Tim Congdon

European Tax Harmonization and British Taxes

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I
Introduction

This pamphlet considers the potential impact of European economic and monetary integration on taxes in Britain. After discussing why tax harmonization and the single currency are widely acknowledged to be related parts of the same project, it considers whether and how much UK tax levels might have to rise.

One point is clear: taxes are higher in other European nations than in the UK. On present rates the UK's tax-to-GDP ratio would have to rise by one-sixth to bring it into line with the rest of the EU. But if government spending in the UK relative to GDP were to rise to the EU level, and if budget deficits were to be harmonized in accordance with the Maastricht Treaty, they would have to rise by over 20%. Given that in the EU the ratio of government spending to GDP has been on an upward trend, the future increase in UK taxation would be larger, indeed, it might be as much as a third in little more than a decade from now.

The pamphlet then considers which taxes would be increased. Surprisingly, the corporate tax burden in the UK is not low by European standards. Indeed, no major divergence in revenue (relative to GDP) is evident from a survey of taxes on personal and corporate income, on indirect tax and taxes of property. Rather, the difference in the tax burden between the UK and the EU is explained entirely by social security contributions, which are about 6% lower (as a share of GDP) in the UK. This contrast is largely explained by the UK's distinctive pension arrangements, with extensive funded coverage by the private sector.

The pamphlet concludes by considering the economic effects of tax harmonization. It argues that full-scale tax harmonization across the EU might result in a special welfare levy designed to equalize labour costs. This would lead to a further shift to low-productivity work in the informal sectors of all European economies, and make for reduced employment, output and living standards in the UK.

II

Tax harmonization and EMU

Tax harmonization and the single currency are integral to European economic and monetary union (EMU). About that there can be no doubt. Dozens of speeches have been given by European heads of state and European Commissioners emphasizing the role of both developments in the process of integration that is now under way. It is therefore reasonable to analyze the consequences of European tax harmonization for the UK as if such harmonization would result from the adoption of the single currency.

This is not to deny that, in principle, tax harmonization and the single currency could be separate and unrelated. It would be possible for the nations of Euroland to have a single monetary unit of account and different tax levels. After all, the states of the USA have a single currency, but widely divergent state and local taxation. It would also be possible for the nations of Euroland to have distinct currencies and similar tax levels and, indeed, much the same tax structure.

However, in the real world of the late 1990s, tax harmonization and the single currency are joint and related aspects of the integrationist project. The close relationship between them was noted by the Commissioner for EMU, Mr Thibault de Silguy, in an interview with *The Sunday Telegraph* in December last year. He ventured the hope that the single currency would strengthen the links between the different nations' financial markets and then judged that, 'For integrated financial markets to work we must harmonize taxes'. Pressure on the UK and Luxembourg to introduce withholding tax on financial securities is the most topical and urgent expression of the harmonization drive, but Mr de Silguy made clear that - as far as he was concerned - this would be only the beginning. In his words, 'Harmonization of corporate taxes is the next item on the agenda'.

Despite the abundance of statements linking tax harmonization and the single currency project, Britain's Prime Minister, Mr Blair, has insisted that one does not imply the other. Both he and Mr Gordon Brown, the Chancellor of the Exchequer, have said that the UK retains its veto in tax matters. They might appeal to the wording of the Presidency Conclusions which emerged from the meeting of the European Council in Vienna on 11th and 12th December last year. Paragraph 21 welcomed 'reinforced tax policy co-operation', but accepted that such co-operation 'is not aiming at uniform tax rates and is not inconsistent with fair tax competition'. Superficially, Mr. Blair is right to assert that tax harmonization would not entail the same tax rates, even though it might involve convergent tax structures. But this does not really wash. The Presidency Conclusions also state that Europe's leaders oppose 'harmful tax competition', 'continuing distortions to the single market' and 'excessive losses of tax revenue'. In other words, once the systems of taxation had become harmonized, pressure for greater uniformity of rates would follow in order to prevent so-called 'distortions' and 'excessive' revenue losses in high-tax countries.

The inevitability of a drive towards similar tax rates is shown by the Commission's approach to value added tax, where 42% of the receipts are already the Union's 'own resources'. The Commission has constantly worked for the harmonization of both the system of assessing and collecting VAT across the EU, and for the rate at which the tax is levied. Moreover, even if harmonization were to stop with tax structures and to leave tax rates at national discretion, it must not be overlooked that significant costs might be incurred by taxpayers even if the tax rates were negligible and revenues trifling. The imposition of VAT on UK transactions in commercial property, of a withholding tax on interest from securities issued in the UK and of the *droit de suite* on sales of works of art by the London auction houses may generate tiny amounts of revenue, but they all imply significant compliance and monitoring costs for the industries affected.

In short, tax harmonization may be interpreted as an explicit and deliberate by-product of the introduction of the single currency. The UK is undoubtedly regarded by other European states as the source of 'harmful tax competition'. The central questions for British policy-makers become 'how much would UK tax levels have to rise?', 'which taxes would be increased most?' and 'what would be the economic effects of such increases?'. Suggested answers to these questions will be given in the following three chapters, which review the tax position of the UK and its European partners, but an important proviso needs to be made at the outset. The main source of information for the charts is the latest issue of the

OECD's publication *Revenue Statistics*. The OECD has attributed revenue to various categories, such as 'corporate taxes', 'property taxes' and so on, while the data are not entirely up-to-date. The categorization is necessarily arbitrary, while some statistical obsolescence is inevitable with any data source. The conclusions of this study therefore depend to some extent on the OECD's approach to compiling the numbers.

III
How much would UK tax levels have to rise?

The answer to this question is fairly clear. In 1996 tax was 36% of GDP in the UK and almost 42% in the rest of the European Union. (See Chart 1.)[1] Assuming that harmonization were to the average in the rest of the European Union (and not to the average of the EU as a whole), the UK's tax burden would have to rise by about a sixth. That would of course be most unwelcome to the UK's taxpayers, but it is not the end of the bad news. In the long run taxes must be related to government expenditure. In the 1990s the difference between the ratio of government expenditure to GDP in the UK and the rest of Europe has been and remains greater than the difference between the ratio of tax to GDP. Of course, the divergence between the tax burden and the importance of the state in the economy largely reflects differences in budget deficits. In the last few years the ratio of the budget deficit to GDP has been lower in the UK than in the rest of Europe and, indeed, at the moment the UK has a budget surplus.

In 1996 government spending was 41.8% of GDP in the UK, but 49.6% in the EU as a whole and somewhat more than 49.6% in the EU excluding the UK. (See Chart 4.) So the burden of government spending was about 20% higher in the rest of the EU than in the UK. The OECD projects that in 1999 the ratio of government spending to GDP will be 38.9% in the UK, but 47.0% in the EU as a whole. The burden of government spending to GDP now is therefore almost 25% higher in the rest of the EU than in the UK. It follows that - if the aim were to harmonize both tax levels and the ratio of the budget deficit to GDP - taxes in the UK would have to rise by between a fifth and a quarter. As the objective of the Maastricht Treaty is openly to secure similar budget deficits (relative to GDP) across the member countries of the single currency zone, this calculation seems more appropriate than that based on 1996 tax burdens alone. The precise figure depends on how far the 1999 projections are viewed as cyclical and temporary, and so put the UK in an unsustainably favourable light. Further, enthusiasts for European integration might claim that the large expenditure increases announced by the present UK Government for the last three years of the current Parliament will narrow the gap between the UK and the rest of Europe.

