Ingredients for a European Fiscal Revolution

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Roadmap of the talk

1. **Euro-bonds**: the current euro zone crisis is very serious; if we do not mutualize our public debt, there is a serious risk that the euro becomes very unpopular very soon
   → new treaty & new euro-parliament

2. **Euro-taxation**:
   2.1. **General context**: globalization, inequality ↑, low growth
       → we need tax justice & fiscal progressivity more than ever
   2.2. **Personal income tax**: left to member states? Ok but we need EU help, e.g. automated information exchange; so far savings directive didn’t work → no more unilateral deals
   2.3. **Corporate income tax**: FTT not enough; we need EU corporate tax → no more unilateral corporate tax cuts
   2.4. **New balance between labor and capital**
       → no more unilateral repeal of wealth taxes
       → **without binding commitments** (in PES platform?), local socialist parties tend to follow tax competition forces & behave like conservatives when they come to power…
1. Getting out the crisis: eurobonds

- Euro zone countries have less public debt than US, UK, Japan... but we have a sovereign debt crisis, not them
- Europe is the richest economic area of the world: we should be able to fix our public finance pb without asking help to China or Brazil or the IMF...
- EU27: GDP 12 tril. €, pop 500m (24 000€ per capita)
  (Euro zone: GDP 9 trillions €, pop 330m)
- China GDP 4 tril. €, Brazil GDP 1,5 tril. €
- EU households own over 50 tril. € in net wealth (incl. over 25 tril. € in financial assets), i.e. 20 times more than China’s reserves (2.5 tril.€), 5 times more than total EU public debt (10 tril. €)

→ our problem entirely come from inadequate fiscal & budgetary institutions
• US, UK, Japan pay 2% on their public debt; but Southern European countries – and maybe France in the coming months – pay 5%, 6% or more, including countries with less debt than US, UK, Japan

• Why? Because in US-UK-Japan the central bank plays its role of lender of last resort; a large fraction of the extra debt (≈10-20% of GDP) was purchased by the central bank; the ECB holds only 1,5% of GDP in public debt

• But the ECB will be able to fully play its role only if eurozone countries mutualize their public debt, which requires federal budgetary decisions, which requires a federal parliament with real budgetary power: either the European Parliament, or a new « European Senate » with MPs from national parliaments’ finance commissions
2.1. Euro-taxation: the general context

• Huge rise of income inequality since the 1970s-1980s, especially in the US (>50% of total growth absorbed by top 1%) & in Anglo-saxon countries

• We observe the same trend in Continental Europe since the 1990s-2000s

• Tax competition tends to reduce taxes on top incomes & capital, and to exacerbate the trend

• Tax progressivity also affects on pre-tax incomes

→ so far the rise of inequality has been much less strong in the EU than in the US; but the same process is at work; this can destroy our social model; we should react before it becomes as large as in the US
FIGURE 1
The Top Decile Income Share in the United States, 1917-2007

Income is defined as market income including realized capital gains (excludes government transfers).
FIGURE 2
Decomposing the Top Decile US Income Share into 3 Groups, 1913-2007
Table 1. Top Percentile Share and Average Income Growth in the US

<table>
<thead>
<tr>
<th>Period</th>
<th>Average Income Real Annual Growth</th>
<th>Top 1% Incomes Real Annual Growth</th>
<th>Bottom 99% Incomes Real Annual Growth</th>
<th>Fraction of total growth captured by top 1%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976-2007</td>
<td>1.2%</td>
<td>4.4%</td>
<td>0.6%</td>
<td>58%</td>
</tr>
<tr>
<td>Clinton Expansion</td>
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</tr>
<tr>
<td>1993-2000</td>
<td>4.0%</td>
<td>10.3%</td>
<td>2.7%</td>
<td>45%</td>
</tr>
<tr>
<td>Bush Expansion</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002-2007</td>
<td>3.0%</td>
<td>10.1%</td>
<td>1.3%</td>
<td>65%</td>
</tr>
</tbody>
</table>

Computations based on family market income including realized capital gains (before individual taxes).
Incomes are deflated using the Consumer Price Index (and using the CPI-U-RS before 1992).
Column (4) reports the fraction of total real family income growth captured by the top 1%.
For example, from 2002 to 2007, average real family incomes grew by 3.0% annually but 65% of that growth accrued to the top 1% while only 35% of that growth accrued to the bottom 99% of US families.
Figure 7A. Top 1% share: English Speaking countries (U-shaped), 1910-2005

Top Percentile Share (in percent)

- United States
- United Kingdom
- Canada
- Australia
- Ireland
- New Zealand

Year:
- 1910
- 1915
- 1920
- 1925
- 1930
- 1935
- 1940
- 1945
- 1950
- 1955
- 1960
- 1965
- 1970
- 1975
- 1980
- 1985
- 1990
- 1995
- 2000
- 2005
Figure 7B. Top 1% Share: Middle Europe and Japan (L-shaped), 1900-2005
Why are US top incomes so high?

• Hard to account for observed variations with a pure technological, marginal-product story

• One popular view: US today = working rich have become very productive; they simply get their marginal product (globalization, superstars);

• Europe today (& US 1970s) = market prices for high skills are distorted downwards (social norms, etc.)

