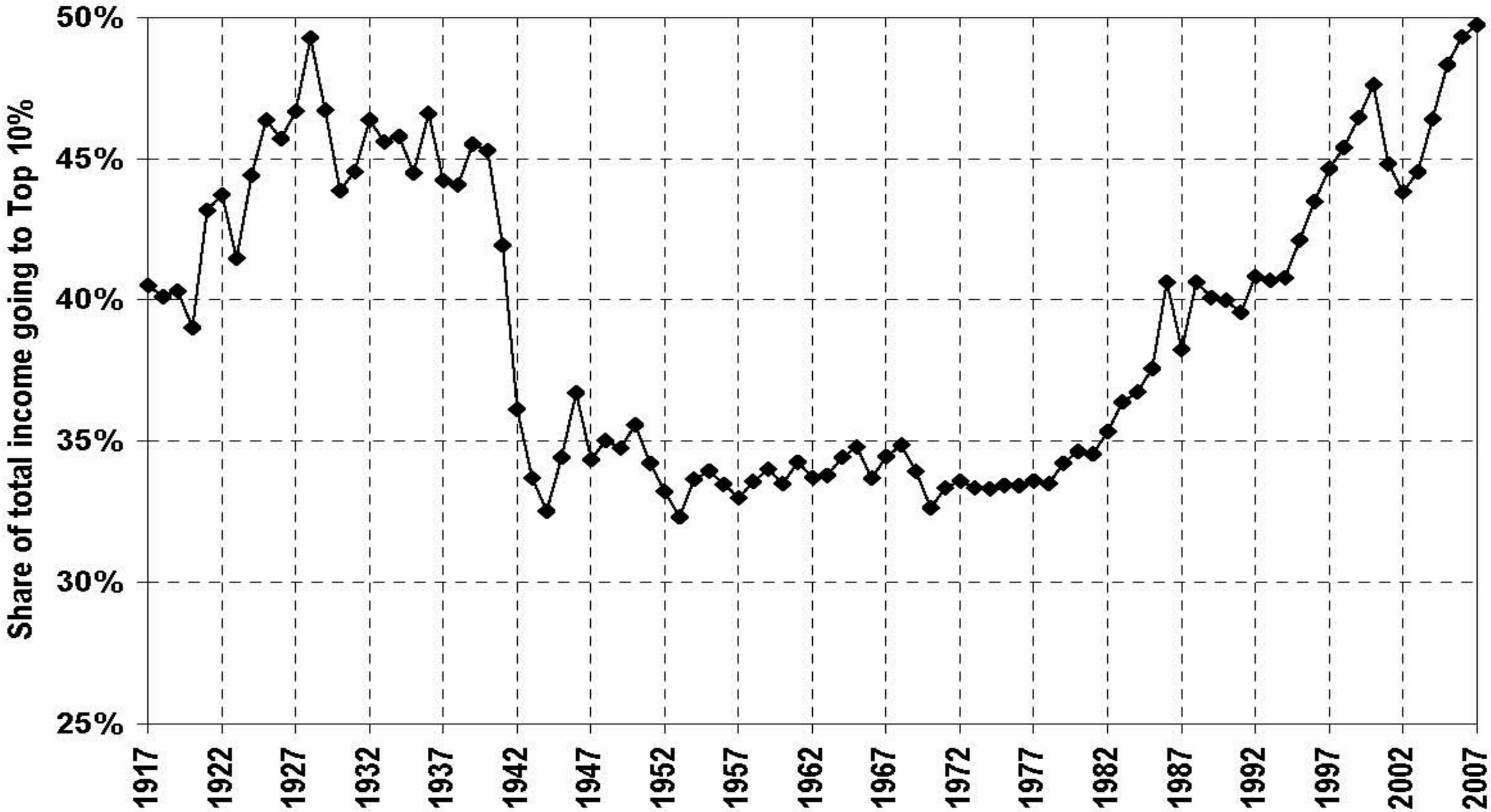


FIGURE 1
The Top Decile Income Share in the United States, 1917-2007

Source: Piketty and Saez (2003), series updated to 2007.
Income is defined as market income including realized capital gains (excludes government transfers).

