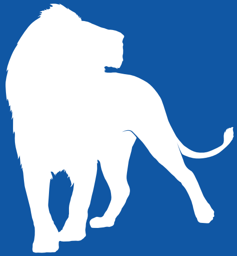


NEW DIRECTION

THE FOUNDATION FOR EUROPEAN REFORM

EU Direct Taxes

Nima Sanandaji

November 2012

NEW DIRECTION
THE FOUNDATION FOR EUROPEAN REFORM

Direct EU taxes will hinder Europe's economies, not help them

Nima Sanandaji, Captus

NEW DIRECTION
THE FOUNDATION FOR EUROPEAN REFORM

New Direction – The Foundation for European Reform is a euro-realist, free market, Brussels-based think-tank, dedicated to reshaping the European Union. It is affiliated to the European Conservatives and Reformists (ECR). *New Direction* seeks to promote policies and values consistent with the 2009 Prague Declaration of the ECR, to help steer the European Union on a different course and to influence the views of governments and key opinion formers in EU member countries and beyond. It was established in 2010 under the Patronage of Baroness Thatcher, to challenge the prevailing EU orthodoxy and encourage reform efforts in Europe. It attaches particular importance to the transatlantic relationship, and to the relationship with India and with other democracies.

New Direction assumes no responsibility for facts or opinions expressed in this publication or their subsequent use. Sole responsibility lies with the author of this publication.

Captus is an independent Swedish free market think-tank that promotes the ideas of liberty and regularly publishes reports on a wide range of topics.

Nima Sanandaji is a Board member of *Captus*. He has written seven books, covering subjects such as entrepreneurship, women's career opportunities and innovation within the IT sector.

This publication has been realized with the financial support of the European Parliament. The European Parliament is not responsible for the content of this publication.

November 2012

Printed in Belgium

ISBN: 978-2-87555-009-5

Publisher and copyright holder:
New Direction Foundation
Rue d'Arlon 40, 1000 Brussels, Belgium
Phone: +32 2 808 7847
Email: contact@newdirectionfoundation.org
www.newdirectionfoundation.org

Table of Contents

Executive summary 4
1. Introduction 6
2. Taxes and debt reduction 7
3. Taxes and economic output 8
4. The effect of direct EU taxes on EU member state finance ministries 10
5. The effect of aviation tax on business and employment 12
6. The shift of economic activity away from Europe due to CO^2 taxes 14
7. The shift of financial transactions away from Europe due to 'Tobin taxes' 15
8. Conclusions 17
References 19
Books and papers 19
Media articles 21
Endnotes 22

Executive summary

As many EU member states are forced to cut public spending to balance their budgets, senior European politicians are proposing to impose new direct EU taxes, in order to raise revenues for the European Union. The German and French governments have united in support for a common tax on financial transactions, news that caused European banking and exchange shares to tumble. The European Commission has followed with a proposal of a new financial transaction tax in September 2011 despite the opposition from number of EU member states and also the fact that the rest of the world resists following the European model in the form of a global tax. In October 2012 the European Commission proposed that a group of 11 member states would move ahead with a common financial transactions tax, after having failed to reach agreement amongst all member states.

Other areas previously singled out for the possible levying of EU taxes are: carbon dioxide emissions, domestic aviation, and wide range of financial activities.

According to EU Budget Commissioner Janusz Lewandowski, such taxes would not have any effects on the finance ministries of EU member states. **This study argues that new taxes on the EU level would significantly burden fragile Europe's economies and therefore these proposals should be dropped and the current system of EU funding through contributions from EU member states should be preserved.**

These are the concrete arguments against imposing new taxes on European citizens:

- Overall tax levels in many EU member states are already so high that they significantly reduce incentives for work, education and entrepreneurship. A study from the European Central Bank has found that the EU-14 nations have tax rates that are close to the top of the Laffer curve, the point after which higher taxes reduce economic output so much that even tax revenues are reduced. That means that each additional euro collected in taxes would shrink the economy considerably.
- All industries supposed to be the subject of direct EU taxes are highly mobile. The more mobile a tax base is, the more revenue is lost if the tax is increased. The reason is that mobile tax bases, such as investments or financial transactions, move out of high tax nations. Even if a small share of financial services migrates to centres such as New York and Singapore, the consequences could be drastic. For example in the UK and Ireland financial services account for 10% of GDP.
- Imposing some of these types of taxes has proved to be damaging in the past. When a transaction tax on stock trading was imposed in Sweden in 1984, the result was that much of the trade migrated to New York and London. The costly policy was abandoned in 1991.
- Aviation taxes have recently been abolished after their introduction in the Netherlands and Denmark, since they had adverse effects on the economies. Travellers are, by definition, highly mobile: Why would a consumer choose a stopover flight in an EU nation with a tax on aviation if a similar option is available in a nation without such a tax?

Conclusion

Research and experience suggest that the best way to achieve debt reduction is a policy of decisive and lasting cuts in expenditure, and by growing the economy out of debt. Tax increases are not only less likely to contribute to debt reductions, but would also hamper long-term economic growth, which is now under threat of a new downturn. Introduction of the proposed direct EU taxes would come at a high price for EU member state economies, at a time when lower, not higher taxation, is needed to encourage growth in many EU member states.

1. Introduction

At the same time that many EU member states are seeking to cut public spending, the European Commission is pushing the idea of direct EU taxes. Plans for EU-wide taxes have also been proposed by Herman Van Rompuy, the President of the European Council.[1]

Currently, national credit transfers from EU member states account for the vast majority of the Union's revenue. 12% of the revenues come from VAT and customs duties, but these taxes are collected indirectly through national governments, since the EU currently lacks the formal power to levy taxes.[2]

However, EU Budget Commissioner Janusz Lewandowski has actively sought to change this, believing the time is right to implement direct EU taxation. Claiming that such initiatives would unburden national governments, Lewandowski has expressed that, "the door has been opened to think about revenues that are not claimed by finance ministers". In addition, he has said that leaders in several capitals, such as Berlin, support this initiative.[3]

> Direct EU taxes are not only unpopular amongst national leaders, but also unreasonable, since they would hurt the prospect of economic development in Europe. The taxes would hurt the free movement of goods, capital and individuals that is the cornerstone of EU cooperation.

