GUEST EDITORIAL

The Future of Taxation in Europe

During the last few years, the European Parliament and the European Commission have co-hosted several high-level symposia on the future of taxation in the European Union (EU). Here's our take on the intriguing question: what might we reasonably expect for the future of taxation in the EU?

1 Looking Back

To look into the future, let's first try to understand the past.

The last one-and-a-half century shows some remarkable change in tax systems. In the old days, say before 1870, states used simple tax handles to fund their operations, such as customs duties, transaction taxes and several funny taxes that were recently described in the fascinating book by Joel Slemrod and Michael Keen (2021): taxes on chimneys, windows, hats, wigs, candles, mirrors, dogs, salt, bricks, and more. Many of these taxes were of course highly distortionary as they are directly penalizing the functioning of markets and trade.

The modern income tax was a major innovation of the late nineteenth and early twentieth century. In Britain, a progressive income tax was introduced earlier, in 1799, (to help finance the Napoleonic Wars). Arguably, this was in line with Adam Smith's prescription from the *Wealth of Nations* (1776), that 'The subjects of every state ought to contribute towards the support of government, as nearly as possible, in proportion with their respective abilities; that is in proportion with the revenues that they respectively enjoy under the protection of the state'. Corporate income taxes came later and served as an effective withholding mechanism for the income tax. Anticipations of the international corporate tax system go back to the 1920s.

These innovations have led to a much more prominent role of the state. Tax-to-GDP ratios rose from a little over 7% in 1870 to well above 27% today. It coincided with the appearance of the modern social welfare state. Brad DeLong (2022) describes it as the long twentieth century that has been associated with the best 140 years of economic growth in history.

In the 1970s and 1980s, top income tax rates on personal income had risen to levels of 70 or 80%, while corporate tax rates were often 40 to 50%. These high rates turned out to be too distortionary to the point of becoming counter-productive. Since then, tax rates have declined. But with base broadening occurring at the same time, revenues have sustained.

After WWII, France invented the Value Added Tax (VAT). This gained traction in the European Union (EU) in the 1970s to replace various distortionary and cascading turnover taxes. Since then, we have seen a global 'spread of VAT', with a leading role of the IMF. In Europe, VAT is now responsible for more than one quarter of revenue.

During the last twenty years we have also witnessed something else: the corrective role of tax. This is based on Pigou's principle to set prices right in the sense of internalizing external effects. One salient example is to make polluters pay. Carbon taxes and other environmental levies were first pioneered in Scandinavia in the 1990s and have since spread to almost fifty countries around the world.

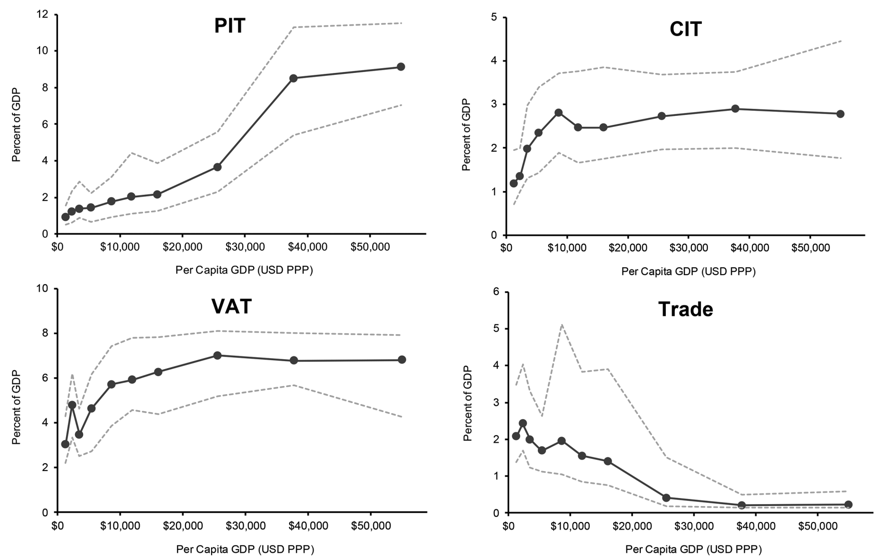
What is striking is that all listed tax innovations originated from Europe. What they have in common is that they came in response to mounting distortions that made the earlier system untenable. They also explored new information and enhanced administrative capacity as it became usable over time. We see that with economic development comes a shift in the tax mix away from distortionary taxes such as on trade toward more sophisticated taxes such as those on personal income (Figure 1).

2 Drivers of Change

The European Commission distinguished four mega trends that will likely shape the tax mix of the future. Our perspective on these matters is based on Joel Slemrod and Christian Gillitzer (2014) who emphasize the importance of integrating tax policy, revenue administration and the legal system:

– **Digitalization** – or perhaps more to-the-point in the context of taxation: the information revolution. Digital revenue administration has already visibly reduced tax compliance gaps around the world. During the pandemic, we saw how quickly transformations happened. And much more is likely to come in the next thirty years – with the mindboggling speed of developments in generative artificial intelligence. The intriguing issue is that the information

Figure 1 Tax Effort by Tax Type and Income Level, 1999–2020 (Percent of GDP in USD, PPP)



Sources: IMF WoRLD and IMF staff estimates.
Note: The dots represent median values for each income decile, and the dotted lines 25 and 75 percentile bounds.

revolution puts classic tax theory on its head. This theory is based on information constraints, which is at the heart of the theory of second-best. Digitalization urges us to rethink the old ways of taxation – distortions are no longer what they were in the past.