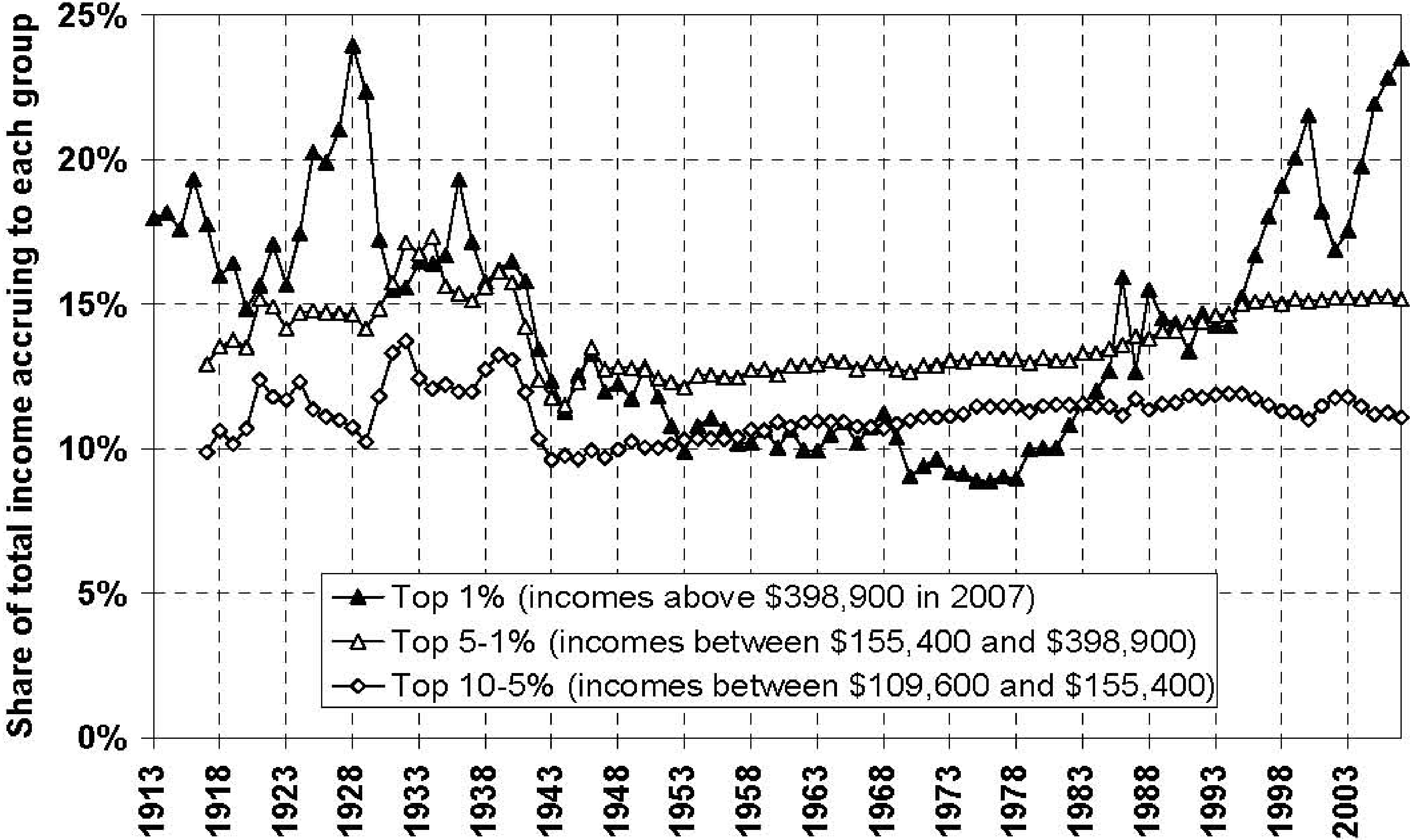


FIGURE 2

Decomposing the Top Decile US Income Share into 3 Groups, 1913-2007

Table 1. Top Percentile Share and Average Income Growth in the US

	Average Income Real Annual Growth (1)	Top 1% Incomes Real Annual Growth (2)	Bottom 99% Incomes Real Annual Growth (3)	Fraction of total growth captured by top 1% (4)
Period 1976-2007	1.2%	4.4%	0.6%	58%
Clinton Expansion 1993-2000	4.0%	10.3%	2.7%	45%
Bush Expansion 2002-2007	3.0%	10.1%	1.3%	65%

Computations based on family market income including realized capital gains (before individual taxes).
Incomes are deflated using the Consumer Price Index (and using the CPI-U-RS before 1992).
Column (4) reports the fraction of total real family income growth captured by the top 1%.
For example, from 2002 to 2007, average real family incomes grew by 3.0% annually but 65% of that growth accrued to the top 1% while only 35% of that growth accrued to the bottom 99% of US families.
Source: Piketty and Saez (2003), series updated to 2007 in August 2009 using final IRS tax statistics.

