



# ***Budget consolidation after the crisis: Do higher tax ratios result in lower growth?***

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*Views expressed are those of the author and shall not be  
attributed to the European Commission*



## *Scene setter*

- Increase in EU-27 budget deficit since the crises from 0.7% of GDP in 2007 to 7.2% of GDP in 2010
- To keep public finances sustainable consolidation required as agreed in the context of the Exit Strategy
- Consolidation only on expenditure side seems not realistic
- How to meet revenue needs, while not negatively affecting growth and employment?

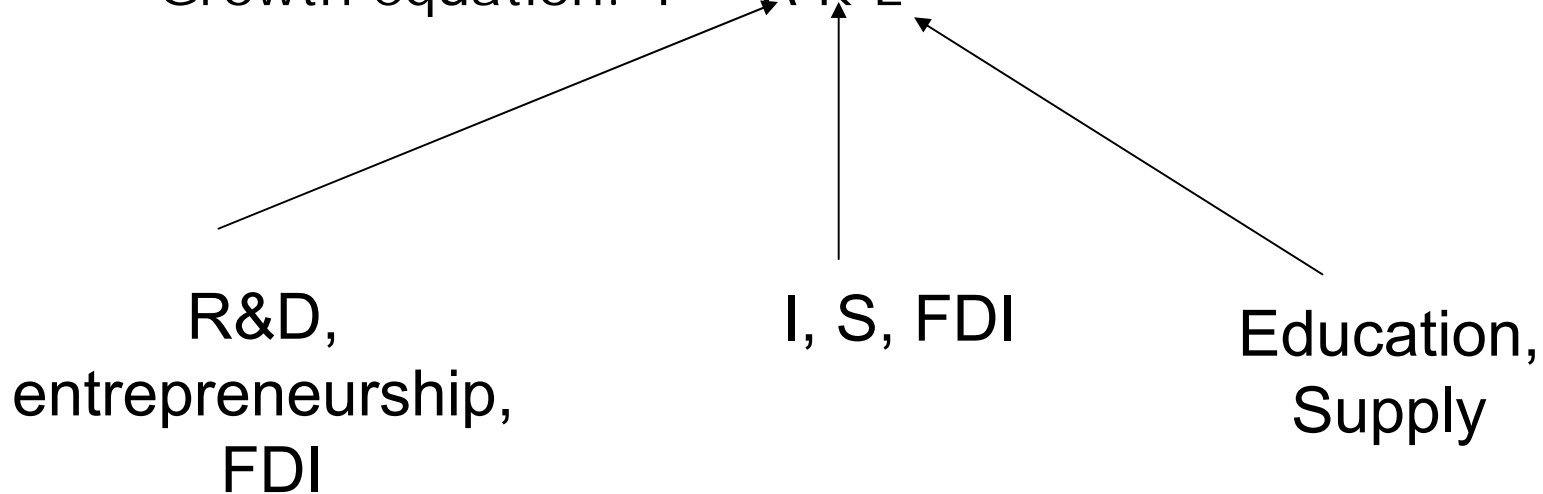
⇒ (HOW) DOES TAXATION AFFECT GROWTH?



## *Taxation and Growth-Theory*

Myles (2008) – Economic growth and the role of taxation

- Growth equation:  $Y = A K^\alpha L^{1-\alpha}$





## ***Taxation and Growth-Theory***

Each of these drivers of growth might be affected by taxation, e.g.

- Tax on labour affects
  - Labour market decisions: income and substitution effect
  - Investment in education
- Tax on capital affects investment decisions
  - *Where* to invest and locate the profits, *how much* to invest, how much R&D
- Tax on consumption affects:
  - impact on people's consumption decisions
- Taxation enables provision of public goods

**IN THEORY MARGINAL TAX RATES INFLUENCE DECISIONS**



## *Taxation and Growth-Empirics*

Extensive empirical literature

- Prior: Taxation has negative and positive effects on growth
  - Negative effect: due to disincentives and distortions
  - Positive effect: provision of public goods
- Results from taxation regressions: ambiguous
  - Some studies find small significantly negative effects
  - Other only find insignificant relationship with growth
- Problem: inadequate summary of tax systems by using total tax/GDP ratio

Numerous literature reviews (e.g. Myles 2009) confirm these ambiguous effects



## *Taxation and Growth-Way forward*

- Recent literature has focused on the effects of tax structure on growth
- OECD 2008, Myles 2009:
  - Ranking of “best taxes” for growth and employment:
    1. Property taxes, in particular recurrent immovable property taxes
    2. Consumption taxes
    3. Personal income taxes
    4. Corporate income taxes
- Also the Europe 2020 strategy gives particular attention to the quality of taxation, asking for “growth-friendly” tax systems
- Pro-growth tax reforms can take equity objectives into account