- **Population dynamics** – An ageing society with a declining population faces the inevitable challenge how the shrinking working population can support the expanding group of retirees. The heavy reliance on labour taxes seems unsustainable. As more elderly people retire and dissave, the tax burden will have to shift to capital and consumption taxation, which are more robust revenue sources in an ageing society.
- **Globalization** – New digital technologies and intangible assets make production factors ever more mobile, and it is therefore harder to sustain taxes where the production factors are located. The destination principle is more robust to globalization because it depends on the location of consumers (who are comparatively less mobile). Destination is already the dominant paradigm for VAT. But it is also applied in pillar 1 of the international corporate tax agreement led by the G20/OECD.
- **Global public goods** – not only do climate externalities call for carbon taxes to reflect the social cost of greenhouse gas emissions, but corrective taxes can possibly also be used for other environmental problems (waste, biodiversity), and other global public goods such as health (pandemics) or externalities in the financial sector (crypto assets).

While the four mega trends will most likely shape the direction of change in the tax system of 2050, such change will need to be managed by governments and institutions. We cannot simply assume that the theoretically ideal tax response can and will be implemented, given the vast uncertainty about the political and institutional situation in Europe and in the rest of the world. It is therefore critical to understand how the political economy of tax reform will evolve in the coming decades. Given uncertainty about this political and institutional dimension, we look at scenarios.

3 Scenarios for the Future

The scenarios are based on two key exogenous uncertainties for the future.

The first uncertainty is related to the degree of trust in government. For instance, for government to be trustworthy in the digital age, it must prove its strong accountability and transparency through the primacy of the rule of law and permanent scrutiny by citizens. Can governments live up to that expectation? Or will they lack credibility, act opportunistically, and create uncertainty?

The second uncertainty relates to the scope and depth of international cooperation. Will countries manage to effectively cooperate to address common challenges? Or will there be fragmentation, polarization and geopolitical rivalry, as we currently observe in some areas?

By combining these uncertainties, we can in principle sketch four scenarios. However, let us for the sake of simplicity focus on two of them, to show how taxation could differ in alternative worlds of the future:

- **Scenario 1 is a world of mistrust in government, polarization and fragmentation.** In this world, citizens demand strict data privacy and digitalization cannot revolutionize tax enforcement. Rather,

digitalization and artificial intelligence exacerbate market power of large multinationals and raise the power of elites. This limits the ability for progressive taxation. Unreliable governments do not deliver on their promises and tax certainty is low; governments rely on instruments such as repeat amnesties and ad-hoc windfall taxes instead of a stable rules-based system. At the same time, fragmentation prevents effective international and European cooperation: countries are reluctant to introduce carbon taxes and there remains fierce tax competition that erodes corporate and personal tax bases. The world fails to deliver on the 2015 Paris agreement commitments.
– **Scenario 2 is a world of trust and international cooperation.** In this world, governments can exploit the gains from digitalization; effectively respond to domestic trends such as ageing; and cope with international challenges such as tax competition, tax avoidance/evasion and climate change (with a central role for carbon pricing, *see* IMF 2023).

While the second scenario is obviously preferable, achieving it requires hard work in building and sustaining credible institutions, including a strong EU.

4 Strong Europe

A strong EU will be ever more important to address the common European challenges that are clearly reflected in the mega trends of the EC, and which cannot effectively be resolved by individual countries. A stronger role of the EU is necessary to deliver macroeconomic stability and Europe-wide public goods. This role will likely have to go beyond the coordination of national tax policies and raises the important question about the vision for the EU budget in 2050: What will be the financing model to the EU budget in 2050? Will there be European taxes? How would that fit in the overall tax system (European; national, sub-national)?

Remember that in the US, the central government in 1780 had no taxing powers and relied entirely on national contributions from the thirteen states of the confederation. And each state had veto power. Alexander Hamilton built the Federal public administration (including the capacity to tax). He managed the transition from a bankrupt government to a financial system where US Treasuries stood as the ultimate safe asset. A financial system that developed to world dominance in the twentieth-century. Today, governments of very large countries – China and India – have a share of spending at sub-national level that is much higher than elsewhere. But even compared with these giants the share of sub-Union government spending in the EU is much higher still. Here, Europe might learn from others.

In recent years, the EU has played a stronger role by helping build resilience against common shocks – COVID 19, Russia's invasion of Ukraine – and in the provision of collective European goods and goals – energy transition and energy security, technology. These trends make an increased role for the EU budget increasingly profound. The paradigmatic example is Next Generation European Union (NGEU). On June 2021, the EU issued the first bonds under the NGEU program. The justifications were the need to ensure macroeconomic stability (with monetary policy constrained by the lower bound on nominal interest rates) and to facilitate investment in European-Union wide public goods. At EUR 750 billion (or more than 5% of GDP) over five years, the initiative is highly relevant.