Lewandowski brought up the notion of direct EU taxes in August 2010, singling out carbon dioxide emissions, financial transactions and domestic aviation as areas from which the EU could seek to raise revenues.[4] Within hours of Lewandowski's remarks being published in *Financial Times Deutschland*[5], a spokesman for Germany's finance ministry criticised the idea, explaining that, "The demand to introduce an EU tax contravenes the position underlined by the (German) Government in its coalition agreement".[6] A spokesman for Lewandowski then remarked that the Commissioner was about to depart on a tour of Europe's capitals to talk with national leaders about the plans. The spokesman added that he would be "surprised" if anybody objected.[7] But it wasn't long before criticism was voiced by other EU member states.

British Treasury Minister Lord Sassoon expressed the view that "taxation is a matter for Member States to determine at a national level", whilst Pierre Lellouche, the French Junior Minister for EU Affairs, said that "this idea of a European tax is completely inopportune".[8] Poland and Belgium stood out as the only countries to openly support the new EU levy, whilst the Swedish Prime Minister joined his British counterpart in strong opposition to direct EU taxes.[9]

The European Commission seems determined to introduce EU taxation one way or another. In October of 2010, EU Tax Commissioner Algirdas Šemeta proposed yet another new tax – this time focusing on financial activities. Rather than taxing all kinds of capital movements (as a financial transactions tax would), this tax would be levied just on the profits and remunerations of financial institutions.[10]

In the summer of 2011, José Manuel Barroso, President of the European Commission, demanded that a bigger share of the EU budget would be supplied from "own resources", i.e. taxes paid directly to Brussels. The main focus was on taxes on the financial sector. Barroso went as far as attacking EU governments who

opposed these measures for "prejudices and Pavlovanian reactions".[11] In August of 2011, the German Government changed its position, together with the French Government supporting a tax on financial transactions.[12] The news caused European banking and exchange shares to tumble.[13]

Already before the summer of 2011, the Commission had brought up plans for introducing an EU tax on CO_2 in 2013. The new tax is planned to coincide with legislation that gives the Commission greater power over energy taxation, reducing the possibilities for EU member states to do their own policy.[14] During 2012 the push towards implementing direct EU-taxes has continued. Recently, in October of 2012, the EU Comission has proposed that a group of 11 member states move ahead with introducing a common transaction tax. After having failed to gain support for implementing the tax throughout the EU, focus has been shifted towards introducing it in the parts of the union where resistance is less persistent.[15]

As shown in this report, direct EU taxes are not only unpopular amongst several national leaders, but are also unreasonable, since they would hurt the prospect of economic development in Europe. The taxes would hurt the free movement of goods, capital and individuals that is the cornerstone of EU cooperation.

2. Taxes and debt reduction

Record levels of government debt currently plague EU member states such as Greece, Spain, and the UK. As debt ratios increase, investors' confidence tends to decline in the governments' creditworthiness. Since debt holders demand higher risk premiums, this pushes interest rates up, exacerbating the debt burden. How then can European nations achieve debt reductions?

In a recent publication from the European Central Bank, this very question was studied using data for the period 1985-2009. The researchers identified factors determining major public debt reductions that have been initiated in the EU nations. They found that major debt reductions are driven by "decisive and lasting (rather than timid and short-lived) fiscal consolidation efforts focused on reducing government expenditure" and that "robust real GDP growth also increases the likelihood of major debt reduction" by helping countries to grow their way out of debt.[16] Conversely, tax increases are found to be "less likely to contribute to a large and persistent debt reduction". The researchers note that there is a positive feedback effect, as reduced expenditure in itself helps promote long-term growth.[17]

> Successful attempts to balance budgets rely almost entirely on reduced government expenditure, while unsuccessful ones rely heavily on tax increases.

Another recent study, "Large Changes in Fiscal Policy: Taxes Versus Spending", examines fiscal stimuli and fiscal adjustments in OECD countries from 1970 to 2007. The study demonstrates that fiscal stimuli based on tax cuts "are more likely to increase growth than those based upon spending increases". Adjustments based on spending cuts (rather than tax increases) are shown to be more likely to reduce debts compared to those based upon tax cuts. Moreover, adjustments on the spending side are less likely to create recessions compared with adjustments on the tax side.[18]

Economists at the American Enterprise Institute have reached a similar conclusion in their analysis of 21 OECD nations over a period of 37 years. They write that, "successful attempts to balance budgets rely almost entirely on reduced government expenditure, while unsuccessful ones rely heavily on tax increases."[19]

Modern economic literature thus clearly points to reduced spending rather than increased taxes as the best strategy to deal with the crisis. High taxes distort economic behaviour by creating a wedge between supply and demand; transactions that would otherwise take place are impaired when a tax is levied. Particularly in open economies with substantial capital mobility, high taxes can lead to stagnation, whilst favourable tax policies can spur rapid growth.

Taxes change the incentives that individuals have to accumulate capital (in both physical and human form), hence affecting growth rates.[20] Taxes – and increased public expenditure – crowd out private investment. On the other hand, lower taxes encourage private investments.[21]

In particular, taxes and the level of public expenditure have an impact on economic behaviour in the long-term, both on individuals and on firms. Work ethics and personal incentives – to strive for career development, higher education or entrepreneurship – can be affected by tax rates (in combination with the privilege of public funds).[22] Even in the short term, a tax increase can lead to reduced working hours in an economy. This can occur by reducing the incentives of those working extra hours to do so or by reducing the incentives of those who are unemployed to seek employment.

But there are other effects that can be expected but are not immediate. An individual who has signed a contract and is working 40 hours a week will in most cases not break the contract if taxes are raised. The effect will usually first become visible when the contract is renegotiated. Increased taxes will influence the tendency of workers and labour unions to opt for lower working hours instead of higher wages. Taxes can also affect the average year of entry into – and exit out of – the labour market, which again highlights the importance of long-term decisions for individuals.

