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EDITORIAL

Fiscal competition is on the increase with the admission of new member states to the European Union. France is in a poor position internationally in this respect, in terms of the size of its levies on the most dynamic and mobile economic agents.

*The report proposes a fiscal reform based on several fundamental principles. The fiscal system would be significantly changed by the reform, with a lowering of average and marginal income tax rates and a drastic reduction in the number of tax bands, a reduction in corporate tax to 18%, an increase in the CSG (a social security contribution taxing – almost– all revenues) to 13% and a widening of its assessment base, the replacement of the wealth tax (ISF) with a tax on wealth revenues (IRF), and the closure of a number of tax loopholes. But the family tax reduction (*quotient familial*) and the employment premium will remain, and in fact are likely to be upgraded.*

The authors say comprehensive and rapid changes are needed. A debate has been launched. Now it is up to the public authorities to draw fruitful conclusions.

Christian de Boissieu
Executive Chairman of the CAE

Equitable Growth and Fiscal Competition

Report by Christian Saint-Etienne and Jacques La Cacheux

The high level of public spending in France requires a high level of fiscal revenue. This tax revenue is generated through very high marginal rates across very narrow assessment bases because of the large number of loopholes. This makes the French tax system inefficient, with relatively poor horizontal equity. Furthermore, fiscal competition is on the rise in Europe and the authors fear a mass relocation of companies and the most well-off households. In order to halt this flow, they propose a sweeping fiscal reform affecting the CSG, corporate tax and household levies. An initial simulation shows that a single tax rate of 13% would leave the overall level of tax and social security contributions unchanged. The report then proposes a reform differentiating between corporate and personal taxation.

This report was discussed at the plenary session of the Council on 8 March 2005, then on 13 July 2005 in the presence of the Prime Minister. This Letter, published by the permanent committee, looks at the main conclusions drawn by the authors.

Features of the French tax system

The French tax system is characterised by the combination of high nominal rates of tax and narrow tax bases, due largely to the existence of a large number of tax loopholes. The level of tax and social security contributions (44.8% of GDP in 2003) is 5.4 points higher in France than in other euro-zone countries. Half of this difference can be attributed to the disparity in social security contributions. The rest of the difference is accounted for by income tax and local tax on businesses. Taxes are concentrated on the most dynamic and most mobile factors. The portion of income tax revenues, including the employment premium, contributed by the top two deciles rose from 78.8% in 2000 to 90.8% in 2003. These high tax rates on narrow tax bases are producing a very limited tax yield.

Fiscal competition rising sharply in Europe

The report highlights the massive rise in fiscal competition within the European Union. Harmonisation has been explicitly rejected by the United Kingdom, Spain and Ireland. Most of the ten new member states are trying to make up economic ground more quickly by using highly attractive tax rates in order to encourage mobile factors of production to establish themselves in their country. The main vehicle of this fiscal competition is corporation tax, and to a lesser extent, the tax on savings. International comparisons are based on a calculation of nominal rates, implicit rates and effective rates. Implicit tax rates are intrinsically retrospective and measure the tax effectively paid on net operating income. The effective rates are forecasts and are calculated by looking at the

CSG and income tax parameters under the two scenarios examined

	Scenario A	Scenario B
CSG	• 13% CSG deductible from all income	• 12% CSG deductible from all income
	• CSG credit *capped* at 600 euros for a single person, 1,200 euros for a couple or single parent	• CSG credit *capped* at 900 euros for a single person, 1,800 euros for a couple or single parent
Income tax	• 0% up to 7,500 euros per tax unit	• 0% up to 10,000 euros per tax unit
	• 13% from 7,500 to 50,000 euros per tax unit	• 12% from 10,000 to 50,000 euros per tax unit
	• 28% above 50,000 euros per tax unit	• 27% above 50,000 euros per tax unit

rate of tax that would apply to the same hypothetical investment. Devereux and Griffith showed that decisions on where to locate a business are based on average effective rates whereas incremental investment decisions are based on effective marginal rates. However, measuring the differences in corporate taxes is by no means straightforward, even for companies. The authors there-fore believe that nominal rates influence the fiscal competiti-veness perceived by the international business community.

France's position

France's implicit and effective tax rates are close to the European average. Its nominal rates, on the other hand, are considerably higher than those of other euro-zone countries. Its perceived fiscal competitiveness is very poor in terms of income tax and to a lesser extent corporation tax. The report stresses that this carries a threat of mass relocation as each generation of qualified workers is replaced. Moreover, tax management by companies is resulting in the choice of the tax base location becoming separate from the choice of location for production activities. The location of the tax bases depends on fiscal competitiveness whereas the location of production activities is determined by the economic competitiveness of the countries in question. If the most mobile taxable bases relocate, the whole burden of the funding of public goods will rest with the less mobile production factors.