But we should pause to consider the centrality of the associated political questions. Just as a reminder, in 1998, John Rawls in correspondence to Philippe van Parijs, wrote:

> One question the Europeans should ask themselves is: how far-reaching should their Union be? It seems to me that much would be lost if the European Union became a federal union like the United States. The large open market is the aim of large banks and the capitalist business class. I can't believe that that is what you want.

Rawls' formulation reminds us of the fundamental political nature of the question.

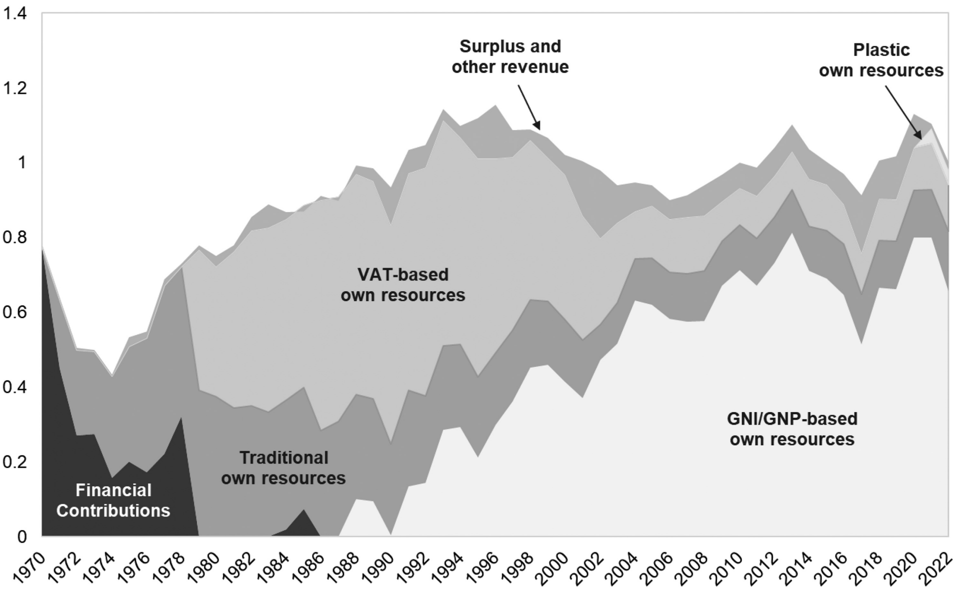
The current financing model of the union is over-reliant on national contributions (Figure 2). Further progress towards fiscal union points to the need for European-wide taxation. A look at existing federations in the world suggests that the corporate income tax deserves consideration. Its tax base is relatively mobile across countries, so that spillovers of national policies are large. In addition, in Europe, it could be argued that large multinational corporations benefit disproportionally from the European Single Market (a point emphasized by John Rawls). In the EU there is yet no significant common tax base. But in the context of the OECD international corporate tax agreement, residual profits are defined. An excess profit tax on EU-based multinationals, in turn, seems an attractive possibility within the sphere of corporate taxation.

5 Global leadership

A strong Europe is important for the world. Europe's role in the global economic order is vital. As history shows, Europe has always been at the frontier of tax system innovation and served as the pioneer of the social welfare state. More generally, the institutional and legal progress towards international integration at continental level, is an example and source of inspirations for other regions across the globe. Going forward, it may continue to play such leadership role.

Remember that the last stage of the 150 years of taxation was the development of corrective taxation. While pioneered in Europe, carbon pricing has been spreading across the world, ranging from Asia to Africa and Latin America (IMF 2023). To further its global leadership role, the EU could advocate for a side agreement among large players – like China, India, the US, the

Figure 2 Funding Sources of the EU Budget (Percent of GNI)



Source: European Commission.
Note: Traditional own resources include agricultural duties, customs duties and sugar levies. GNI-based own resource replaced GNP-based own resource in 2002. Financial contributions are defined as financial contributions (pre-own res. system) for the period 1970–1981 and as reimbursable and non-reimbursable advances for the period 1984–1985. Other revenue is excluded for 2021 and 2022.

African Union, and the EU – to attain the Paris temperature goals through a carbon price floor, as advocated by the IMF (Parry et al. 2021). The revenues could be shared among signatory parties to ensure that the benefits also accrue to smaller and poorer countries (De Mooij and Gaspar 2024).

The single market of 1992 and the single currency of 1999 are Europe's most emblematic achievements. The best environment for Europe is capitalism embedded in a rules-based global order. For Europe to be effective in the global arena, its countries must work together. As Jean Monnet said to his colleagues on 9 November 1954: '*Our countries have become too small for the world of today, for the scale of modern technology and of America and Russia today, or China and India tomorrow*'.

6 References

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Vitor Gaspar & Ruud de Mooij,
International Monetary Fund
Email: vgaspar@imf.org and rdemooij@imf.org.