Due to these long-term effects, studies in which different countries are compared on the basis of different tax policies tend to show a greater effect from taxation compared to short-term studies of the same nation.[23] For example, a paper focusing on the development in OECD nations between 1956 and 2004 has found that the majority of the changes in working hours can be explained by the tax rates in the various nations.[24]

In order to grow out of debt, European economies must avoid high taxes that limit the reward for work, education and entrepreneurship. The European Commission's focus, however, is currently on reducing tax competition within the EU and giving the EU the power to levy direct taxes. These policies are misdirected; both of these measures would lead to higher rather than lower tax rates. As many European countries already have very high tax burdens, further increases will significantly reduce the economic activity and global competitiveness of European countries.

3. Taxes and economic output

The effect of tax rates on tax revenues can be seen from two differing perspectives. The *arithmetic effect* states simply that as tax rates are increased, tax revenues increase by the same rate; the reverse being of

course true of a decrease in tax rates. The *economic effect* however, recognises that low tax rates have a positive effect on work, employment and economic output. As tax rates are increased, the tax base thus diminishes due to low incentives for economic activity. When the tax level is low, the arithmetic effect dominates: increasing the total tax rate on labour from 5% to 10% would likely result in more or less double the revenue, since individuals still have relatively strong incentives to work if they can keep 90% of their income.

However, increasing the tax on labour from 40% to 80% should not be expected to double revenues, as this change significantly lowers the incentives to work. In the event of such a change, many would choose to work fewer hours, work less hard in order to advance their careers, focus less on studies that lead to well-paid jobs in the future – some would even opt to work in the black market where taxes can be avoided.

According to the Laffer curve – named after the American economist Arthur Laffer – tax revenues will be zero both when the tax rate is 0% and when it is 100%; the reason being that at 100% taxation there are no incentives left to work. The tax base – the activity that can be taxed – is profoundly affected by taxes. At some point between these two extremes the tax rate becomes so high that each additional euro levied in tax would lead to zero, or a negative, change in tax incomes. This point is the tip of the theoretical Laffer curve.[25] It is difficult to quantify where exactly the tip of the Laffer curve lies. A study recently published by the European Central Bank attempts to find this point for the EU-14 nations. The report finds that the nations on average can increase revenues from labour taxes by 8% and from capital taxes by 1% before reaching the peak of the Laffer curve.[26] In Denmark and Sweden – which have the highest taxes of the industrialised nations – it has been found that the public sector might actually increase revenues by cutting rather than increasing taxes. Income tax revenues are expected to be unaffected by changes in income taxes in both nations.[27]

How should these results be interpreted? The goal of economic policy is not solely to maximise taxes, since this comes at the expense of the citizens and businesses paying the taxes. The tip of the Laffer curve is reached when taxes have a very significant negative impact on economic output. This is exemplified by research that examined how increases in marginal tax rates affect the Swedish economy, and showed that for each extra Swedish krona levied, the efficiency losses can be as high as 1-3 additional kronor.[28]

To illustrate the dynamic effect of taxes and the Laffer curve, let us assume that taxes in a given nation are at 50%, and that a marginal tax increase of 1 euro would lead to efficiency losses corresponding to 2 euros. The simple arithmetic effect is that 1 euro extra is levied. However, since the economy shrinks by 2 euros and the tax rate is 50%, this leads to reduced tax revenues of 1 euro which cancel out the new revenue. Public revenues are not affected in this case, which represents the tip of the Laffer curve, whilst higher taxes considerably shrink economic output.

> The fact that the EU-14 economies are close to the tip of the Laffer curve shows that they have reached a point where additional tax increases would reduce economic output significantly. There is ample reason to decrease rather than increase taxation.

Now let us assume that taxes are instead at 45% and that a marginal tax increase of 1 euro would lead to efficiency losses corresponding to 1.5 euros. If taxes were increased by 1 euro, public revenues would only increase by 0.325 euros. The reason for this is that economic output has shrunk by 1.5 euros,

45% of which corresponds to 0.675 euros.

If the sole purpose of economic policy were to maximise taxes, one could justify the tax increase. It should however be noted that the private sector has lost 1.825 euros in the process of increasing public revenues by 0.325 euros (1 euro in additional taxation, plus 55% of 1.5 euros which equals 0.825 euros). The tax increase would only be sound policy if each euro spent by the public sector were worth close to 6 euros spent by the private sector.

The fact that the EU-14 economies are close to the tip of the Laffer curve shows that they have reached a point where additional tax increases would reduce economic output significantly. There is ample reason to decrease rather than increase taxation. The European Central Bank report on the Laffer curve reaches the conclusion that labour tax cuts in the EU-14 economies on average would be self-financing up to a threshold of 54%. This means that if taxes were to be decreased by 1 euro, public revenues would only decrease by 0.46 euros. Capital tax cuts would be self-financing to 79%, which means that reducing taxes by 1 euro would only lead to 0.21 euros less in public revenues. The researchers explain that tax cuts are not a “free lunch”, but that “a substantial fraction of the lunch will be paid for by efficiency gains in the economy due to tax cuts.”[29]

In conclusion, European economies are at a point where reducing taxes would lead to significant efficiency gains, whilst increasing taxes would lead to significant efficiency loss. Growth potential can therefore be expected to decrease if new direct EU taxes were to be added on top of the existing taxes.

In conclusion, European economies are at a point where reducing taxes would lead to significant efficiency gains, whilst increasing taxes would lead to significant efficiency loss.

4. The effect of direct EU taxes on EU member state finance ministries

Lewandowski has claimed that the direct EU taxes being considered "would not affect the finance ministries".[30] It is interesting that the focus seems to be on how finance ministries (the public sector) will be affected, not the economy as a whole (including the private sector). Is it irrelevant to the European Commission how citizens and companies would be affected by the new taxes?