Figure 7A. Top 1% share: English Speaking countries (U-shaped), 1910-2005

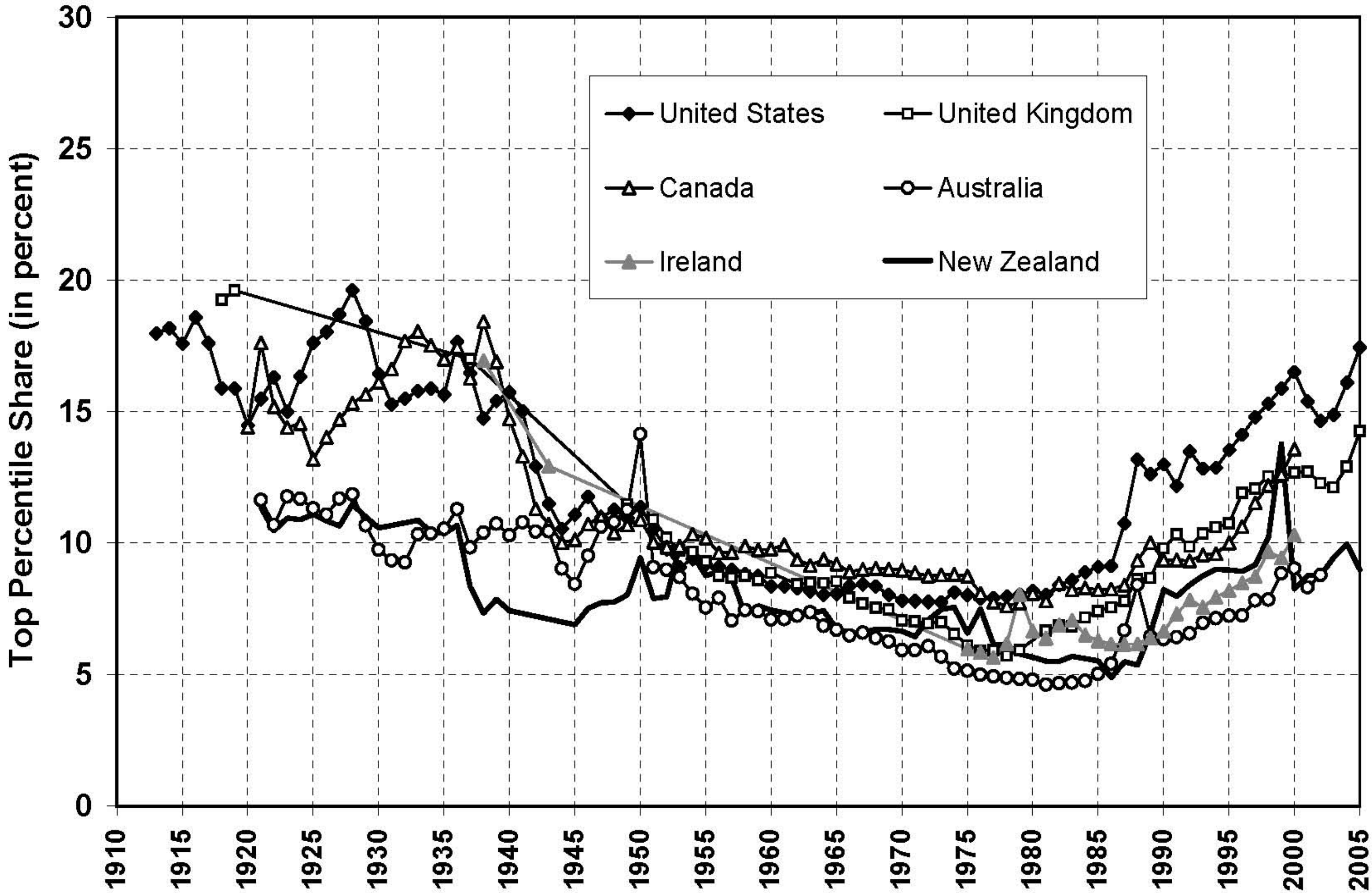
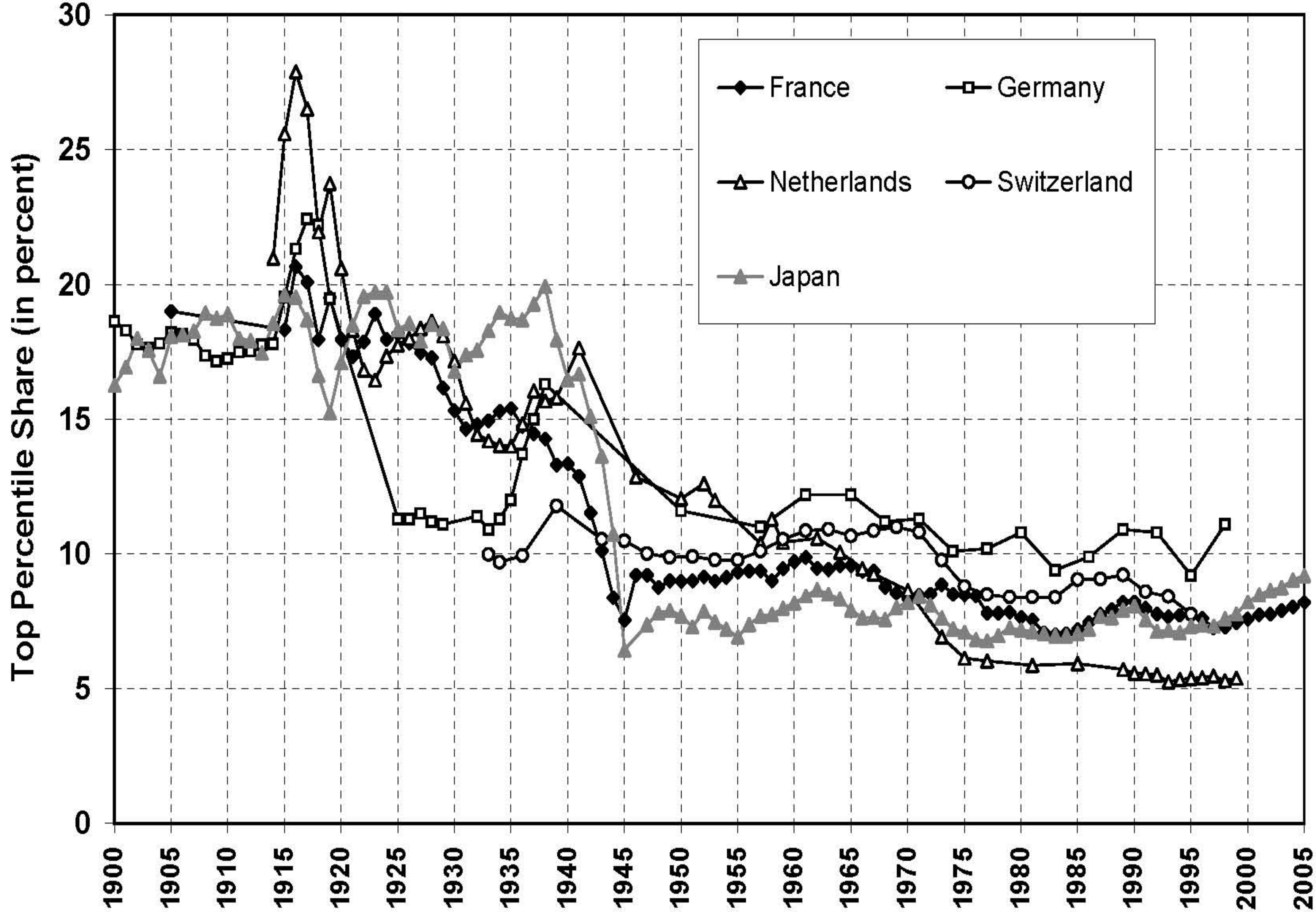


Figure 7B. Top 1% Share: Middle Europe and Japan (L-shaped), 1900-2005



Why are US top incomes so high?