According to the authors, this situation threatens to undermine the financing of the French social security system which is designed both to provide quality public services and to ensure a high level of redistribution.

The report also underlines the importance of very small companies and SMEs in job and wealth creation. These companies are very often set up using individual or family capital. The authors show that it is in the interests of the owner-managers of fast-growing companies of this kind to sell them, more often than not to foreign investors, rather than work on expanding them, due to wealth tax and tax on dividends. Indeed, once the wealth tax threshold is reached, which happens when the company reaches a certain size, its net rentability becomes inadequate for shareholders.

The Swedish example

Sweden, like France, has an extremely supportive social security system, with an unemployment rate half that of France and an economic growth rate one-and-a-half times higher over 2003-2005. Swedish companies invest nearly twice as much in R&D as French companies. Taxes and social security contributions account for 6 GDP points more than in France, and taxes on corporations and on the income from capital invested in shares are substantially lower in Sweden than in France. This comparison shows that it is possible to have a high level of redistribution provided you invest massively in the knowledge and innovation economy, and do not have a tax system which penalises the main players: researchers, managers and venture capitalists.

The key principles of fiscal reform

In the authors' opinion, the fact that taxes are heavily concentrated on narrow bases and the most dynamic factors of production is leading to low revenues and provides scope for reform with spectacular effects. The objectives of this are two-fold: fostering growth by reducing the tax burden on the most dynamic production factors; and putting France in a position to withstand fiscal competition. The proposed new tax system must comply with the constraints of horizontal and vertical equity. The first stipulates that two identical persons must be treated in the same way. The second states that taxpayers with the highest incomes should contribute proportionally more than others. The system must also be easy to understand and manage. This leads the authors to recommend broad assessment bases and the lowest possible average and marginal rates.

When designing their new tax system, the authors made it a condition that revenues remained unchanged in the first year. The relevant taxes are income tax, proportional capital gains tax, CSG (a social security contribution taxing –almost– all revenues), wealth tax, free transfer taxes and corporate tax.

Macro-accounting simulations

Firstly the authors produced macro-accounting simulations. They started using a single tax rate applied identically to all tax bases (flat tax). The rate that provided an unchanged level of revenues came out at 13%. This model, which offers the advantage of efficiency and simplicity, cannot, however, be used as it fails to meet the objective of vertical equity.

Consequently a second round of simulations was conducted based on the following principles. Most of the current tax loopholes are eliminated apart from the family tax reduction (*quotient familial*). Income tax is levied after payment of the CSG, which would therefore be fully deductible from taxable income. The tax allowance for calculating income tax is doubled compared to the current level of around 4,000 euros per tax unit. The simulations suggest an allowance of 7,500 or 10,000 euros per tax unit would be appropriate. Wealth tax would be replaced with a tax on wealth revenues which is equivalent to imposing an additional levy of y% above 50,000 euros per tax unit, which should bring in the same level of gross revenues as wealth tax currently does. Lastly, no income decile must suffer a loss of income of more than 5%. Under one variant, no income centile is allowed to suffer a drop in income, but no decile is allowed to gain more than 5%. With this variant, the rate of tax and social security contributions is reduced.

Overall, income tax would be levied in three bands:

- 0% up to 7,500 or 10,000 euros per tax unit;
- $x\%$, between 7,500 or 10,000 euros and 50,000 euros of income per tax unit;
- $x + y + x'\%$ above 50,000 euros per tax unit, $y\%$ being the tax rate on wealth revenues and x' the rate applied in the variant under which no decile is allowed to enjoy a gain of more than 5%.

With a rate of $x\%$ applied to CSG, and in order to make the new

French Tax System equitable, a tax credit would be created capped at 600 euros per tax unit for a single person and 1,200 euros for a couple or single parent. The employment premium would remain in place, in the form in which it existed on 1 January 2005. A same rate of *x* applies for the second band of income tax, corporate tax, CSG, capital gains tax and free transfer tax.

The results of the simulation for 2002 produce a rate *x = 13%* given an income tax allowance of 7,500 euros per tax unit, *y = 5%* and *x' = 10%*. The upper marginal rate of income tax, including deductible CSG, would be 38% (13% deductible CSG, plus tax of 28% on 87% of income). Government tax revenues are the same as under the current taxation system.