The Commissioner would not likely have made the same remark had he pushed for an increase in *existing* taxes on labour or capital. So why should he remain unchallenged when he advocates adding an additional EU level of taxation? Firstly, it is clear that an alternative exists: for EU member states to levy the increased taxes instead of the EU. Since the alternative to EU taxation is taxation by EU member states, it is clearly false to state that EU taxes “would not affect the finance ministries”. Secondly, as previously discussed, taxes on capital and labour are already so high in many EU member states that further increases would come at the cost of lower economic output.

The aforementioned European Central bank study estimated that capital taxes in the EU-14 nations are on average 33%, and that a reduction would have a self-financing degree of 79%. A simple calculation shows that, on the margin, each additional euro collected in increased tax revenue for the state first destroys approximately 2.4 euros in the private sector.[31] This reduction of the tax base in turn reduces tax revenue by 0.79 euros for each new euro levied, so that the state in net only collects 0.21 euros. In order to increase net revenues by 1 euro, the tax on capital must be raised by 4.8 euros, which would destroy wealth to the value of 11.5 euros.[32]

Labour taxes in the EU-14 are estimated to be 41% on average and self-financing to the degree of 54%. A simple calculation shows that, on the margin, an increase of 1 euro in the tax rate would destroy wealth to an economic value of 1.3 euros in the private sector.[33] In order to increase net revenues by 1 euro, the tax on labour must be raised by 2.2 euros, destroying an economic value of 2.9 euros, as the tax base shrinks.[34]

Rather than increasing existing forms of capital and labour taxes, the European Commission is trying to implement new and unusual taxes, perhaps because they would face much greater criticism trying to raise 'traditional' tax forms. Financial transactions – to take just one example – are not currently taxed in Europe. Since there is relatively little international precedent by which to assess the impact of such taxes, it is comparatively difficult to predict their possible effects. Taxes with longer histories enable economists to calculate the extent to which a tax reduction can be self-financing. This is not the case for any of the new taxes proposed by the Commission.

Different taxes have different effects on the economy. It is for example no coincidence that several European nations cannot raise revenues by increasing their capital taxes, whereas their income taxes have still not reached the tip of the Laffer curve.[35] Labour is often taxed more heavily than capital, but capital is more mobile since it can more easily move to other nations. The more mobile a tax base is, the more it is likely to be affected by taxes.

However, although different taxes impact the economy in different ways, their effects still add up. It is easier for researchers to examine how an increase in tax A (which already exists) would affect the economy. But it is wrong to assume that the economy would be unaffected if instead the new revenues would be collected by introducing a new tax B on top of tax A. The aviation tax that Lewandowski has mentioned as an option for a direct EU tax is a good example of this. Aviation companies in Europe are already subject to corporate taxes, energy taxes, capital taxes and taxes on incomes[36].

The proposed aviation taxes would be added on top of all of these, and since the other options for direct EU taxes proposed by the Commission are taxes on carbon dioxide emissions, financial transactions and financial activities, all of these taxes would also burden aviation firms, directly and indirectly. If taxes did not have negative cumulative effects in this way, it would be rather simple for policymakers to avoid the problems with high taxation. The total tax level could be pushed to very high levels simply by creating a range of different taxes. In reality, it does not seem possible to avoid the negative effects of taxes by simply adding different taxes on top of each other. This is shown by the fact that a strong correlation exists between the overall size of government and economic growth.

In a newly published research book, Andreas Bergh and Magnus Henrekson have studied this correlation in detail. They demonstrate that when government size increases by 10%, annual growth rates decrease between 0.5% and 1%.[37] Although at the first sight this appears to be a small loss, it is important to realise what a 0.75% reduction in annual growth rate would mean in real terms. Let us take for example an

imaginary economy of only 100 euros with a 30% tax level: if the tax rate was increased to 40%, and annual growth would go down from, say, 2.5% to 1.75% annually for a 30-year period, the following would occur:

Instead of the economy growing to a value of 210 euros after 30 years (as it would at the lower rate of tax), it would only grow to 168 euros. The overall economy would be 25% higher in the lower tax scenario. In addition, tax revenues would be only slightly higher with the 40% tax rate (generating 67 euros) compared to the 30 % rate (63 euros).

As previously discussed, it makes little sense for the EU Budget Commissioner to claim that the new proposed EU taxes "would not affect the finance ministries". This statement is untrue not least of all because all the proposals relate to relatively mobile tax bases – a fact which creates additional associated problems.

5. The effect of aviation tax on business and employment

We now turn to the question of how the proposed aviation tax would affect the economy and the environment. To answer this, we can turn to the UK where such a tax has existed since 1994. When the air passenger duty tax was first introduced it was a flat rate on all passengers departing from British airports, regardless of the class of travel. Over time, the tax has increased and become structured according to four 'bands', representing the length of journeys.[38]

Before the four-band system was introduced, a research publication model predicted that the doubling of the tax would have "the perverse effect of increasing carbon dioxide emissions, albeit only slightly, because it reduces the relative price difference between near and far holidays". The tax was also found to decrease tourism flows to and from the UK. Doubling the tax was found to reduce the number of arrivals by some 163,000 people in 2010. The authors of the study concluded, "Aviation taxes are unlikely to substantially change aviation emissions".[39]

Since the four-band system was introduced, criticism has been voiced over the fact that the system discriminates against some tourist destinations compared to others. Flights from London to the Caribbean are taxed more than flights to Hawaii, although the latter is a much longer distance flight from London. Political considerations seem to have created this skewed tax policy.[40]

Having examined the evidence of the aviation tax creating distortions in the UK economy, it is worth noting that several other European nations, such as France, Germany, the Netherlands and Denmark, have also introduced aviation taxes. In the Netherlands and Denmark the taxes were abolished not long after their initial introduction, partly due to their adverse effects on the economy.[41]

There are some arguments in favour of aviation taxes, such as to engender tax neutrality with other forms of transport, or to compensate for the externalities aviation creates in terms of noise and pollution.[42] But at the same time, limiting travel by increasing taxes has been seen to impede economic development.

The rise of information technology and globalisation has led to an increased, rather than decreased, demand for personal meetings. The reason for this seems to be that vital aspects of business deals still have to be made face to face; information technology remains a complement rather than a supplement to personal meetings.

