Box 5

Tax reforms in the euro area

Important tax reforms are under way in the euro area

Most euro area countries are currently implementing or planning significant reductions in labour and corporate income taxation and social security contributions. The objectives, which are broadly shared by all countries, are (i) to promote employment and investment via lower marginal taxation and contribution rates, (ii) to increase tax neutrality with respect to savings and financing instruments, (iii) to improve the efficiency of tax administration, and (iv) to simplify tax codes. This is expected to raise aggregate supply and the non-inflationary growth potential in the euro area.

Tax reforms are also needed from an international perspective. Most euro area countries have an average tax burden far in excess of the main industrialised countries outside the euro area. Relative to the tax plans announced at the beginning of 2000, tax reforms have gained momentum in all euro area countries: future plans have been brought forward and, in some cases, the announced measures have been frontloaded. The quantitative effect of tax and social security cuts is quite significant, reflecting the large scale of reforms in many of these countries. At the same time, some increases in indirect taxes, the widening of tax bases and efficiency gains in tax collection will compensate for a small share of the revenue loss. In the euro area, the cumulative total of tax cuts in 2000 and 2001 will average some 1 percentage point of GDP. Further tax cuts are planned in a number of countries in 2002 and beyond.

Reforms are following a common pattern and are moving in the right direction

The tax reforms are following a common pattern, although they differ across countries in terms of their size and composition. About half of the euro area countries are expected to cut taxes by more than 1 percentage point of GDP over 2000-01, whereas one country is expected to raise taxes. In most countries, tax cuts will benefit the household sector more than the corporate sector.

Most euro area countries have introduced or plan to introduce significant corporate and personal income tax cuts. The latter will typically benefit all income groups, although many countries favour low-income earners. A number of countries explicitly state the objectives of alleviating poverty and unemployment traps, promoting "fairness" in the tax system and stimulating labour demand and supply. The objective of promoting employment is also behind the social security contribution cuts pursued in roughly half of the euro area countries.

Most countries have also implemented or are planning corporate tax rate reductions. The related costs are partly being offset by broadening the tax base via less generous tax allowances for depreciation. A number of countries have reorganised and rationalised capital income taxation, aiming at a more neutral taxation of income from various sources (i.e. dividends, interest income and capital gains) in order to reduce distortions in investment and financing decisions. Some countries have also implemented tax measures to promote corporate reorganisation and restructuring. A number of countries have passed legislation or reinforced existing legislation favouring small and medium-sized firms.

Tax and social security contribution cuts are being partly compensated for by increases in indirect and environmental taxes in a minority of countries. All countries expect a positive fiscal contribution from more efficient tax systems and tax fraud prevention, and three of them have set explicit targets in this direction. A number of countries are also seeking to simplify different parts of their tax systems.