- Hard to account for observed variations with a pure technological, marginal-product story

- One popular view: US today = working rich have become very productive; they simply get their marginal product (globalization, superstars);
- Europe today (& US 1970s) = market prices for high skills are distorted downwards (social norms, etc.)

→ very naïve view of the top end labor market…

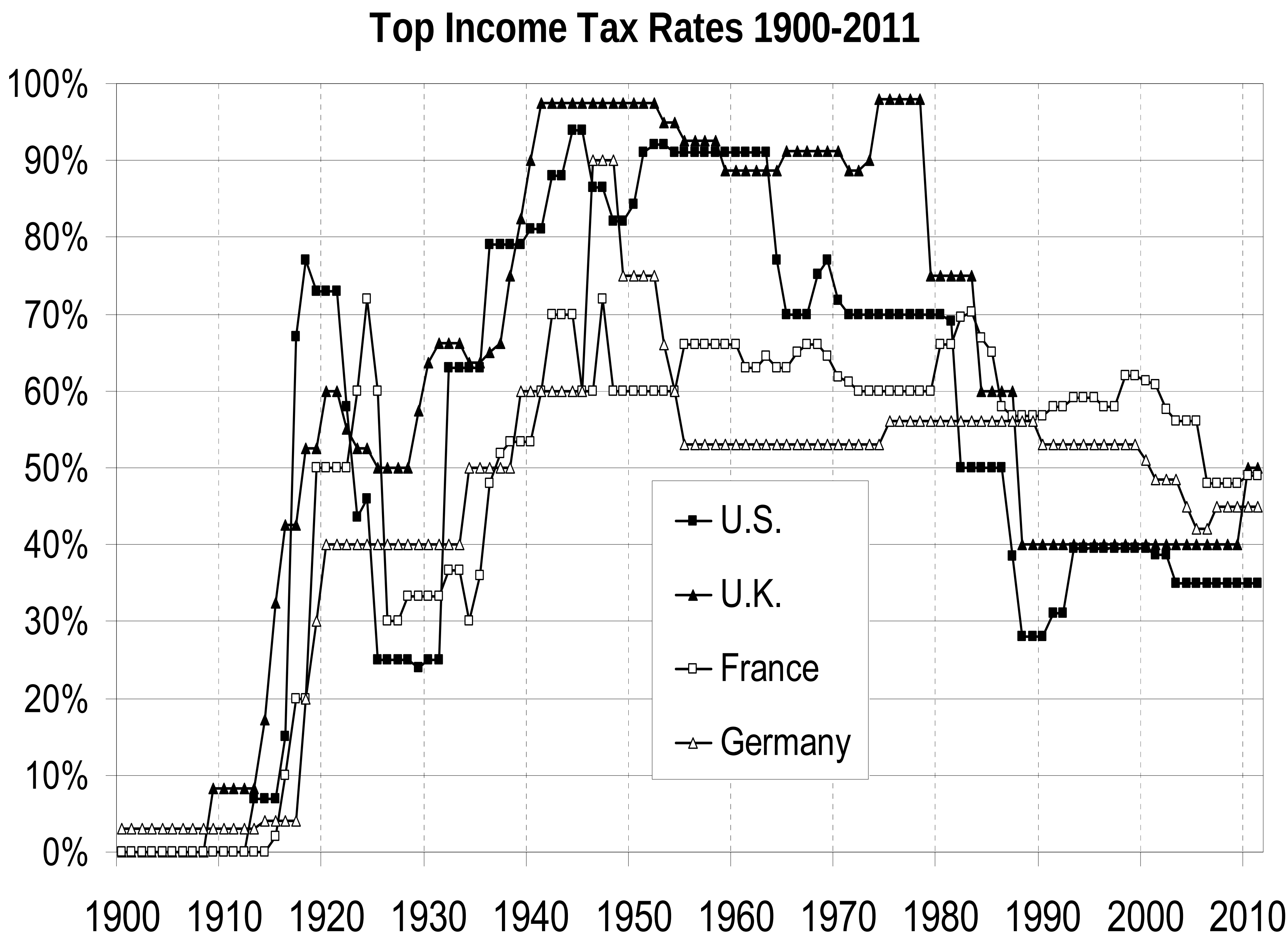
& very ideological: we have zero evidence on the marginal product of top executives; it could well be that prices are distorted upwards… very likely given that they set their own price !

- A more realistic view: **grabbing hand model** = marginal products are unobservable; top executives have an obvious incentive to convince shareholders & subordinates that they are worth a lot; no market convergence because constantly changing corporate & job structure (& costs of experimentation)

→ when pay setters set their own pay, there's no limit to rent extraction... unless confiscatory tax rates at the very top

→ **the decline in tax progressivity largely explains the huge rise in top incomes**

(memo: US top tax rate (1m$+) 1932-1980 = 82%)