This explains why knowledge-extensive services thrive in big cities, where a large market exists for experts in various fields.[43] The size of the market is in turn partly dependent on how easy it is to travel; two cities that are near to each other and connected with rapid and efficient transportation can be considered a single market. But if transportation is difficult, the two cities will continue to function as separate markets.

Transportation also affects how easy it is to conduct commerce between one city and another. This is not only important for the transportation of goods (which in itself might be affected by EU aviation taxes), but also of people – i.e. the consumers.

The easier it is for professionals across Europe to meet personally, the more one can expect the European economy to thrive. It would therefore be good to introduce tax neutrality by reducing overall taxes on travel, and working towards increasing competition rather than hindering it by regulation and complicated tax systems that discriminate against one destination compared to another.

Travellers, by definition, are among the most mobile of tax bases. If some countries introduce an aviation tax but others do not, flight traffic will move out of the high tax nation to the low tax neighbour. Why make a stopover flight in a nation with a tax on aviation rather than one without a tax?

Flows of tourists and other visitors are also very mobile and sensitive to policies that increase prices. Airline carriers and airports in themselves create many jobs, some of which would be lost were aviation taxes to be introduced. Not only visitors but also carriers could easily opt for a nation outside of the EU to avoid an aviation tax.

Given this context, it is no surprise that Denmark abolished their aviation tax. Copenhagen airport is the workplace with the single most employees in Denmark. Besides the 2,000 employees who are employed by the airport, some 22,000 individuals work at the 500 companies that provide various services there.[44] The government has ample reason to encourage the growth of the airport, not least since the economic activity there creates substantial tax revenue. The EU tourism industry has an annual turnover of close to 600 billion euros, approximately 5% of the total GDP of the union. It also employs around ten million people, representing 5% of total employment.[45]

Additionally, many of those employed in tourism are relatively young, which indicates that employment in that sector is an important entry point into the labour market. The industry is growing rapidly, at the same time that it is facing strong competition from non-European nations.[46]

There are no current estimates as to how much an EU aviation tax would curtail the tourism sector. But even if tourism flows decreased by just 0.5% due to aviation taxes, the effect would be significant. A simple calculation shows this could result in a loss of 3 billion euros in turnover and a loss of 50,000 jobs.

Since travel plays an integral part of economic activities, it is clear that a direct EU aviation tax would indeed affect the finance ministries of EU member states negatively, not least by reducing the competitiveness of the important tourism sector.

6. The shift of economic activity away from Europe due to CO^2 taxes

As with aviation, environmentalist arguments have been made in support of taxes on carbon dioxide emissions. It is clear, however, that an EU tax on carbon dioxide emissions would affect the competitiveness of European economies and European manufacturers and transport firms would face an even higher tax burden than they do currently. Carbon dioxide taxes have been shown to shift production away from the countries that impose them. This not only dampens economic activity, but spells failure for the policy from an environmental viewpoint.

A number of feedback mechanisms have been examined by researchers in recent years, which offset the effect of climate policies such as carbon dioxide taxes. Occasionally the policies are even shown to increase rather than decrease emissions of greenhouse gases such as carbon dioxide.

One such mechanism is "carbon leakage", where strict taxes or regulations in one country lead to emissions instead moving to another country with less harsh regulations. The OECD estimates that a cost increase of 1% in certain industries can lead to reduced production in Europe of a magnitude of 3-4%.[47]

Leakage can also result from factors such as vacations abroad, through which people shift their consumption to nations with lower environmental taxes. Studies put the carbon dioxide emissions from Sweden at about six tons per inhabitant per year. However, when including the effect of international trade and consumption, the figure can be up to twice as high, depending on what assumptions are used.[48]

Another noted phenomenon is that of "rebound effects", in which energy savings in Europe lead to lower energy prices, thus increasing demand in nations such as China. Policymakers trying to reduce global emissions of greenhouse gases such as carbon dioxide try to avoid rebound effects by implementing global treaties. In practice however, many countries are reluctant to implement policies as harsh as, or even close to, those discussed and introduced in Europe. Therefore strong rebound effects persist. It has been estimated that rebound effects can offset the majority of the effect of potential energy savings by 2030.[49]

A research survey that tries to summarise the effects of leakage, rebound effects and other feedback mechanisms concludes that "aggregate policy feedback mechanisms tend to make current climate policies much less effective than is generally assumed. In fact, various policy measures involve a definite risk of 'backfiring' and actually increasing carbon dioxide emissions."[50]

> There can also be little doubt that businesses in European nations – already burdened by high tax rates – will face a particularly harsh time competing globally, especially if they also have to pay higher carbon dioxide taxes than other nations. Taxes do indeed add up.

We cannot say for certain whether feedback mechanisms will lead to policies such as carbon dioxide taxes to fail in their objectives completely, or simply become less effective, since the outcome likely depends on what policies are implemented by nations outside of Europe – such as Iran, India, China and Venezuela; nations that have little willingness to reduce their

emissions and can compete with Europe by not implementing environmental taxes.

Nevertheless, it is clear that carbon dioxide taxes, like the others we have examined, also have a mobile tax base, where both production and consumption could move out of Europe due to high taxes. This not only reduces the effectiveness of the environmental tax, but also illuminates the economic costs of such a tax. As with a tax on aviation, a direct EU carbon dioxide tax would certainly have a negative effect on the finance ministries – and economies – of EU member states. There can also be little doubt that businesses in European nations – already burdened by high tax rates – will face a particularly harsh time competing globally, especially if they also have to pay higher carbon dioxide taxes than other nations. Taxes do indeed add up.

7. The shift of financial transactions away from Europe due to 'Tobin taxes'

Lewandowski has pointed out that a "transaction tax can bring in a big amount of money" whereas the other proposed direct EU taxes "will only contribute a smaller part of the 140 billion euros a year we are spending".[51] There are also other signs that a multinational transaction tax is also being considered by EU legislators.