Impact of the tax reform on companies

The authors then suggest a fiscal reform which differentiates corporate taxation from household taxation. The reduction in corporation tax is set at 1% of GDP. This brings the new rate of corporation tax to 18%. Local tax on businesses would be a single rate per band, of 2% up to 1 million euros of value added, and 2.75% above that. The wage tax (*taxe sur les salaries*) would be set at 4.25% up to 8,000 euros, 8.5% from 8,000 to 40,000 euros, and zero above that.

The authors believe that an average corporate tax rate of 12 to 13% –as currently applied by Ireland and Estonia– is set to become the norm for small countries in the European Union. France is taking a limited risk by keeping its rate five or six points higher than this target rate. Large countries offering sizeable markets and substantial conglomeration effects can maintain higher tax rates than small peripheral countries. However the relocation of tax bases away from the base of operating activities precludes maintaining a very large gap. In the authors' view, if the rate of corporation tax is converging towards 12-13% for small countries and towards 18-19% for large countries, incentives to relocate tax bases from large to small countries should be limited. The supplement by Agnès Bénassy-Quéré, Nicolas Gobalraja and Alain Trannoy, included with the report, shows that fiscal competition centres on the combination of the corporate tax rate and the *public factor*. A policy which, in an effective manner with appropriate evaluation procedures, results in an increase in public assets which directly aid corporate productivity and efficiency (the *public factor*), increases the attractiveness of a country for international capital investment. The same authors demonstrate that fiscal competition leads simultaneously to an increase in public sector efficiency and, within public spending, to emphasis on the *public factor* to the detriment of those public assets that are only consumed by households. They also show that a one-percentage-point increase in the nominal rate of corporation tax reduces by 3.5 percentage points the level of direct investment being channelled into foreign companies in France. Government decision-makers therefore face the following choice. Either public spending is effective, and enough of a *public factor* is produced (in terms of quantity and quality) to attract companies, and fiscal competition does not rule out a taxation gap, provided this gap is smaller than the productivity gap for relocatable operating activities. Or public spending is not effective, and fiscal competition forces the countries to improve the quality of their public spending.

Impact of the fiscal reform on households

Micro-simulations conducted by INSEE (the French statistical Office) were used to test the redistributive effects for households of two variants presented in the table. Under scenario A, the overall level of tax and social security contributions is kept unchanged. Levies on households therefore have to be increased by one GDP point to compensate for the reduction in corporation tax. Under scenario B, no income centile loses out on average from the reform, but no decile gains by more than 5%. Hence the requirement for constant revenues no longer applies in this case.

Under scenario A, tax revenues from households increase by 16.3 billion euros and offset the decline in corporate revenues by one GDP point. Under scenario B, tax revenues from households shrink by 12.4 billion euros. The total cost of this reform therefore amounts to 2 GDP points.

The chart shows the gains or losses from the reform by initial standard of living centile.

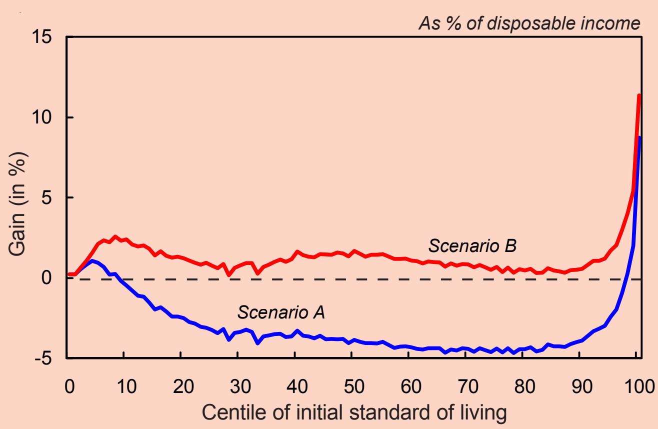
Under scenario A, only those individuals in the top and bottom deciles of the initial standard of living scale gain on average from the reform. The households in deciles 2 to 9 on average incur losses which, in terms of absolute value, increase in line with the standard of living, peaking in the 9th decile.

For the first decile of the initial standard of living scale, the reform is entirely positive: there are more individuals, particularly those in poorly paid employment, whose CSG would be reduced compared to the present system thanks to the flat-rate credit, than persons whose CSG would be increased (mainly the unemployed and pensioners, who lose the exemptions they enjoy under the present system). Furthermore, the reform is neutral for households not liable to tax, for whom no income is subject to CSG.

The majority of households in deciles 2 to 9 lose out as a result of the reforms due to the hike in the rate of CSG. In the last decile, though, there are considerable disparities between households: 65% of households lose out as a result of the reform, but the average effect is a gain of 0.9%. Indeed, the households in the last three centiles enjoy gains as a result of the reforms due to the reduction in the tax rate for the upper bands, and a relative easing of the tax burden on financial income: these very last centiles are the ones that benefit most from the reform.