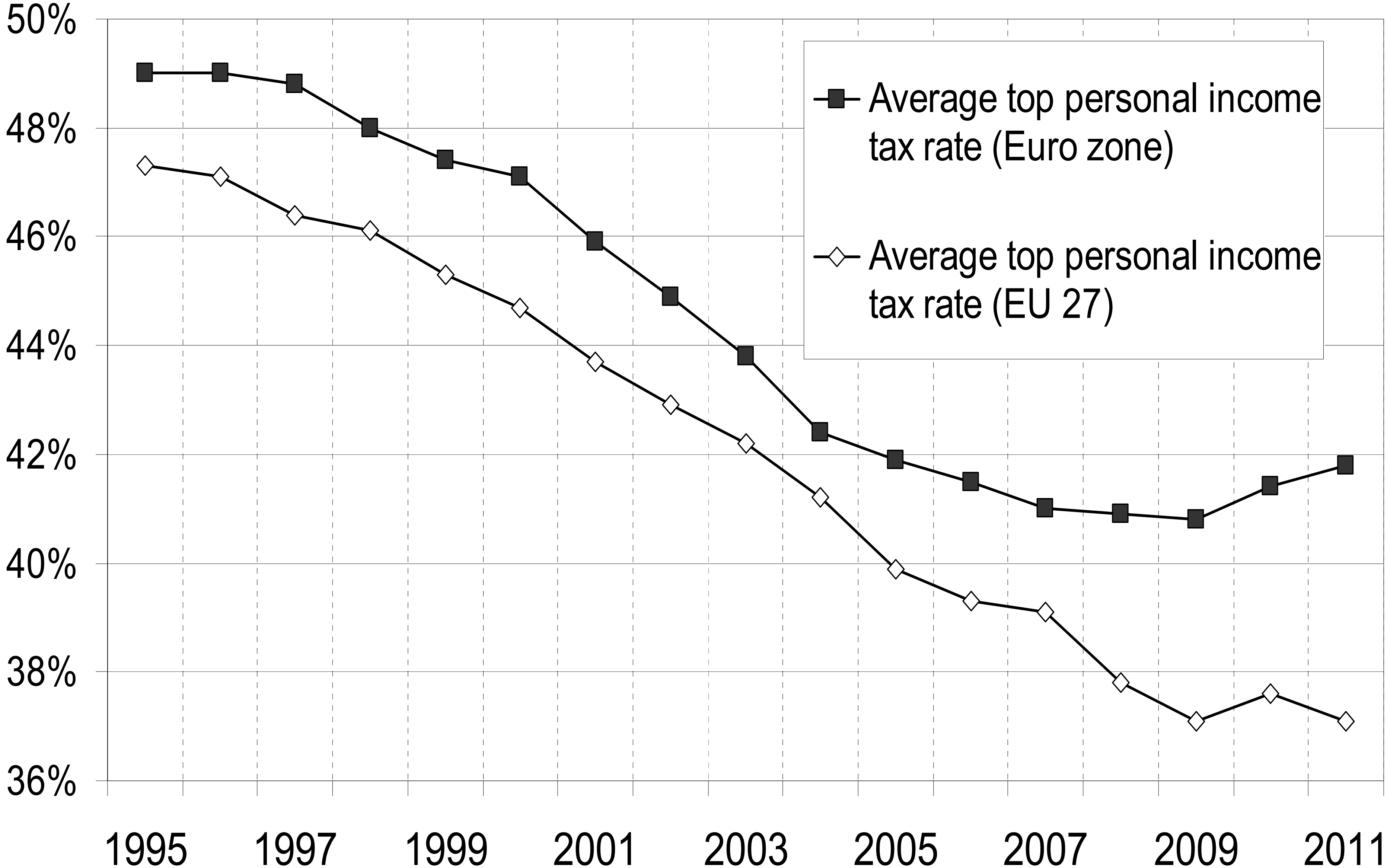
Top Income Tax Rates 1900-2011
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
1900
1910
1920
1930
1940
1950
1960
1970
1980
1990
2000
2010
U.S.
U.K.
France
Germany

2.2. Personal income taxation

- We need tax progressivity more than ever
- Standard EU view: personal income taxation should be left to member states. **Yes, but…**
- **Yes**. We cannot centralize everything at EU level. It makes more sense to centralize corporate taxation rather than personal taxation: firms more mobile than individuals.
- There is a lot that member states can do on their own in order to make their tax system more transparent, efficient and progressive
- Europe should not be used as an excuse to do nothing
- E.g. French income tax particularly archaïc: many special tax regimes, tax not levied at source → tax reform proposal to be implemented at the national level, interactive web site, see www.revolution-fiscale.fr
- **But…** the lack of tax coordination is becoming more and more problematic