At the end of 2009, the European Council urged the IMF "to consider the full range of options [for renewing the economic and social contract between financial institutions and society] including insurance fees, resolution funds, contingent capital arrangements and a global financial transaction levy".[52] The introduction of a global tax seems very unlikely, but it is still possible that a direct EU tax will be introduced on tax financial transactions. What effects would such a tax have?

> A financial transaction tax not implemented worldwide would simply move trading out of any country that enforced it.

The idea of a tax on transactions was first proposed by Nobel Laureate economist James Tobin in the early 1970s. By placing a tax on currency trades, Tobin believed that speculative trading would reduce, thus leading to greater exchange rate stability. There are, however, a number of drawbacks with such a tax. To begin with, it would be difficult to implement and investors would be encouraged to find ways around the tax, creating economic distortions. Additionally, a decline in currency flows might harm the function of markets, leading to poor liquidity in currency markets.

The tax might also discourage "hedging" – a valuable tool for firms to insure against currency movements. As *The Economist* recently pointed out, a financial transaction tax not implemented worldwide would simply move trading out of any country that enforced it.[53]

There is no strong empirical evidence that a financial transaction tax would reach its goal of dampening volatility. When a transaction tax on stock trading was imposed in Sweden between 1984-1991, it actually

led to an increase in volatility and a dramatic reduction in home market liquidity as trade migrated to New York and London.[54]

Financial transactions are a particularly mobile tax base. Were the EU to introduce a financial transaction tax, financial transactions would simply move outside of European centres such as London.

In fact, the theoretical assumption that a financial transaction tax would reduce volatility by increasing transaction costs may well be wrong. In the US, a reduction of commissions in 1975 – which led to a reduction rather than an increase of transaction costs – was associated with a reduction in the volatility of stock returns.[55] The general decline in transaction costs that has been observed in foreign exchange markets since the 1970s has also been associated with a significant decline in volatility and increase in trade volume.[56]

New York and Singapore would be set to benefit from an EU transaction or activity tax, with Europe losing out.

Furthermore, as economist Ingrid Werner has pointed out, "financial markets participants are ingenious when it comes to creating new instruments to circumvent taxation. Hence, the tax legislation will have to be continuously updated to keep up with financial market innovation, and I predict that the effective tax base is likely to diminish over time as a result."[57]

Even if a financial transaction tax was introduced globally and politicians managed to enforce it perfectly and avoid shifts in the tax base, there is no way of knowing if it would reduce or increase volatility in the financial market. Costs would be imposed on businesses already paying high taxes and poor liquidity in financial markets would impair the growth of successful firms.

In reality, one must remember that financial transactions are a particularly mobile tax base. Were the EU to introduce a financial transaction tax, financial transactions would simply move outside of European centres such as London. The same reasoning applies for financial activity taxes, which would – even more directly than financial transaction taxes – impact financial institutions such as banks, by taxing their profits and remunerations rather than the trade. London and the other European financial centres do not have large natural competitive advantages in financial settlement that would persist long following the introduction of an EU tax on financial activity or transactions. Business would rapidly shift to financial centres not burdened with such obstacles or threatened by the prospects of yet more legislation and taxes in the future.

Since financial activities and transactions can easily move to alternative locations, long-term global growth would be unlikely to be strongly affected by an EU financial transaction tax. The transactions could easily move from London to Singapore or New York, for example. However, Europe would experience a significant reduction in economic activity, in high paying jobs, and in tax revenues. Additionally, EU policymakers would have to follow up financial activity or transaction taxes with a number of other regulations and taxes,

in order to prevent traders from circumventing the financial taxes. Needless to say, those regulations and taxes would likely create further distortions.

London benefited from the transaction tax on stock trading imposed in Sweden between 1984-1991, as large portions of trading activity migrated overseas.[58] In the same way, New York and Singapore would be set to benefit from an EU transaction or activity tax, with Europe losing out. Financial services account for fully 6% of the GDP of the EU, almost four times more than agriculture. In the UK and in Ireland the services account for 10% of GDP and in Luxembourg for fully 26% of GDP.[59] Even if only a small share of financial services were to migrate overseas from the EU, the economic impact would be significant.

The introduction of a direct EU tax would put EU member states at an economic disadvantage. Such a move would not only limit economic growth and destroy jobs but also affect the ability of finance ministries to levy taxes.

Again, the introduction of a direct EU tax would put EU member states at an economic disadvantage. Such a move would not only limit economic growth and destroy jobs but also affect the ability of finance ministries to levy taxes.

8. Conclusions

The implementation of direct EU taxation would drastically increase the tax burden on EU member states and their citizens. We have examined many pertinent reasons to avoid such a policy. As shown by modern research – based on the experience of European and OECD countries – debt reductions are best achieved by decisive and lasting cuts in expenditure, and by growing the economy out of debt. Tax increases have been found to hinder sizeable and persistent debt reductions.

Whereas reducing the size of the public sector can increase long-term growth, tax increases tend to have the opposite effect. Tax cuts are more likely to increase growth than spending increases, since taxes have a more profound effect on the economy. Not only do they reduce incentives for productive activities such as work, education and entrepreneurship, but they also crowd out private investments.

It has been shown that tax rates in several EU member states are already so high that further increases would destroy a significant portion of their economic value. In some cases, this effect could be so strong that tax increases would not even increase public revenues. EU Budget Commissioner Janusz Lewandowski claims that the direct EU taxes being considered would not have any effect on the finance ministries. This notion, however, is clearly misdirected, since taxes have been shown to be cumulative. If an aviation firm for example is already burdened by very high corporate taxes, energy taxes, capital taxes and taxes on incomes, then a new aviation tax would have an extremely damaging effect.

The more mobile a tax base is, the more revenue will be lost if the tax is increased. This is particularly true for open economies that implement higher taxes than their global competitors, and is therefore very relevant for European economies. As discussed in this report, financial transactions, financial activities, aviation and even carbon dioxide emissions all represent mobile tax bases. Thus we saw Sweden losing a

large portion of its trade after imposing a tax on stock trading in 1984-1991; and saw how aviation taxes reduced travel to and from the UK; and explored how the various feedback mechanisms all reduce the efficiency of carbon dioxide taxes.