1 For all charts, please refer to the end of the text.

This may or may not be so. It needs to be remembered that Europe is dominated at present by left-wing governments, all of which have plans for extra expenditure. Arguably, a neutral procedure is to examine the past behaviour of tax as a share of GDP in the UK and the rest of Europe, and to see whether any long-established trends can be identified. (See Chart 6.) If they can be identified, the trends may reasonably be extrapolated. Taking the OECD data as the source, a simple time trend was estimated back to 1965 for tax as a share of GDP in the UK and the EU15. The equation for the EU15 found a significant positive coefficient on the trend term, whereas that in the UK equation was not significant.

So, in a forward projection, it is fair to suggest that the ratio of tax to GDP will continue to rise in the EU15, but not in the UK. Chart 7 shows the results of this exercise. By 2011 (i.e., 15 years from 1997, the last year for which actual figures are prepared by the OECD) tax is over 50% of GDP in the EU15, but under 40% in the UK. When allowance is made for the UK itself accounting for about a seventh of EU output, the implication is that - little more than a decade from now - the UK tax burden would have to rise by over a third to equalize taxes in the UK and the rest of Europe.

This result may come as a shock to supporters of the UK's participation in the single currency project. It certainly goes a long way to explain our neighbours' interest in preventing so-called 'harmful tax competition'. Euro-philes might object that the statistical extrapolation is naive and flimsy; they might claim that the obvious political importance of the conclusion is out of balance with the limitations and simplicity of the analytical method. Fair enough, but this does not excuse them from conducting their own work on prospects for public expenditure within Europe. Of course, the UK's advantage could be squandered by policy mistakes. If the Labour Government's intention is a large expansion of public expenditure and a sharp increase in taxation in order to make the UK comparable with the rest of Europe, its leaders might be more forthcoming on the details.

As for our neighbours, big changes in the direction of public expenditure and fiscal policy are implausible. In fact, studies have been carried out by such organizations as the OECD, the International Monetary Fund, the World Bank and the International Labour Office on future trends in public spending across Europe[2]. They arrive at much the same verdict as the one suggested here, that the gap between the tax burden in the UK and the rest of Europe is likely to widen, not narrow, over the next few decades. This widening is readily explained as the joint product of the ageing of Europe's populations and the UK's distinctive reliance on substantial private provision for pension funding. Contrary to much propaganda, there is little evidence of a worthwhile shift across the continent of Europe towards so-called 'Anglo-American' styles of pension funding.

To summarize the answer to the first question, the increase in UK taxation implied by European tax harmonization is at least a sixth and, more likely, it is between a fifth and a quarter. Moreover, the initial jump in taxes would be only the start. Over the next 15 years or so, the increase compared with current levels might be as much as a third. This increase - which is to be understood in terms of the ratio of tax to GDP - would occur as the result of the UK's alignment with a European average boosted by neighbouring governments' long-term promises on pensions and social security.

2 See International Labour Office, *From Pyramid to Pillar* (Geneva, 1989); World Bank, *Averting the Old Age Crisis* (Oxford: OUP, 1994); and OECD, *Policy Implications of Ageing Populations* (Paris, 1996).

IV
Which taxes would be increased most?

It is time to consider the second question. Where would this extra burden fall? What kind of taxes would be raised? The stated purpose of tax harmonization is to end alleged distortions due to differential tax incidence on essentially the same economic activities. Presumably this end would be achieved if much the same revenue (or revenue-to-GDP ratio) were to arise from particular kinds of tax in all EU countries. If so, one way of answering the question is to compare the amounts of revenue raised at present by different types of tax in the UK and the rest of the EU, on the assumption that tax harmonization would in future move the UK closer towards the EU's existing pattern.

Much political attention is paid to income tax, because it is direct, transparent and newsworthy. Taxes on personal income are indeed higher in the EU than in the UK. Whereas in 1996 they represented 11.3% of GDP in the EU on average, in the UK they were 9.3%. (See Chart 8.) As is well-known, tax on particularly high incomes is lower in the UK than in other European countries. The UK's top rate of 40% compares with top rates elsewhere typically above 50%, which may be one reason for the often-expressed preferences of European company managements to locate their headquarters and research functions in the UK. However, the 2% difference between the UK and the rest of the EU in the personal-tax-to-GDP ratio is small compared with the contrast in the overall tax level. The major source of difference in the tax burden must lie elsewhere.

Europe's leaders have made no secret that they want to target the taxation of income from capital (such as interest and dividends) and corporate taxation. The Vienna meeting of the European Council invited the Commission 'to pursue work on the proposals for a Directive on the taxation of savings and for a Directive on interest and royalties'. Despite protests from Mr Blair, Mr Brown and their Luxembourg counterparts, these Directives are to be ready before the Helsinki meeting of the European Council in December 1999. Again following a recommendation from the Vienna meeting of the European Council, the Commission has started work on a study of company taxation in the EU. As noted earlier, Mr de Silguy has been outspoken in urging that harmonization of corporate taxation be the next step after the harmonization of withholding taxes.

Apparently, the advocates of increased European integration believe that the UK has a lower level of company taxation than other EU countries, while they see harmonization as raising UK corporate taxes towards the European norm. The truth is more complex. The standard rate of corporation tax varies widely across the EU. According to Ernst & Young, the lowest rates are in Sweden and Finland, and are under 30%. The UK comes next with 30%, but it is not particularly abnormal. Several countries have rates between 30% and 40%, and only two (Germany and Italy) are above 50%. A starkly different message is given by the OECD statistics on actual revenues from corporate taxation. Expressed as a ratio of GDP, company taxation is higher in the UK than in the EU as a whole. Indeed, it is above the level in 11 other EU countries. According to the OECD, the country with the lowest burden of company taxation in the EU is Germany and the second-lowest is France. (See Charts 10 and 11.)

This contradiction of the stereotypes may be surprising. It emphasizes the importance of careful attention both to the definition of terms and to the detailed structure of tax at the national level. The key point here is that Germany, France and Italy may ostensibly have heavy corporate tax, but in reality they do not. The high rate of corporation tax is more than offset by generous depreciation rules and investment allowances; the effective rate of company taxation is much less than the standard rate of tax on company profits. Paradoxically, the harmonization of company taxation might lower the taxes paid in the UK on company profits. However, this should not be understood as a recommendation that the UK participates in the process. Theoretical analysis and ample empirical evidence suggest that a low standard rate accompanied by sensible depreciation rules and minimal investment allowances is more conducive to economic efficiency than a high rate balanced by a multitude of special concessions.

The facts - as opposed to the conventional wisdom - show that the UK is not a tax haven for companies. Despite all the accusations of 'harmful tax competition' directed at the UK, and despite the widely-held view that tax competition between nations is concentrated in the corporate sphere, British companies pay taxes amounting to a higher ratio of GDP than their

European equivalents. Even more unexpected is that the statistics do not show international tax competition leading to a long-term decline in the ratio of taxes on corporate income to GDP. The ratio of taxes to corporate income is highly cyclical, due to the marked cyclicality of profits themselves, but the underlying trend over the last 30 years has been for it to increase both in the UK and in the nations of the EU taken together.