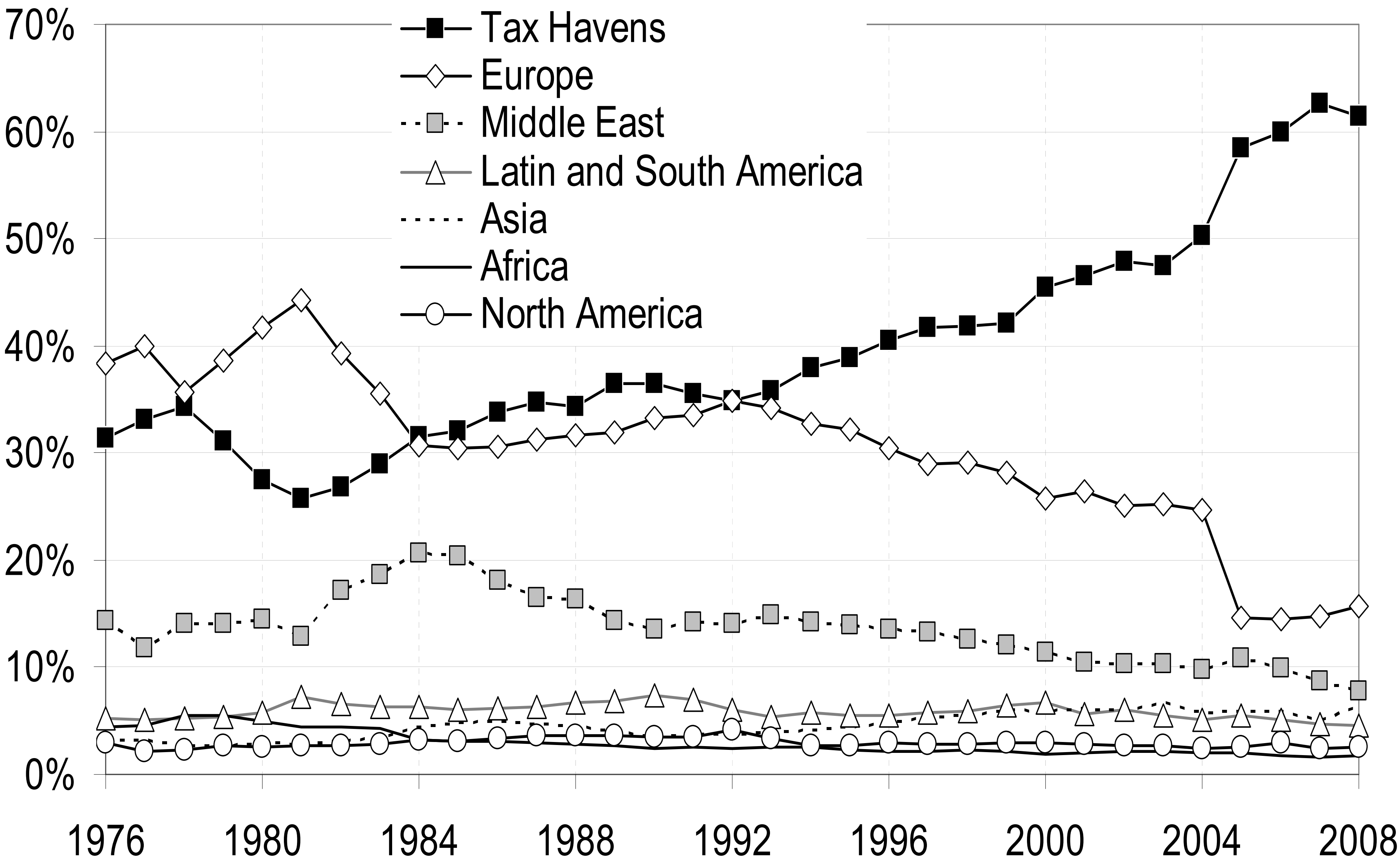
- **(a)** Tax competition → gradual decline of top tax rate (+ special regimes to attract foreigners with top incomes, see e.g. Denmark…) → can PES members agree to a minimal top rate of 50% ?
- **(b)** Without automated information transmission between countries, taxing capital income at the same rate as labor income is becoming increasingly difficult
- So far the EU savings directive has been a failure: too many loopholes; the “transitory regime” should come to an end; the directive should apply to accounts held via tax havens
- Can PES members commit not to pass unilateral side deals with Switzerland and other tax havens ?

Personal income tax competition in the EU



Source: Taxation trends in the EU, Eurostat 2011

Swiss deposits by country: The impact of the EU savings directive



Source: Gabriel Zucman, "The Missing Wealth of Nations", Paris School of Economics 2011, using Swiss National Bank data

2.3. FTT & corporate income tax

- Total financial transactions = 60 x GDP (6000% of GDP)

→ with a 0.05% tax, one can raise 3% of GDP in revenue

… except that the volume of financial transactions will fall following the introduction of a FTT

→ PES flyer: 200bil. € in revenue, i.e.≈ 2% EU GDP

- This is probably over-optimistic
- **FTT revenue: 0.5-1% GDP seems more realistic**

[Note: Financial sector ≈ 5-6% GDP, incl. 2% GDP in profits
→ it is hard to raise 2% GDP from a sector making 2% GDP
in profits → be careful with double-dividend illusion]

- **Bottom line: FTT is a good idea, but is not sufficient**

→ we also need a EU corporate income tax

- Total corporate profits (fin+non-fin) ≈ 12-13% of EU GDP

→ with a 30% tax, one can raise 3-4% of GDP revenue

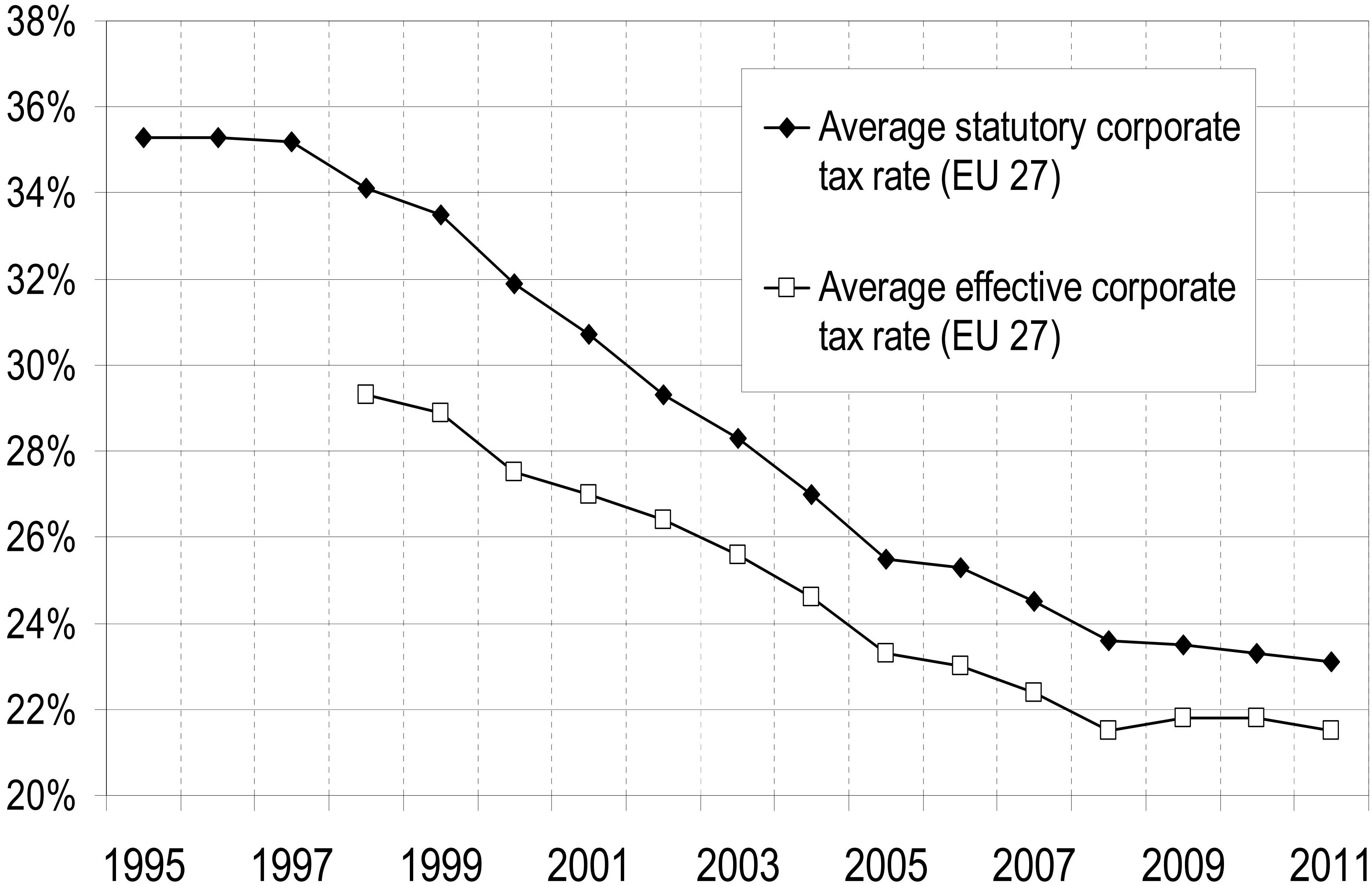
→ **corporate income tax might be less sexy than FTT, but its revenue potential is much larger !**