It is thus patently wrong to claim that the proposed EU taxes on financial transactions, aviation, and carbon dioxide would not affect finance ministries. All proposed taxes would have a significant effect on economic activity, destroying jobs and hurting European businesses. Not only would this affect the finance ministries but it would affect the citizens of EU member states as well.

> Again, the introduction of a direct EU tax would put EU member states at an economic disadvantage. Such a move would not only limit economic growth and destroy jobs but also affect the ability of finance ministries to levy taxes.

Whilst taxes on aviation and carbon dioxide emissions might lead to some environmental benefits, experience has demonstrated that a financial transactions tax might completely miss its purpose. Not only would a financial transactions tax lead to loss of trading and jobs and poor credit liquidity in Europe, but possibly also increased rather than decreased volatility in financial markets.

The governments of EU member states thus have ample reasons to criticise the notion of direct EU taxation. The EU currently needs lower taxes, not the introduction of new ones onto mobile tax bases. The European Commission should set an example for the EU member states by opting to reduce the expenditure of the EU rather than push for the introduction of new taxes.

References

Books and papers

Alesina, AF, Ardagna, S, Perotti, R & Schiantarelli, F 2002, 'Fiscal Policy, Profits, and Investment', *American Economic Review*, vol. 92, pp. 571ff.

Alesina, AF & Ardagna, S 2010, 'Large Changes in Fiscal Policy: Taxes Versus Spending", NBER Working Paper No. 15438.

Aliber, RZ, Chowdhury, B & Yan, S 2003, 'Some evidence that a Tobin tax on foreign exchange transactions may increase volatility', *European Finance Review*, vol. 7, pp. 481ff.

Barker, T, Dagoumas, A & Rubin, J 2009, 'The macroeconomic rebound effect and the world economy', *Journal Energy Efficiency*, vol. 2, no. 4, pp. 411ff.

Bergh, A & Henrekson, M 2010, *Government Size and Implications for Economic Growth*, American Enterprise Institute Press.

Blanchard, O & Perotti, R 2002, 'An Empirical Characterisation of the Dynamic Effects of Changes in Government Spending and Taxes on Output', *The Quarterly Journal of Economics*, vol. 117, no. 4, pp. 1329ff.

Carlsson-Kanyama, A, Getachew, A, Peters G & Wadeskog, A 2007, 'Koldioxidutsläpp till följd av Sveriges import och konsumtion—beräkningar med olika metoder', KTH, TRITA-IM 11.

Ecorys, Teknologisk Institut, Cambridge Econometrics, CES info and Idea Consult 2009, 'Study on the Competitiveness of the EU tourism industry – with specific focus on the accommodation and tour operator & travel agent industries', Within the Framework Contract of Sectoral Competitiveness Studies – ENTR/06/054.

Freshfields Bruckhaus Deringer 2011, 'European Commission proposes a new CO2 tax and an amended energy tax', April.

Fölster, S & Nyström, J 2010, 'Climate policy to defeat the green paradox', *Ambio*, vol. 39, no. 3, pp. 223ff.

Hansson, Å 2009, *Vad kostar beskattning – analys av den samhällsekonomiska kostnaden av beskattning*, Confederation of Swedish Enterprise.

Heinemann, F 2008, 'Is the Welfare State Self-destructive? A study of Government Benefit Morale', *Kyklos*, vol. 61, no. 2, pp. 237ff.

Jones, C & Seguin, P 1997, ‘Transaction costs and price volatility: Evidence from commission deregulation’, *American Economic Review*, vol. 87, pp. 728ff.

Keen, M & Strand, J 2006, ‘Indirect Taxes on International Aviation’, IMF Working Paper WP/06/124.

King, RG & Rebelo, S 1990, ‘Public Policy and Economic Growth; Developing Neoclassical Implications’, *Journal of Political Economy*, vol. 98, no. 5, pp. 126ff.

Mayor, K & Tol, RSJ 2007, ‘The impact of the UK aviation tax on carbon dioxide emissions and visitor numbers’, Economic and Social Research Institute Dublin, working paper FNU-131.

Nickel, C, Rother, P & Zimmermann, L 2010, ‘Major public debt reductions: Lessons from the past, lessons for the future’, European Central Bank Working Paper Series, 1241.

Ohanian, L, Raffo, A & Rogerson, R 2008, ‘Long-term changes in labor supply and taxes: Evidence from OECD countries, 1956-2004,’ *Journal of Monetary Economics*, vol. 55, no. 8, pp. 1353ff.

OECD 2008, *The economics of climate change mitigation: Policies and options for the future*.

Rankka, M, Ydstedt, A & Johansson, F 2010, *Far och flyg! Hur resor förändrar världen*, Timbro.

Rogerson, R 2009, ‘Market Work, Home Work, and Taxes: A Cross-Country Analysis,’ *Review of International Economics*, vol. 17, no. 3, pp. 588ff.

Sussman, G 1999, ‘Urban Congregations of Capital and Communications: Redesigning Social and Spatial Boundaries’, *Social Text*, vol. 17, no. 3, pp. 35ff.

Trabandt, M & Uhlig, H 2010, ‘How far are we from the slippery slope? The Laffer curve revisited’, European Central Bank Working Paper Series no 1174.

Umlauf, SR 1993, ‘Transaction taxes and the behavior or the Swedish stock market’, *Journal of Financial Economics*, vol. 33, pp. 227ff.

Werner, IM 2003, ‘Comment on ‘Some Evidence that a Tobin Tax on Foreign Exchange Transactions may Increase Volatility’’, *European Finance Review* , vol. 7, pp. 511ff.

Media articles

Airlines magazine 2010, ‘The German Aviation Tax, will it last?’, 2010-10-01.

Bloomberg 2011, ‘European Banks Fall as Merkel, Sarkozy Propose Financial Tax’, 2011-08-17.

Daily Mail 2010, ‘Now Brussels wants to tax Britons directly with EU-wide levies on banks and air travel’, 2010-08-10.