So taxes on personal income are only 2% lower relative to GDP in the UK than in the EU as a whole and taxes on corporate income are slightly higher. Where, then, is the big difference in the tax burden? Two other OECD's categories are taxes on 'goods and services' (i.e., indirect taxation) and taxes on property. Do they go some way to bridging the gap between the UK and other European nations? The answer is a clear 'no'. In 1996 indirect taxes in the UK yielded revenue amounting to 12.7% of GDP, much the same as the EU average of 13.0%. The UK exempts food and children's clothing from VAT (unlike the rest of the EU), whereas its excise duties are more important revenue raisers than their equivalents in neighbouring countries. However, despite the differences in structure, the UK's overall indirect tax burden is close to the European norm. Taxes on property are very miscellaneous. In the UK the most important is the council tax, whereas some European countries have a proliferation of minor wealth taxes as well as local property taxes. At any rate, the OECD estimates that taxes on property raise 3.8% of GDP compared with a European average of 1.8% of GDP. (See Chart 12.)

So where is the big difference in the tax burden? The aggregate tax take is certainly lower in the UK than in its neighbours, but a survey of taxes on personal and corporate income, indirect taxation and taxes of property has failed to identify any major divergences in the amount of revenue (relative to GDP) raised from any of them. Only one important type of levy remains, social security contributions. It turns out that virtually all of the difference in the aggregate tax burden between the UK and the rest of Europe is explained by this one item. In 1996 social security contributions amounted to 6.2% of GDP in the UK, which was almost half the EU average of 12.2%. The 6% gap here was virtually identical to that between a total tax take in the UK of 36.0% of GDP and in the EU of 42.4% of GDP. (See Chart 13.)

A case could be made that social security contributions are not 'taxes' in the usually understood sense. In the UK - as in other European countries - they are credited to an account which, by statute, is distinct and separate from the main central government accounts. The resulting National Insurance Fund is intended to cover benefit payments without affecting the rest of the Government's finances. Indeed, every five years an actuarial appraisal is made of the National Insurance Fund's ability to meet future claims[3]. The UK's national insurance contributions could be regarded as analogous to life insurance premiums within the private sector and not really as taxes at all.

The counter-argument is that the link between any one individual's contributions and benefits is tenuous, as well as being opaque to most people. The Government has the power both to raise NI contributions while leaving benefits unchanged and to boost benefits without accompanying it by an increase in contributions. In the last 20 years the Government has often used this power without much regard to actuarial solvency. Moreover, the pattern in the UK for many years has been a decline in the relative importance of contributory benefits, which are paid from the National Insurance Fund and notionally related to contributions. Non-contributory benefits, paid by general taxation, have gained ground and are doing part of the job once assigned to contributory benefits. In short, the boundaries between contributory and non-contributory benefits, and between the National Insurance Fund and other government accounts, are arbitrary and administrative, not substantive. 'Social security contributions' can be seen as a form of taxation.

The evolution of social security contributions in the UK over the 30 years to 1995 has been distinctive. Even in the 1960s they were lower, as a share of GDP, in the UK than in the rest of Europe, but the difference was little more than 1% of GDP. Over the following decade social security contributions rose - again relative to GDP - in both the UK and the EU15. It was in the 20 years from 1975 that the divergence became marked. In the UK social security contributions remained steady at about 6% of GDP, while in the EU15 they climbed from under 10% of GDP to over 12% of GDP. Perhaps the key event differentiating the UK from other European countries was the decision in 1981 to base future increases in the state pension on prices, not earnings. The implication was that - with economic growth, rising real earnings and stable demography - the ratio of state-financed pension

3 National Insurance Fund, *Long Term Financial Estimates* (London: HMSO,

spending (and so of national insurance contributions) to GDP would fall. This adjustment, combined with the Conservative Government's related measures to phase out the State Earnings-Related Pension Scheme (SERPS), signalled a large future increase in reliance on private pension provision.

Now - almost 20 years after the changes - the benefits to the UK in terms of lower social security contributions, and so in lower labour costs, have become apparent. Employers' social security contributions are only 3.4% of GDP in the UK, while the unweighted average for the EU15 is more than twice as high at 6.9%. (The weighted average for the EU excluding the UK might be nearer 8%. The EU average includes a figure for Denmark of 0.3%, but this arises because of an anomaly in the Danish arrangements whereby social security taxes are categorized with indirect taxes.) In France employers' social security contributions are 12.2% of GDP, while in Germany and Italy they are 7.8% and 10.3% of GDP respectively. The difference between the UK and other European countries has undoubtedly affected behaviour. High social security contributions discourage employment and reduce participation in the labour force. In 1995 the labour force participation ratio for men aged between 55 and 59 was 73.7% in the UK, compared with 66.1% in France, 71.6% in Germany and 67.9% in Italy; in the same year the labour force participation ratio for men aged 60 to 64 was 50.1% in the UK, but 28.9% in Italy, 28.5% in Germany and only 17.0% in France.

Heavy social security costs also cause people to transfer from full-time work as employees; they stimulate the growth of self- employment and of small-scale, part-time, informal employment, where the payment of contributions is administratively a nuisance and may be legally unnecessary. The productivity of self-employed workers and part-timers in the informal sector is far less than in full-time work for large companies. Perhaps not surprisingly, in most European countries the number of people working full-time in the private sector is lower today than it was 20 years ago, while productivity growth has slowed. The UK has suffered from these patterns, but not to the same degree as its neighbours.

In some ways the crucial role of social security arrangements in explaining the UK's tax advantage is ironic. Decisions taken during the 18 years of Conservative rule to 1997 explain both the lower aggregate tax burden in the UK and the particularly low burden of social security costs. The Conservatives are sometimes criticized for being biased towards business and profits, at the expense of labour, wages and employment. When EU Commissioners say that harmonization of company taxation is the next priority in the integration project, they may have this image of the UK in mind. Their targets undoubtedly include the UK's 30% standard rate of corporation tax and similarly low standard company tax rates in a few other countries.

But - to repeat - the facts do not conform to the stereotype. Despite the common perception that the UK has manipulated company taxation in order to attract foreign direct investment, the statistics show that UK companies pay more tax on profits - relative to GDP - than companies elsewhere in the EU. The dramatic contrast between the UK's tax structure and the average EU tax structure lies not in the corporate area, but in taxes on employment. The policy reforms in the two decades of Conservative rule were favourable to increased labour force participation and employment, particularly when compared with contemporaneous developments in the rest of the EU.

V
What would be the economic effects of tax harmonization?

Assuming that tax harmonization means a move both to a uniform aggregate European tax burden and to a similar structure of taxation, the conclusions of the analysis are straightforward. Incentives for employers to take on workers and for workers to seek employment would be reduced. Further, workers would regard permanent, full-time and high- productivity employment as less worthwhile. Such employment requires full payment of social security contributions, whereas temporary, part-time and low-productivity employment often does not. In short, for the UK the harmonization of its tax system to the European norm implies a big rise in taxes, which in the medium term might be as much as a third; this rise would be concentrated in social security contributions; and its results would be less employment, lower productivity per person and lower national output.