→ very naïve view of the top end labor market…

& very ideological: we have zero evidence on the marginal product of top executives; it could well be that prices are distorted upwards… very likely given that they set their own price!
A more realistic view: grabbing hand model = marginal products are unobservable; top executives have an obvious incentive to convince shareholders & subordinates that they are worth a lot; no market convergence because constantly changing corporate & job structure (& costs of experimentation)

→ when pay setters set their own pay, there’s no limit to rent extraction... unless confiscatory tax rates at the very top

→ the decline in tax progressivity largely explains the huge rise in top incomes

(memo: US top tax rate (1m$+) 1932-1980 = 82%)
2.2. Personal income taxation

- We need tax progressivity more than ever
- Standard EU view: personal income taxation should be left to member states. **Yes, but…**
- **Yes**. We cannot centralize everything at EU level. It makes more sense to centralize corporate taxation rather than personal taxation: firms more mobile than individuals.
- There is a lot that member states can do on their own in order to make their tax system more transparent, efficient and progressive
- Europe should not be used as an excuse to do nothing
- E.g. French income tax particularly archaic: many special tax regimes, tax not levied at source → tax reform proposal to be implemented at the national level, interactive web site, see [www.revolution-fiscale.fr](http://www.revolution-fiscale.fr)
- **But…** the lack of tax coordination is becoming more and more problematic
• **(a)** Tax competition $\rightarrow$ gradual decline of top tax rate (+ special regimes to attract foreigners with top incomes, see e.g. Denmark…) $\rightarrow$ can PES members agree to a minimal top rate of 50% ?

• **(b)** Without automated information transmission between countries, taxing capital income at the same rate as labor income is becoming increasingly difficult

• So far the EU savings directive has been a failure: too many loopholes; the “transitory regime” should come to an end; the directive should apply to accounts held via tax havens

• Can PES members commit not to pass unilateral side deals with Switzerland and other tax havens ?
Personal income tax competition in the EU

Average top personal income tax rate (Euro zone)

Average top personal income tax rate (EU 27)

Source: Taxation trends in the EU, Eurostat 2011
Swiss deposits by country: The impact of the EU savings directive

2.3. FTT & corporate income tax

- Total financial transactions = 60 x GDP (6000% of GDP)
  → with a 0.05% tax, one can raise 3% of GDP in revenue
  … except that the volume of financial transactions will fall
  following the introduction of a FTT
  → PES flyer: 200bil. € in revenue, i.e.≈ 2% EU GDP
- This is probably over-optimistic
- **FTT revenue: 0.5-1% GDP seems more realistic**
  [Note: Financial sector ≈ 5-6% GDP, incl. 2% GDP in profits
  → it is hard to raise 2% GDP from a sector making 2% GDP
  in profits → be careful with double-dividend illusion]

- **Bottom line: FTT is a good idea, but is not sufficient**
  → we also need a EU corporate income tax
• Total corporate profits (fin+non-fin) ≈ 12-13% of EU GDP
  → with a 30% tax, one can raise 3-4% of GDP revenue
  → corporate income tax might be less sexy than FTT, but its revenue potential is much larger!

• Pb = tax competition between EU countries tends to drive effective corporate tax rates towards 0%...
• In principle, socialist parties are against tax competition
• But when they are in power they tend to do the same as conservative parties: see French PS proposal to cut corporate tax rate on re-invested profits in 2012
  → without a EU corporate tax, there will be no more taxation of corporate profits in 10 years…
  → **binding commitment in PES platform?**
Corporate tax competition in the EU

- Average statutory corporate tax rate (EU 27)
- Average effective corporate tax rate (EU 27)

Source: Taxation trends in the EU, Eurostat 2011
2.4. New balance between labor and capital

• **Key mechanism:** $r > g \rightarrow$ bad for labor, good for capital → we need a new fiscal balance

• With low growth and $r > g$, two things happen:
  (i) wealth-income ratios tend to be very large
  (ii) inheritance tends to dominate new wealth; i.e. the past eats up the future

  (with: $r =$ rate of return to capital = \((\text{net profits + rents})/(\text{net wealth})\); $g =$ growth rate)

• **Intuition:** with $r > g$ & $g$ low (say $r=4\%-5\%$ vs $g=1\%-2\%$), wealth coming from the past is being capitalized faster than growth; heirs just need to save a fraction $g/r$ of the return to inherited wealth

  → It is only in countries & time periods with $g$ exceptionally high that self-made wealth dominates inherited wealth (Europe in 1950s-70s or China today)
Figure 2: Wealth-income ratio in France 1820-2008

- Aggregate private wealth as a fraction of national income
Annual inheritance flow as a fraction of disposable income, France 1820-2008

Conclusion

• A world with $g$ low & $r > g$ is gloomy for workers with zero inherited wealth… especially if global tax competition drives capital taxes to 0%…especially if top labor incomes take a rising income share

• **Europe is particularly vulnerable**: $g$ very low (negative population growth in Italy, Spain, Germany), tax competition very high

• In the long run, we need EU coordination on all capital taxes: inheritance taxes, wealth taxes

• In the short run, let’s try at least not to suppress wealth taxes when the left is in power (Spain…)