EU Observer 2010, ‘Brussels feels time is right to suggest EU tax’, 2010-08-09.

EU Observer, 2012, 'EU commission tables financial tax for 11 states', 2012-10-24.

EurActiv.com 2010, ‘Commission backs €24bn 'Financial Activities Tax'‘, 2010-10-07.

Financial Times Deutschland 2010, ‘Brüssel plant Europasteuer’, 2010-08-09.

eTurboNews 2009, ‘Britain's Air Passenger Duty Tax: A disaster for the Caribbean’, 2009-11-23.

European Council 2009, ‘‘EUCO 6/09’ from the General Secretariat of the Council to Delegations’, 2009-12-11.

Radio Sweden 2010, ‘Sweden and Britain say no to 'EU tax'‘, 2010-11-26.

Reuters 2010, ‘Brussels preparing proposals for EU-wide tax’, 2010-08-09.

Reuters 2011, ‘Sarkozy, Merkel push tax plan, closer economic coordination’, 2011-08-16.

The City UK 2011, ‘Key Facts About EU Financial and Professional Services’.

The Economist 2009, ‘Gordon Brown and the Tobin tax’, 2009-11-12.

The Guardian 2010, ‘Treasury states its opposition to EU direct taxation proposal’, 2010-08-09.

The Guardian 2011, ‘'Tobin Tax' called for by EU in seven-year blueprint’, 2011-06-30.

The Sunday Times 2009, ‘Herman Van Rompuy, front-runner for presidency, wants EU-wide tax’, 2009-11-17.

The Wall Street Journal 2010, ‘The Right Way to Balance the Budget’, 2010-12-29.

Endnotes

1 The Sunday Times 2009.

2 EU Observer 2010.

3 Ibid.

4 Daily Mail 2010, EU Observer 2010 and The Guardian 2010.

5 Financial Times Deutschland 2010.

6 Reuters 2010.

7 Ibid.

8 The Guardian 2010, EU Observer 2010.

9 EU Observer 2010, Radio Sweden 2010.

10 EurActiv.com 2010.

11 The Guardian 2011.

12 Reuters 2011.

13 Bloomberg 2011.

14 Freshfields Bruckhaus Deringer 2011.

15 EU Observer 2012.

16 Nickel, Rother & Zimmermann 2010.

17 Ibid.

18 Alesina & Ardagna 2010.

19 The Wall Street Journal 2010.

20 See for example: King & Rebelo 1990.

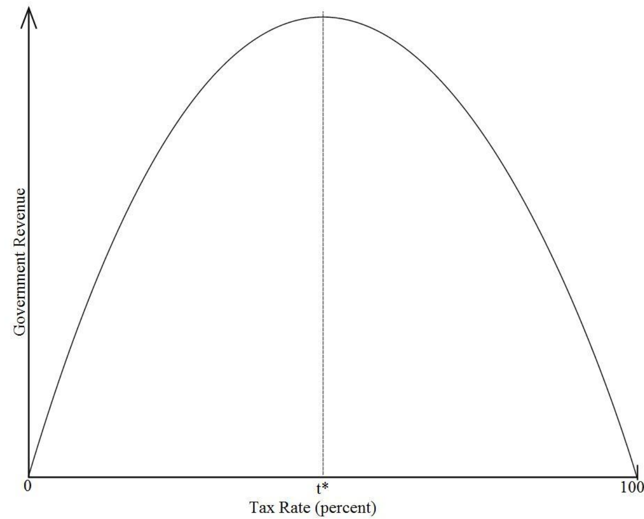
21 Blanchard & Perotti 2002; Alesina, Ardagna, Perotti & Schiantarelli 2002.

22 See for example: Heinemann 2008.

23 See for example: Rogerson 2009.

24 Ohanian, Raffo & Rogerson 2008.

24 The Laffer curve (see below) is a widely accepted and often useful theoretical instrument to illustrate that there must be an optimal tax rate between two extremes, namely zero and 100 %. In the first case the state has no revenue, in the second he has no (future) revenue either because people will stop work. As a consequence, there must be a at least one point between the two extremes beyond which further tax increases lead towards the second case and a shrink in the economy. However, this point is difficult to determine and how to do this is controversially discussed among economists.



26 Trabandt & Uhlig 2010.

27 Ibid.

28 Hansson 2009.

29 Trabandt & Uhlig 2010.

30 The Guardian 2010.

31 0.79/0.33 = 2.4.

32 1/0.21=4.8; 4.8*2.4=11.5

33 0.54/0.41 = 1.3.

34 1/0.46=2.2; 2.2*1.3=2.9

35 Trabandt & Uhlig 2010.

36 The latter affects wages, the possibility to attract foreign experts, and the incentive of the employees to work hard.

37 Bergh & Henrekson 2010.

38 Airlines magazine 2010, eTurboNews 2009.

39 Mayor & Tol 2007. Contrary to aviation taxes, emission taxes were found to reduce emissions.

40 eTurboNews 2009.

41 Airlines magazine 2010.

42 Keen & Strand 2006.

43 See for example: Sussman 1999.

44 Rankka, Ydstedt & Johansson 2010.

45 See for example: Ecorys, Teknologisk Institut, Cambridge Econometrics, CES info and Idea Consult 2009.

46 Ibid.

47 OECD 2008.

48 Carlsson-Kanyama, Getachew, Peters & Wadeskog 2007.

49 Barker, Dagoumas & Rubin 2009.

50 Fölster & Nyström 2010.

51 Reuters 2010.

52 European Council 2009.

53 The Economist 2009.

54 Umlauf 1993.

55 Jones & Seguin 1997.

56 Aliber, Chowdhury & Yan 2003.

57 Werner 2003.

58 Umlauf 1993.

59 The City UK 2011.

November 2012

© 2012 New Direction – The Foundation for European Reform

Publisher and copyright holder:
New Direction – The Foundation for European Reform
Rue d'Arlon 40
1000 Brussels, Belgium
Phone: +32 2 808 7847
contact@newdirectionfoundation.org