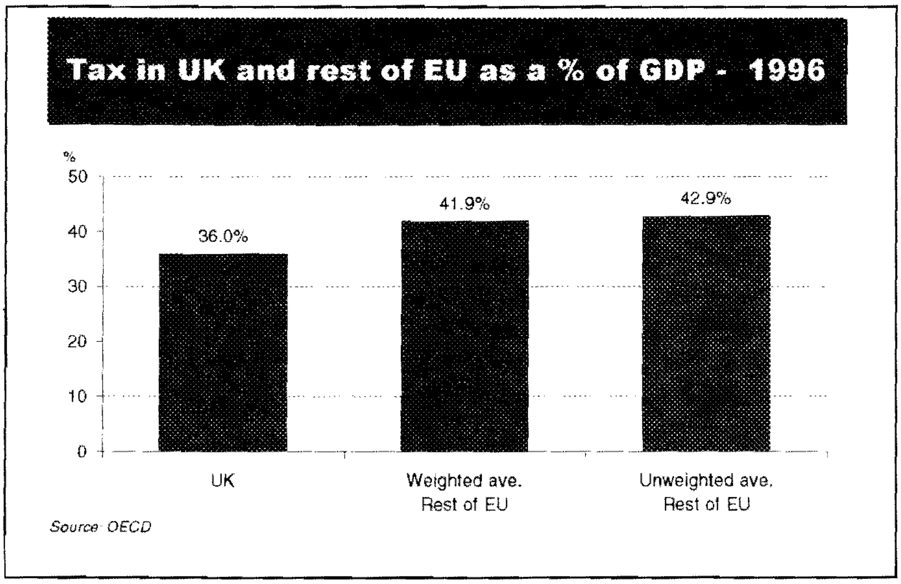
It is difficult to believe that any British politician - whatever his or her party affiliation - could be in favour of these outcomes. Enthusiasts for greater British involvement in European integration might protest that no EU initiative exists either for uniform levels of government spending or for harmonization of social security arrangements; they might therefore insist that pan-European tax harmonization does not necessitate the large increase in the UK's social security contributions indicated by the analysis in this paper. But they cannot escape the connections between tax, deficits and spending. Recent statements from the European Commission and leading European politicians are unquestionably for tax harmonization, including a levelling of tax rates, while the Maastricht Treaty takes away most national discretion on the size of budget deficits. If tax and budget deficits are given, national governments cannot be free to determine the level of expenditure. That is a matter of logic.

Similarly, the contention that social security contributions are linked to welfare benefits at a national level, and so cannot be transformed into an EU-wide scheme for welfare provision, is unconvincing. Of course, the wholesale pan-European amalgamation of national social security systems is implausible. But it would not be beyond the wit of the European Commission to propose a European welfare levy, to be applied uniformly to wage costs all over Europe and yet with the proceeds redistributed to high-cost countries. (Indeed, the EU's existing Structural Funds have an openly redistributive purpose. Note also the recent hints of changes to the Common Agricultural Policy, which would reduce support for high-income farmers. The UK has a relatively concentrated farm sector, with more high-income farmers than other EU countries.)

VI
Conclusion

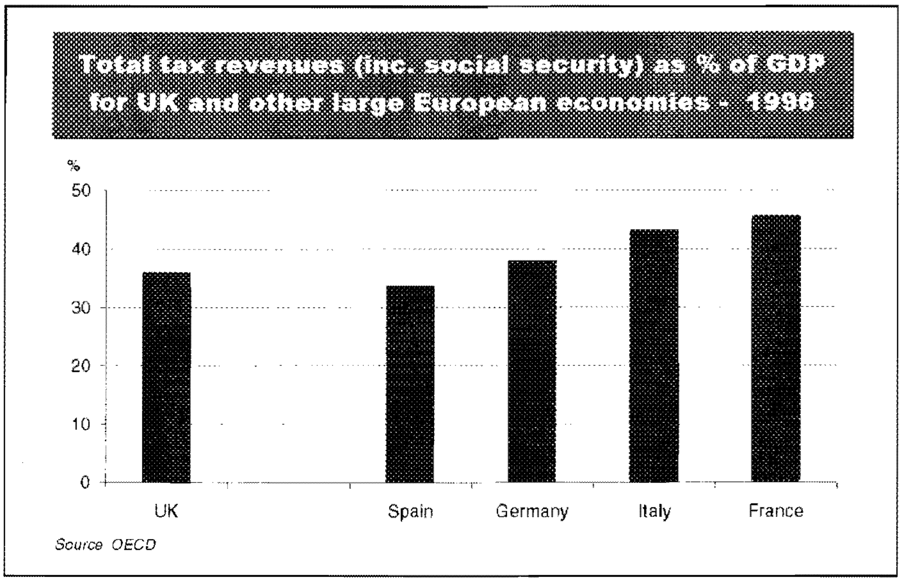
Europe's leaders deserve to be judged by their rhetoric as well as by their actions. Whatever the weaknesses in the single currency project, the rhetoric has in the end led to action. Over the last few years members of the European élite have been forthright in their views about tax and EMU. They have advocated tax harmonization in an increasingly unified European state, not tax competition between sovereign nation states within a European free trade area. Largely because it had almost 20 years of continuous rule by a political party which believed in the free market and a reduced economic role for the state, the UK is nowadays a low-tax country by European standards. If it participates in EMU, the UK would become a higher-tax country; if it embraces European integration warmly, it might a generation from now be part of a high-tax region in a world where tax competition between regions is intensifying.

Charts



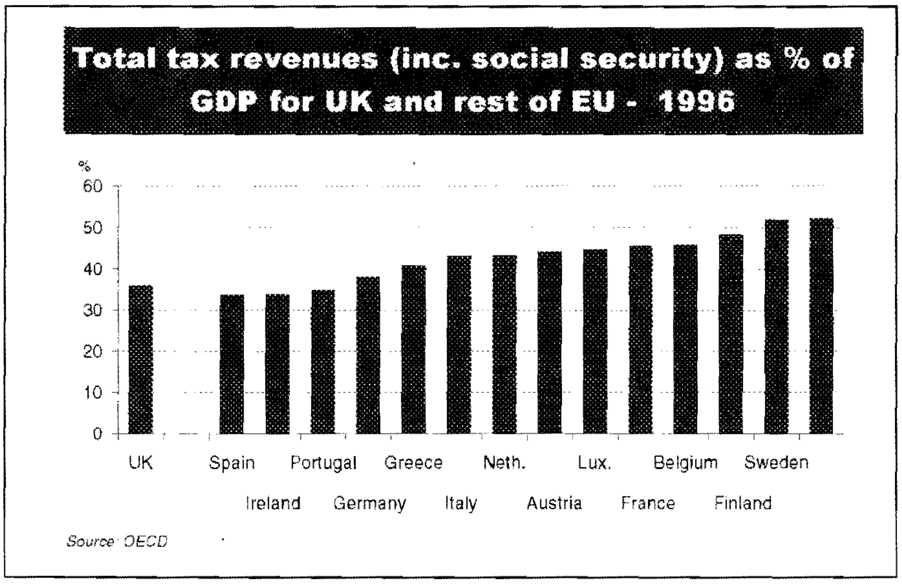
1 Tax in UK and rest of EU as a % of GDP – 1996

Several methods of comparing different nations' tax burdens are possible. A comparison of the ratio of tax to GDP has the virtue of simplicity, but note that – by having a good tax structure – a country may be able to raise considerable amounts of revenue without too much damage to incentives. The UK is generally regarded as having a relatively straightforward tax structure by European standards, with its system of company taxation being one of the least complex and distorting. (For example, the UK has a low rate of corporation tax, but raises more taxes from companies – relative to GDP – than other European countries. Its tax rules do not give extensive hidden subsidies to the corporate sector, as in Germany.) The UK tax system is far from ideal, but - if the tax-to-GDP ratio were the same - it would probably be less destructive of incentives and economic efficiency than the tax system in most of its European neighbours. In fact, the tax-to-GDP ratio is somewhat lower, as the chart shows.