At the bottom of the standard of living scale, households of over-60s and persons living alone (both categories are closely correlated) are the main losers from the reform, whereas families with children are less affected than the average. Meanwhile, from the 6th decile upwards, families with children lose out more than average due to the transfer of the burden from income tax to CSG. Lastly, taking a fixed standard of living, single parents are much less affected by the reform than the other categories of households, particularly those at the bottom of the scale, because the flat-rate CSG credit accounts for a larger portion of their income.

Gain from the reform according to initial standard of living



Source : INES Micro-simulation model, INSEE calculations.

Under scenario B, the average gain is positive or zero for all initial standard of living centiles. However this does not mean that there are no losers as a result of the reform: 30% of households lose out from the reform. The standard of living deciles that benefit most from the reform are the first two deciles, thanks to the flat-rate CSG credit, and in particular the last centiles, as a result of the reduction in tax rates for the last bands. Meanwhile the middle deciles benefit from the raising of the limit for the first band of income tax. On the other hand, the reform is virtually neutral for deciles 3, 4, 7, 8 and 9. However, situations vary considerably in deciles 2, 3 and 4: in decile 4, 8% of households suffer a loss of more than 5% of their income whereas two thirds are winners, and in deciles 2 and 3 more than 40% of households lose out.

At the bottom of the scale (excluding the 1st decile), single-person households and households of over-60s lose out on average, while families with children benefit from higher than average gains as a result of the reforms. At the top end of the scale, families with children, and large families in particular, see smaller gains than the average, or even losses in the case of deciles 7 to 9. As in scenario A, single parents benefit more from the reform than the other family units with a set standard of living.

Comments

Jean-Philippe Cotis praises the authors for having the courage to propose such a sweeping tax reform. He points out that the report was not intended to tackle the issue of public spending. French marginal rates are higher than those in other European countries. This higher level reflects a lack of efficiency in the tax system which can be attributed to the large number of loopholes, which has a detrimental effect on horizontal equity. In OECD countries, there is a very marked decoupling between the nominal tax rate and the corporate tax burden as a percentage of GDP. A lowering of marginal rates is therefore not incompatible with the maintenance of high average rates. On the other hand, the discussant questions whether such a reform can be justified in terms of fiscal competition. He mentions the potential benefits of this kind of competition, and the lack of tangible pointers that would allow its adverse effects to be examined. Invoking fiscal competition might be considered as an exaggeration of the external threat, leading the authors to justify policies which may not be in the interests of equity. There have already been too many attempts in France to justify useful domestic reforms through arguments relating to external pressure. In the end, these assertions tend to alienate public opinion and to remove some of the issues relevant to the debate over reform. It would be worth assessing, in absolute terms, the actual domestic costs associated with a complex system that lacks clarity and discourages initiative, and this should be sufficient to justify such a reform. Meanwhile, lowering marginal rates while maintaining high average rates is unlikely to be very effective in combating relocations. Lastly, the discussant regrets that VAT was not included in the scope of the reform. Countries with high public spending tend to rely heavily on VAT as a source of tax revenues. Being neutral by nature, it contributes significantly to limiting the progressiveness of overall marginal rates in the economies in question. In this respect, there is some doubt over whether the burden of VAT has reached its optimum level in France.

Jacques Delpla stresses the importance of this report which recommends a comprehensive, radical reform of the tax system. It opens up a debate that has been somewhat muted in France but very lively elsewhere in Europe as a result of the flat tax concept applied by some of the new member states. Jacques Delpla is critical of the approach justifying fiscal reform similar to the flat tax solely on the basis of fiscal competition. In his view, it is necessary to substantially qualify the remarks about fiscal competition to take account of the size of the countries and the lack of labour mobility, especially towards Eastern Europe. On the other hand, a far-reaching reform could, he believes, be motivated by the concept of the efficiency and productivity of taxation. He reiterates that the large number of tax loopholes that have appeared over time in France produce distortions. Narrow bases and high rates produce a highly inefficient system. Getting rid of these loopholes and simplifying the tax system can only be positive, he believes, for the wealth of the country. He emphasizes that the report shows that a radical re-form introducing something similar to a flat tax system could be implemented that would keep overall tax revenues unchanged, without altering the income distribution compared to the present situation. It is the two extremes of the income scale that stand to benefit most from the proposed reform. The discussant concludes by underlining the virtues of a comprehensive reform: in his view, marginal reforms are useless or can have adverse overall effects.

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