EU Tax Symposium "Road to 2050: A Tax Mix for the Future"
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[1] TITLE SLIDE

Thank you very much for inviting me to speak in the EU Tax Symposium: Road to 2050.

I find the topic of 'the tax mix for 2050' timely and important. To me, it shows how the EC is ahead of the game in preparing for the challenges of the future. This is very welcome and very necessary in today's turbulent times. Many policy makers are occupied with the transition out of the pandemic or dealing with the challenges of inflation. During such turbulent times, the contrast between wisdom and folly looms large and can have long lasting consequences.

The focus on tax and 2050 allows me to reminisce on my experience at the Commission's Bureau of European Policy Advisers and the last report I wrote for the President of the European Commission on Taxation in the Digital Economy.

[2] BACK IN HISTORY

To predict the future, we first need to understand the past. Let me take 4 minutes to highlight some of the remarkable changes in taxation that have occurred over the last 1½ century or so.

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 a fascinating book by Joel Slemrod and Michael Keen (e.g. taxes on chimneys, windows, hats, wigs, candles, mirrors, dogs, salt and bricks). Many of these taxes were of course highly distortionary as they are directly penalizing the functioning of markets and trade.

You may even have noticed that I stole the reference—to wisdom and folly—from the Keen and Slemrod book.

The modern income tax was a major innovation of the late 19th and early 20th century. It was first developed in Britain. Corporate income taxes came a little 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 showed that this long 20th century is 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 and became unstainable. Since then, tax rates have declined.

After WWII, France invented the Value Added Tax. This gained traction in the 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 20 years we have also witnessed something else: its corrective role. This is based on Pigou’s principle to set prices right and, for example, make polluters pay. Carbon taxes and other environmental levies were first pioneered in Scandinavia in the 1990s and have since spread to 45 countries around the world.

Please note that all listed tax innovations originated in Europe. What they have in common is that they came in response to mounting distortions that made the earlier system untenable. They also explored information and administrative capacity as they became usable, over time. These themes I will explore in the remainder of my talk.

[3] DRIVERS OF CHANGE

The EC has identified 4 mega trends that will likely shape the tax mix of the future. Let me reflect briefly on each of them and how I think they will drive changes in taxation. I think the best perspective to take is that of Joel Slemrod in his book of 2014 who emphasizes the importance of an integrated approach encompassing tax policy, administration and legal aspects.

#1 Digitalization: or in the context of taxation, perhaps call it **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 30 years. What I find intriguing is that this information revolution is putting classic tax theory on its head. This theory is based on information constraints—the theory of 2nd best. We now need to rethink the old ways of taxation—distortions are no longer what they were in the past.

#2 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 to be unsustainable. As more elderly people retire and dissave, the tax burden will have to shift to consumption taxes, which are a more robust revenue source in an ageing society.

#3 Globalization has been ongoing for decades. 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. The destination principle is more robust to globalization because it depends on where less mobile consumers are. We already see a tendency toward destination-based taxes, for example in Pillar 1 of the global tax deal and the gradual shift toward VAT.

#4 Global public goods: Not only do climate externalities call for carbon tax to reflect the social cost of GhG emissions; corrective taxes can possibly 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).

So, the 4 mega trends will likely shape the direction of change in the tax system of 2050. However, change needs to be managed by people in governments and institutions. We therefore need to understand also how the political economy of tax reform evolves to make informed predictions of the future.

[4] SCENARIOS FOR TAX MIX

Let me offer a brief perspective on what might happen with the tax system over the next 3 decades by sketching two scenarios. It emphasizes that we cannot take for granted that the theoretically ideal tax response can be implemented. The scenarios are based on two key uncertainties for the future:

(i) **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. That is exactly what Lorenzetti's painting here and on the first slide reflect. Can governments live up to that expectation? Or will they lack credibility, act opportunistically, and create uncertainty?

(ii) **International cooperation**: Will countries manage to effectively cooperate to address common challenges? Or will there be fragmentation, as we currently see in some areas?

By combining the two key uncertainties, we can in principle sketch 4 scenarios. Given time, I'm highlighting only two (2) of them, to show how the tax mix could differ in these diverging worlds.

- **Scenario 1 is a world of mistrust in government and fragmentation.**
    - In this world, citizens demand strict data privacy and digitalization can't revolutionize tax enforcement. Rather, digitalization exacerbates market power of large multinationals and raises the power of elites. This limits the ability for progressive taxation.
    - Also in this world, 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.
- **Scenario 2 is a world of trust and international cooperation**
    - In this world, governments can (i) exploit the gains from digitalization; (ii) effectively respond to domestic trends such as ageing; and (iii) cope with international challenges such as tax competition, tax avoidance/evasion and carbon pricing.

I prefer the second scenario. But that scenario requires hard work in building and sustaining credible institutions, including in the EU. A strong Europe will be essential for two reasons.

[5] EU IN THE WORLD

First, in 2050 we need a strong Union to address the common European challenges reflected in the mega trends that cannot be resolved by individual countries. A stronger role of the EU based on macroeconomic stability and Europe-wide public goods will be essential to remain credible. This role might go beyond the coordination of national tax policies and also 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 13 States of the confederation. And each state had veto power.

Second, 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. Is may again play this leadership role in the developments to 2050.

The single market of 1992 and the single currency of 2001 are its 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. Let me conclude with a quote from Jean Monnet from November 9, 1954. On that day, he said to his colleagues. "*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*".