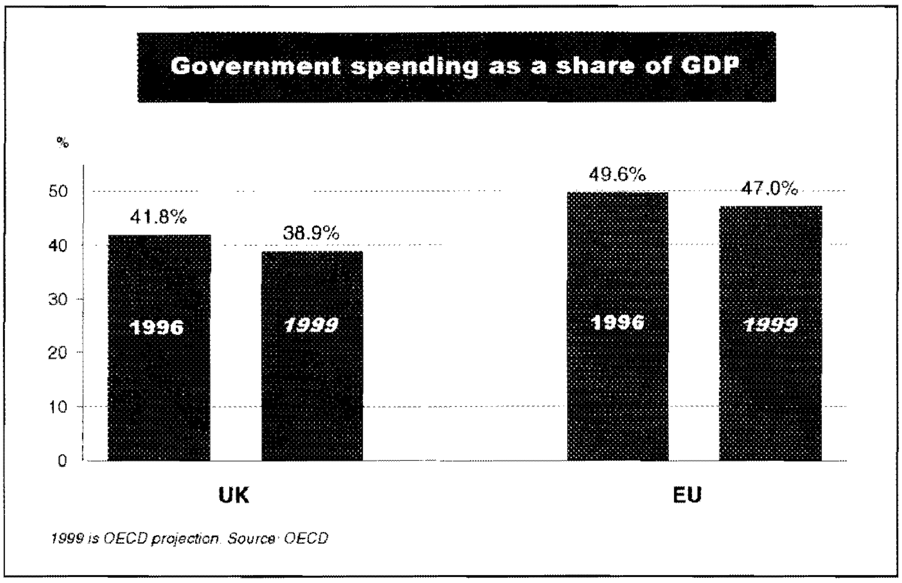
2 Total tax revenues (inc. social security) as % of GDP for UK and other large European economies – 1996

In 1996 the UK has much lower taxes (relative to GDP) than France and Italy, but – according to the chart - it had only a small advantage compared with Germany and a somewhat higher tax burden than Spain. The small advantage compared with Germany may be deceptive, because German companies also had to make government-imposed payments for nursing homes and coal subsidies, and some allowance should perhaps also be made for church tithes. However, this brings in a further dimension, of how far certain private-sector payments (such as pension contributions) are virtually compulsory and so akin to taxation. Spain's relatively low tax burden helps to explain why the UK and Spain worked together at the 1998 Vienna meeting of the European Council to resist tax harmonization. But Spain – unlike the UK – benefits substantially from the EU's Structural Funds.



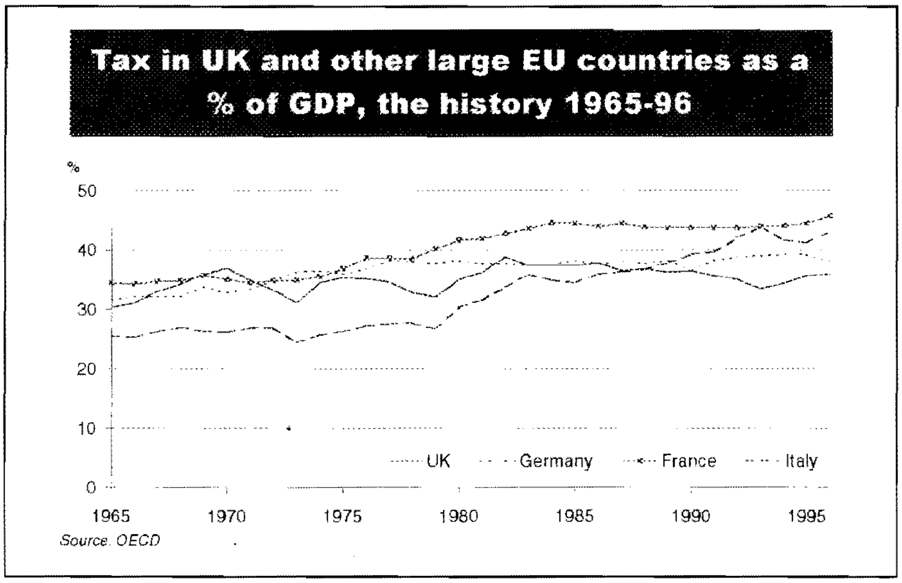
3 Total tax revenues (inc. social security) as % of GDP for UK and rest of EU – 1996

The British press often attributes resentment about the UK's low taxes to German politicians, such as Oskar Lafontaine, the former finance minister. But the chart shows that some smaller countries have a much higher tax burden than Germany. If some relocation of corporate activity to the UK has occurred from Germany, the pressures ought to be much more intense on Sweden, Denmark and Finland. In fact, the last few years have provided clear evidence of corporate relocation from these countries to the UK. For example, the merger of Pharmacia (a Swedish company) and Upjohn was followed by a decision to have the new entity's headquarters in Windsor. On the whole these relocations have been of expensive headquarters and research staff, implying that the relatively low taxation on high personal incomes has been an important motive.