- Pb = tax competition between EU countries tends to drive effective corporate tax rates towards 0%...
- In principle, socialist parties are against tax competition
- But when they are in power they tend to do the same as conservative parties: see French PS proposal to cut corporate tax rate on re-invested profits in 2012

→ without a EU corporate tax, there will be no more taxation of coportate profits in 10 years…

→ **binding commitment in PES platform?**

Corporate tax competition in the EU



Source: Taxation trends in the EU, Eurostat 2011

2.4. New balance between labor and capital

- **Key mechanism: r > g** → bad for labor, good for capital → we need a new fiscal balance
- With low growth and r > g, two things happen:

(i) wealth-income ratios tend to be very large

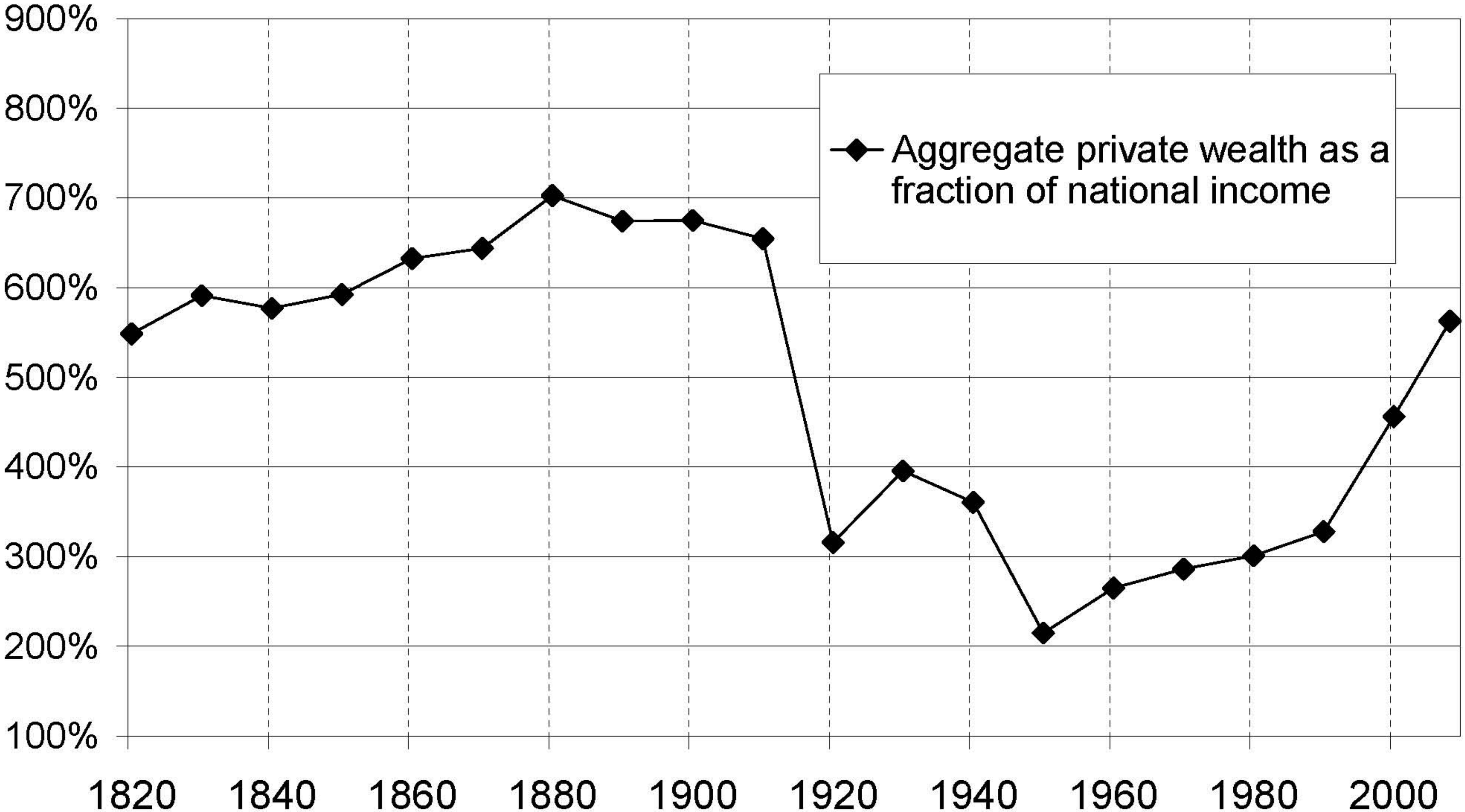
(ii) inheritance tends to dominate new wealth; i.e. the past eats up the future