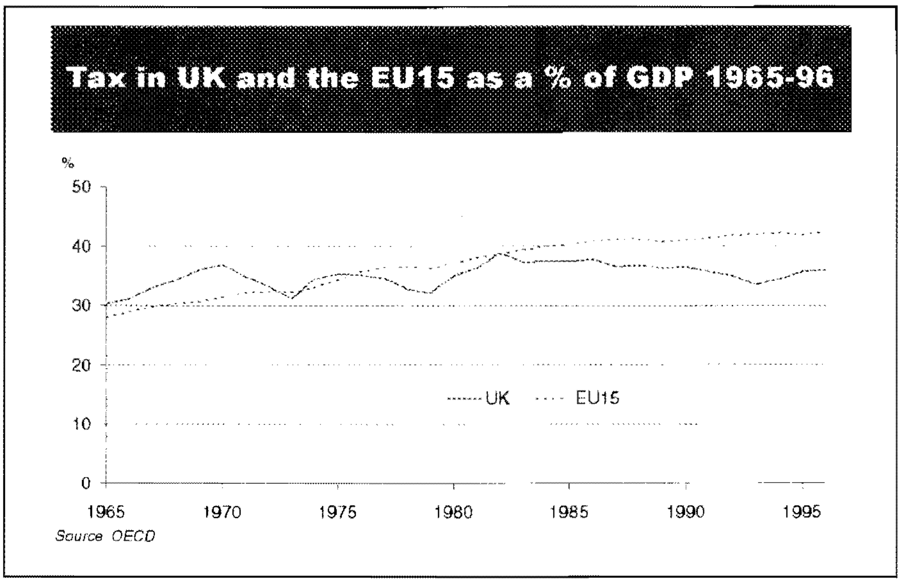
4 Government spending as a share of GDP

Comparison of tax-to-GDP ratios may be misleading, because – sooner or later – taxes have to be related to government spending. Arguably, comparison of government spending relative to GDP is a more reliable way of assessing the burden of the state. In recent years the gap between the UK and the rest of the EU on the government-spending-to-GDP ratio has been greater than the gap on the tax-to-GDP ratio, because the UK has usually had a smaller budget deficit. In fact, the UK's record in controlling public debt has been the best in the EU over the last 20 years. It is the only EU country where the ratio of gross public debt to GDP is lower now than it was in 1979, an achievement which owes much to North Sea oil revenues and privatization, but which is still worth emphasizing. All European countries have benefited in the 1990s from lower defence spending (as a share of GDP) and a smaller debt interest charge due to lower interest rates.



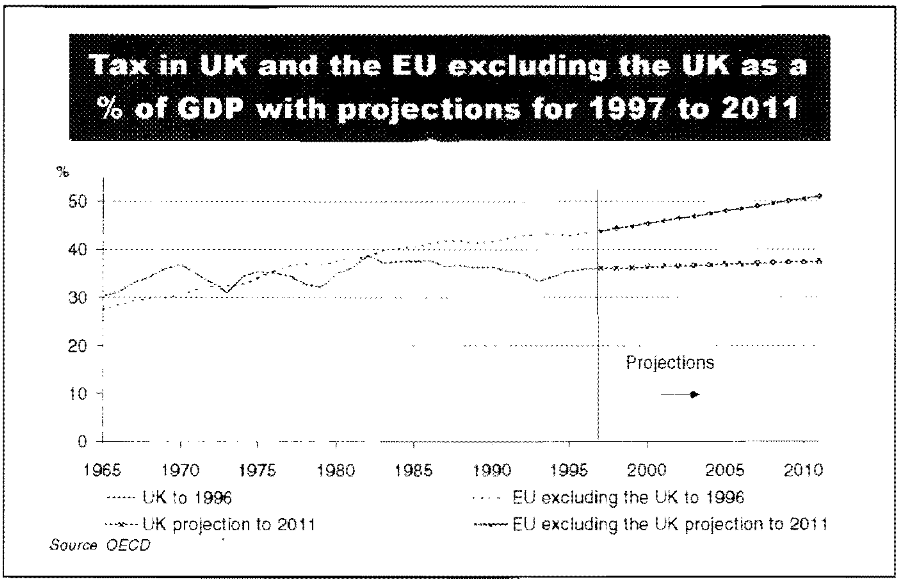
5 Tax in the UK and other large EU countries as a % of GDP, the history 1965 - 96

The UK has not been a low-tax country by European standards for most of the post-war period. The chart shows that in the 1960s and 1970s Italy had the lowest tax burden of the four large European countries. Indeed, the tax-to-GDP ratio in Italy only exceeded 30% in the early 1980s. But Italian government expenditure was already rising rapidly in the 1970s, largely because of over-generous social welfare promises. In the 1980s and 1990s taxes have had to catch up, with the result that the Italian tax burden in the early years of the next century will be almost double what it was in the 1950s and 1960s. The paucity of foreign direct investment in Italy in recent years may be partly explained by this development. The contrast with the UK – which has become a favoured destination for such investment - is obvious. (Note that in the 1950s UK taxes were higher than the European average.)



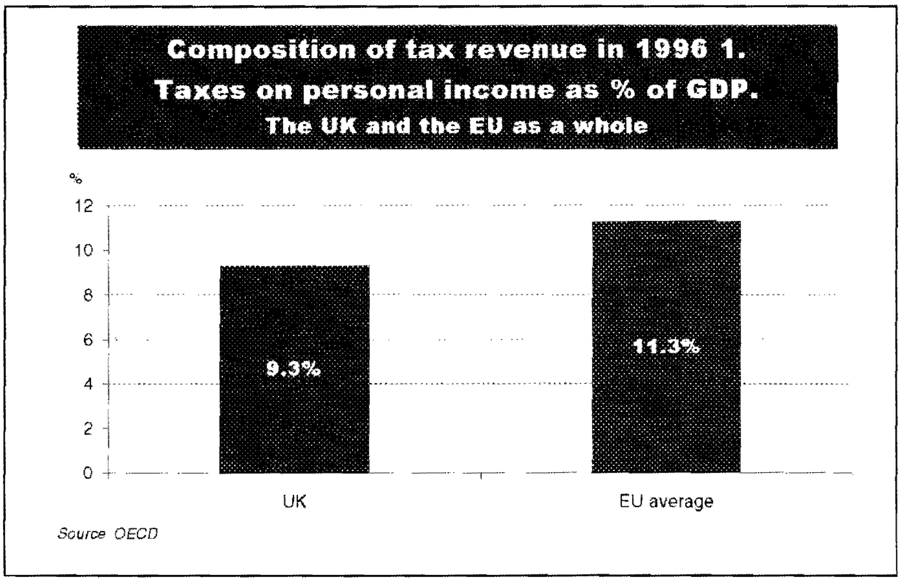
6 Tax in UK and the EU15 as a % of GDP 1965 – 96

Like other statistical material in this study, the data for the chart is taken from the OECD's *Revenue Statistics.* The OECD publication gives a figure for the tax-to-GDP ratio in the EU15 as far back as 1965, even though in 1965 the EU did not exist. (The European Economic Community had only six members.) At any rate, most of the EU's current members have had the same borders and similar population sizes over the last 35 years. (The exception is Germany, because of re-unification in 1991.) There is little reason to doubt the general message given by the chart, that in the mid-1960s the UK's tax burden was close to the European average but that by the late 1990s it was rather lower. (Note that the EU15 includes the UK. So the gap between the UK and the other EU14 is slightly greater than shown by the chart, both when the UK's tax burden was above the EU average and more recently.)



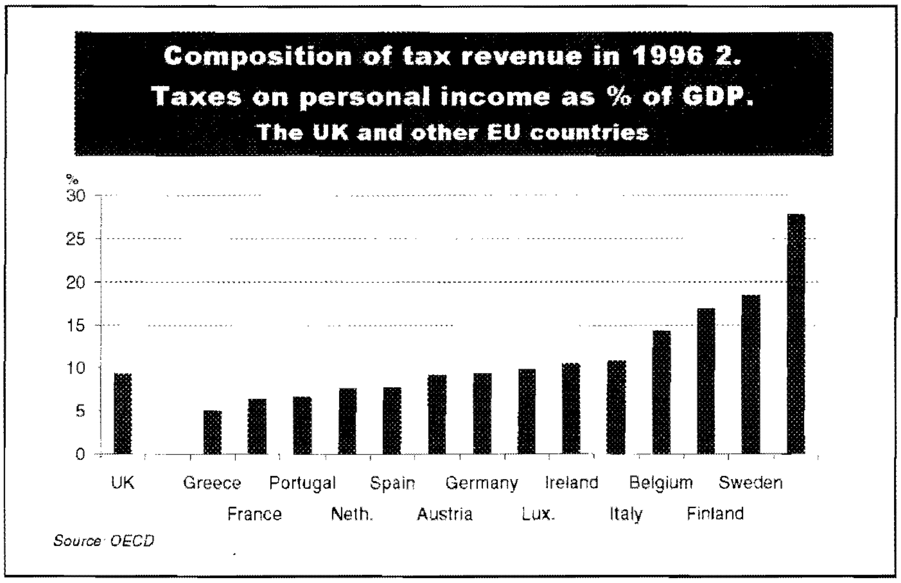
7 Tax in the UK and the EU excluding the UK as a % of GDP, with projections from 1997 to 2011

This chart required some simple statistical analysis. To obtain a series for the tax-to-GDP ratio in the EU excluding the UK it was necessary to estimate the UK's share of EU15 GDP. As several GDP series might have been used, there was some arbitrariness about the exercise. The resulting figures are nevertheless unlikely to need major revision from other assumptions or methods. A time trend of the ratio of tax to GDP was then estimated for both the UK and the EU excluding the UK, by ordinary-least-squares regression. As explained in the main text, the time trend was not significant in the UK equation, but it was significant in the equation for the EU excluding the UK. The upward trend was therefore extrapolated for the EU excluding the UK, whereas the UK's tax-to-GDP ratio was held constant. Most other analyses on these lines have reached the same conclusion, that the gap in the tax-to-GDP ratio between the UK and the rest of the EU will widen, not narrow, over the next 20 years.



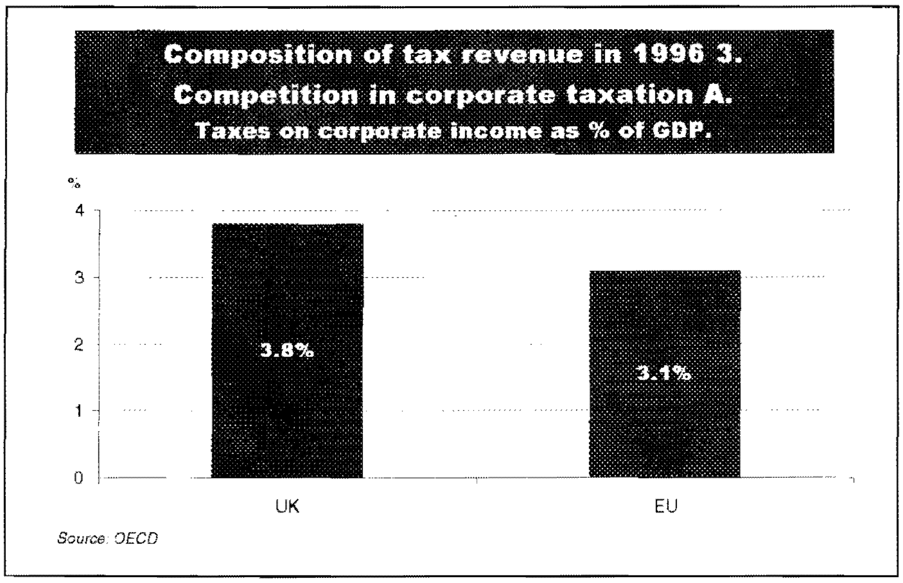
8 Composition of tax revenue in 1996 1: Taxes on personal income as a % of GDP: the UK and the EU as a whole

In line with the media stereotype, the UK does have a lower burden of direct personal income tax than its European neighbours. The personal-tax-to-GDP ratio is a measure of the average rate of tax, which is arguably a less satisfactory measure of the tax burden than the marginal rate of tax. (The best tax – in terms of minimizing the effect on incentives – is a lump-sum tax which must be paid regardless of income. The marginal rate is then nil at all levels of income, but the average rate could be extremely high for low-income earners and therefore socially unacceptable.) In the 18 years of Conservative rule the Government consciously tried to reduce marginal tax rates, as well as lowering the overall burden. Perhaps partly as a result the average number of hours worked by full-time employees is at present higher in the UK than in the rest of Europe, while labour force participation is also above that in countries such as France and Italy.



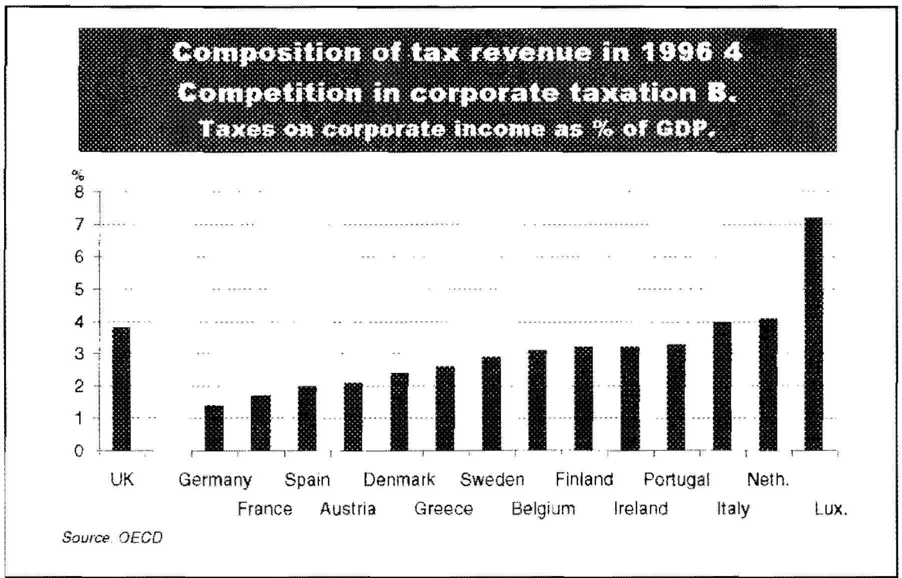
9 Composition of tax revenue in 1996 2: Taxes on personal income as a % of GDP: the UK and other countries

This chart gives a somewhat different perspective from Chart 8. It appears that – apart from the Scandinavian countries – the UK's personal tax burden is rather similar to that in the rest of Europe. Indeed, direct taxes on personal income raise much less revenue, relative to GDP, in five European countries (France, Spain, Portugal, the Netherlands and Greece) than in the UK. As the proportion of people of working age actually in work is higher in the UK than in most of these countries a possible implication is that the structure of the UK system of income taxation causes less damage to incentives than the systems elsewhere. However, this should not be pushed too far, as Sweden – which has exceptionally high levels of personal tax – also boasts high labour force participation, particularly by women. (The high level of Danish personal tax shown by the chart is misleading. It is due to a different approach to classifying taxes.)