(with: r = rate of return to capital = (net profits + rents)/(net wealth); g = growth rate)

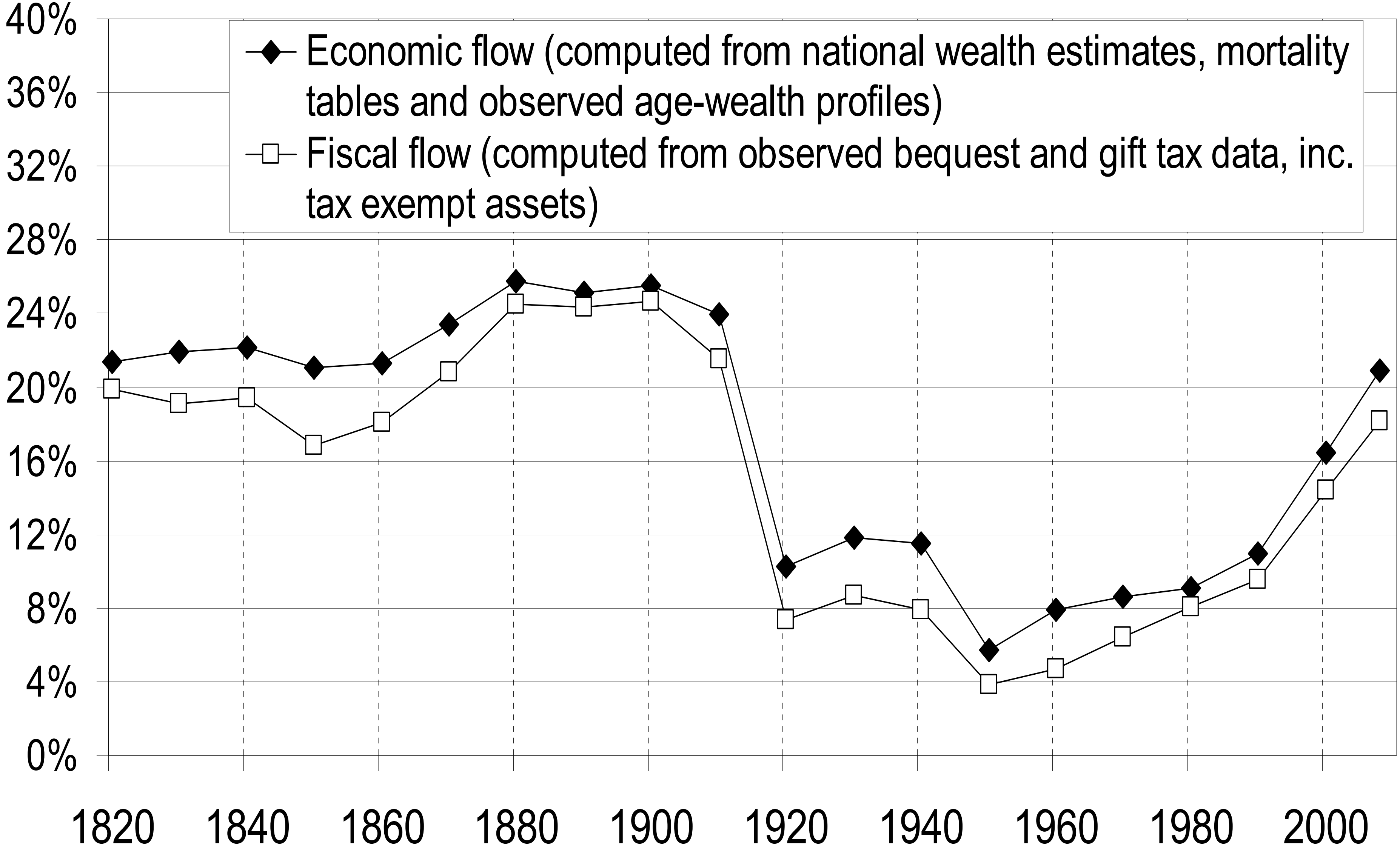
- **Intuition**: with r>g & g low (say r=4%-5% vs g=1%-2%), wealth coming from the past is being capitalized faster than growth; heirs just need to save a fraction g/r of the return to inherited wealth

→ It is only in countries & time periods with g exceptionally high that self-made wealth dominates inherited wealth (Europe in 1950s-70s or China today)

Figure 2: Wealth-income ratio in France 1820-2008



Annual inheritance flow as a fraction of disposable income, France 1820-2008



Source: T. Piketty, "On the long-run evolution of inheritance", QJE 2011

Conclusion

- A world with g low & r>g is gloomy for workers with zero inherited wealth… especially if global tax competition drives capital taxes to 0%…especially if top labor incomes take a rising income share

- **Europe is particularly vulnerable**: g very low (negative population growth in Italy, Spain, Germany), tax competition very high
- In the long run, we need EU coordination on all capital taxes: inheritance taxes, wealth taxes
- In the short run, let's try at least not to suppress wealth taxes when the left is in power (Spain…)