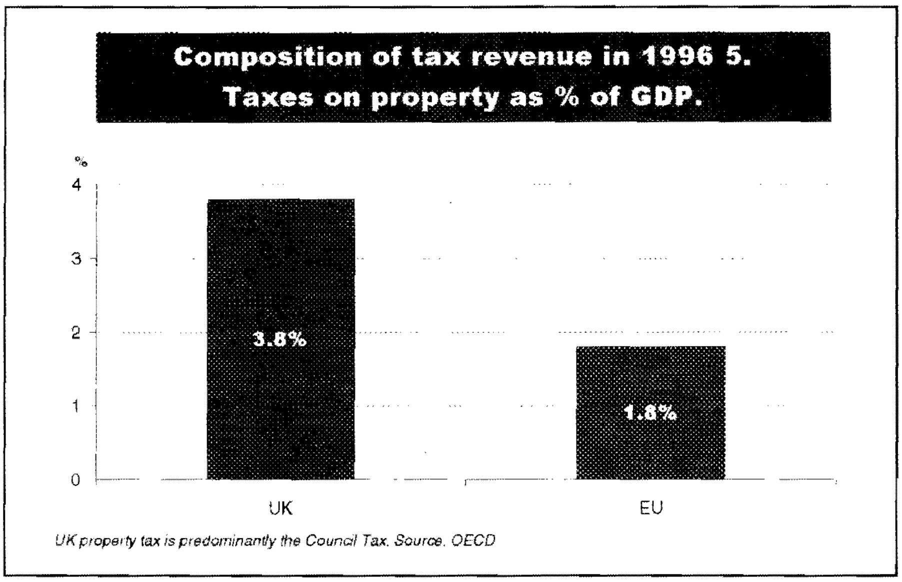
10 Composition of tax revenue in 1996 3: Competition in corporate taxation A

The main message from this chart – that UK companies pay higher taxes (relative to GDP) than their European counterparts – may seem surprising. As explained in the main text, the UK's low standard rate of corporation tax is offset by its eschewal of costly investment incentives and over-generous depreciation rules. German industry also receives a much wider range of government subsidies than British and the OECD may count these as negative taxes. Differences in tax structure are important here. Note that the UK had the 'imputation system' of taxing dividends in 1996, whereas most European countries had the 'classical system'. (Under the imputation system profits distributed as dividends are taxed once, whereas under the classical system they are taxed twice. The UK's tax credits on dividends to pension funds would have been counted against companies and included in personal sector income, which may be part of the reason for the apparently high UK corporate tax burden.)



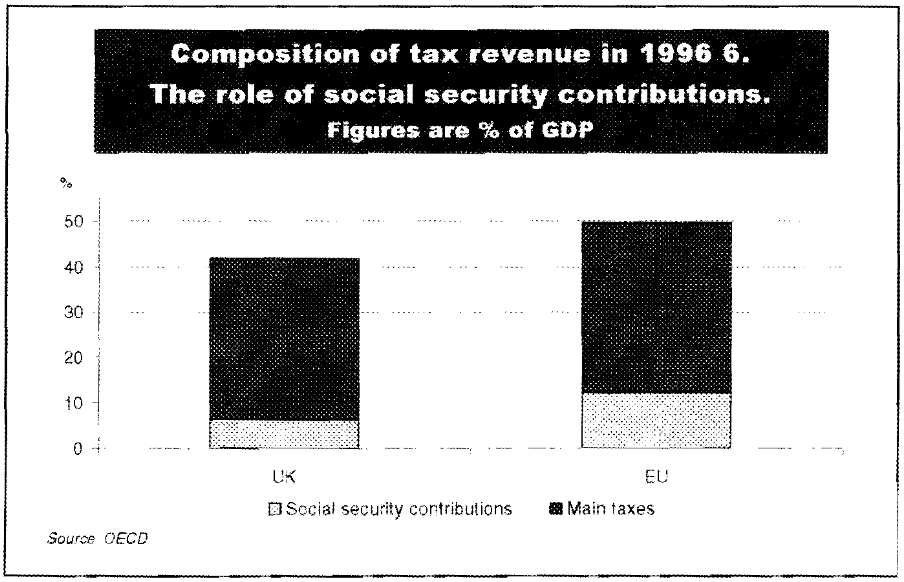
11 Composition of tax revenue in 1996 4: Competition in corporate taxation B

One startling revelation of this chart is that there is almost no connection between the standard rate of corporation tax and the corporate tax burden. The European nations with the lowest standard rate are Sweden, Finland and the UK, but UK companies pay rather high taxes (relative to GDP) by most countries' standards, while Sweden and Finland are in the middle of the pack. Huge complications arise because of differences in tax structure (in, for example, the taxation of dividends, as discussed in the commentary to Chart 10) and differences in the levels of subsidies (i.e., negative taxation), as well as the need to allow for the marked cyclicality of profit performance. Note that the UK has a special tax regime for profits from North Sea oil and gas extraction, while in international comparisons complex adjustments need to be made for publicly-owned industries and government transfers to such industries.



12 Composition of tax revenue in 1996 5: Taxes on property as % of GDP

Until the late 1980s the UK was quite successful – by international standards – in raising money from local taxation, especially from local authority rates. In the rest of Europe arrangements varied, but a common pattern was superficially heavy but actually ineffective taxation on property transfers (such as stamp duties) and immovable wealth (i.e., buildings and land). Stamp duties on property transfers in countries like France and Belgium remain extraordinarily high by British standards, but they do not collect much revenue, partly because of avoidance measures. (In France the owners of commercial property package their holdings in companies, and buy and sell the companies instead of the properties. Company transfers do not pay stamp duty.) In the UK the unpopularity of the Community Charge (or so-called 'poll tax') in 1989 and 1990 forced its replacement in 1991 by the Council Tax. The Council Tax was made palatable by introducing it with a sharp reduction in the burden of property taxation, while the revenue loss was made good by a big rise in VAT. Nevertheless, in 1996 the UK's taxes on property were much higher – relative to GDP – than in the rest of Europe.



13 Composition of tax revenues in 1996 6: The role of social security contributions

This chart demonstrates one of the key points of the paper, that virtually all of the difference in tax burdens between the UK and the rest of Europe is explained by the lower level of social security contributions. In general, contributions are lower in the UK, both for individuals and their employers. A counter-argument is that the UK's favourable position is illusory, because British companies have to pay higher pension fund contributions than their European counterparts. If employers' social security contributions and their pension fund contributions are combined, the gap between the UK and the rest of Europe is sharply reduced. A fair point is that the British arrangements are nevertheless more conducive to long-run economic efficiency. Under the British system of private funded pensions, the eventual transfers from the working-age population to pensioners are subject to market pressures (i.e., the pressures of capital markets to find the most profitable investment) with relatively low marginal tax rates; under the European publicly-financed pay-as-you-go structure the transfers are via the tax system and the government welfare bureaucracy, and are associated with high taxes.

Over the last few years, members of the European élite have been forthright in their views about tax and EMU. They have advocated tax harmonization in an increasingly unified European state, not tax competition between sovereign nation states within a European free trade area. But what will be the impact of the Euro on taxes in Britain, a low-tax country by European standards? In this pamphlet, Tim Congdon, Managing Director of Lombard Street Research, considers the three key issues related to European tax harmonization: to what extent taxes will rise, which taxes would be increased, and what the broader economic effects of tax harmonization would be. If the UK participates in EMU, he argues, it would become a higher-tax country; if it embraces European integration warmly, it might a generation from now be part of a high-tax region in a world where tax competition between regions is intensifying.

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