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The impact of the tax system on gender equality in Luxembourg

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1. Taxation in Luxembourg

1.1. The current system

In Luxembourg, personal income tax, *l'impôt sur le revenu des personnes physiques*, is currently imposed at the level of the family unit where the family unit is defined by marriage or civil partnership. Taxpayers are accorded a tax class according to their family status. Married taxpayers belong to tax class 2 as do civil partners who live together for a full tax year and elect to file jointly. Most other individuals belong to tax class 1 (except for the elderly, single parents and some widow(er)s).

The tax schedule is progressive. For taxpayers in tax class 1, tax is determined by applying the tax schedule to taxable income. For taxpayers in tax class 2, tax is determined by applying the tax schedule to taxable income, divided by 2. The tax bill obtained is then multiplied by 2. A form of "marriage premium" called an *abattement extra-professionnel* also exists consisting of a tax-free allowance of EUR4,500 per annum awarded to married couples in which both spouses work.

A recent analysis of the Luxembourgish labour market by Doorley (2016) showed that, among 25-55 year olds, just 40% of married women work full-time while a further 29% work part-time. The corresponding figures for men are 95% and 3%, giving a participation rate of working-age married women of 69% compared to a participation rate of working-age married men of 98%. Luxembourg has one of the largest discrepancies in the EU between the proportion of men working part-time and the proportion of women working part-time. As well as large differences in working probabilities, there are differences in wage rates with working age married men earning EUR26 per hour compared to EUR21 for working age women.

1.2. Reform

From 2018, married and civil partnered taxpayers[1] will be able to opt for individual taxation. Couples opting for individual taxation will have the choice between two different regimes:

- A full individual taxation (*individualisation pure*), where each item of income is allocated individually to each partner;

[1] Currently, civil partnered taxpayers are taxed individually. Upon request, they can be taxed jointly by tax assessment at the end of the tax year, provided they complete a tax return and that they have shared a common residence for whole tax year.

- An individual taxation with reallocation of income (*individualisation avec réallocation des revenus*), where the total adjusted taxable income of the household (determined based on the aggregate net income and applicable tax deductions) will, by default, be allocated equally between the spouses, irrespective of the level of their individual income. The spouses can also request a different allocation of the total adjusted taxable income.

Individual taxation with reallocation of income is thus a partial shift to individualisation as partners will still be allowed to reallocate their income in order to use all available tax credits and lower rate tax bands. The “marriage premium” will be split equally between spouses who opt for full individual taxation or individual taxation with equal reallocation of income. The couple’s total tax bill should be identical whether they opt for joint taxation or individual taxation with reallocation of income. Taxpayers, either by choosing the full individual taxation or the individual taxation with reallocation of income, will only be responsible for paying taxes due on their own earned income.

Doorley (2016) investigated the expected impact of a switch from joint taxation to a wholly individualised system of earned income taxation in Luxembourg. The main findings of this study were that a straight switch to individual taxation would have a large and negative effect on disposable income for almost all married households. The average loss is 4% of disposable income. The biggest losers are the households in which the partners have more unequal incomes, with one earner couple households standing to lose the most. This study also showed that the labour supply of married women could be expected to increase by at least 1% if the current joint taxation system was fully individualised. This increase could be expected at the extensive margin (the decision to work) rather than at the intensive margin (the number of hours of work). However, the switch would mainly incentivise part-time work. The policy change would have a large and positive effect on fiscal budgets, leaving scope for further policy changes (to tax credits or band rates) to make the entire package of changes revenue neutral and, importantly, more palatable to the taxpayer.

Since the 2018 reform is not a shift to full individualisation, but, rather, provides an option for taxpayers in couples to choose how to allocate taxation among themselves and how, administratively, to pay it, it should have no effect on the disposable income of couple households. It should also have little effect on the labour supply decision of married women or on fiscal budgets. This, however, remains an empirical question which may only be tackled in the wake of the policy change in January 2018.

1.3. Other relevant institutional features

There are many other institutional features of the Luxembourgish system which reduce barriers to work for secondary earners. Luxembourg has a high-quality, flexible childcare system, which is heavily subsidised according to household income. Paid parental leave is granted to each parent for up to six months each, full-time, or the equivalent, part-time, and is non-transferable between parents, ensuring the primary earners can also take part in full or part-time childcare in the early years. Despite these measures, the fertility rate in Luxembourg is low, at 1.55 in 2013. A tax credit for paid domestic work is available, encouraging households to outsource their domestic tasks. Finally, long-term care insurance is a branch of compulsory Social Security which provides universal long-term care to those who need it, reducing the barriers for individuals with elderly dependents to work.

2. Policy debate

In most European countries, the labour force participation of the population as a whole is currently very topical in light of growing financial pressure on public social security systems. Research by Dolls et al (2015) has shown that projected demographic change over the next two decades will lead to fiscal stress in most European countries. Among other measures, policymakers are generally in agreement that a careful examination of which policy instruments to use to increase the labour force participation of women, without reducing the fertility rate, is needed.

The Luxembourgish government have stated that promoting gender equality, in general, and female labour force participation, in particular, is a priority for them. Individual taxation is seen as one step in this direction, in order to equalise the treatment of primary and secondary earners and to increase the labour supply of women. However, increasing the hours worked by women in the labour force is also important (and unlikely to result from an individual taxation system) as this would reduce the gender pay gap, the gender promotion gap and, given the increasing incidence of divorce, would also decrease the gender pension gap.

With a view to attaining the Europe 2020 headline target of a 75% employment rate, switching to optional individual taxation or even switching to a wholly individualised system is not likely, in itself, to be a sufficient measure in Luxembourg (Doorley, 2016). Further incentives which reward the number of hours of work as well as the decision to work in Luxembourg could come in the form of reforms to the retirement age (Dolls et al, 2015); decreased progressivity of the tax-benefit system (Bick and Fuchs-Schündeln, 2017), increased tax credits for employing domestic employees and further measures in the area of childcare.

3. Transferability issues

If Luxembourg were to proceed with a mandatory and fully individualised system of taxation in the future, there are a number of policy lessons that can be learned from the Swedish experience:

- Optional individual taxation, introduced in Sweden in 1966, was an ineffective policy measure with just 5% of the population opting to be taxed individually. A similar result may be observed in Luxembourg after the policy reform in 2018.

- Abolishing the Luxembourgish “marriage premium” (*abattement extra-professionnel*) would have to be done to transition to a fully individualised taxation system. The Swedish strategy of leaving the “housewife deduction” fixed in nominal terms until it became small enough to abolish completely might be a palatable way to do this from the point of view of the Luxembourgish public.

- More generally, Sweden changed its taxation system very gradually, individualising taxation on earned income in 1971 but not transitioning to a fully individualised system until 2007. This gradual move to individual taxation is credited with the change overcoming public resistance and being pursued by successive governments. A similar strategy in Luxembourg might be considered for the same reasons.

4. Conclusions and recommendations

Over the last few decades, the general trend in European Union countries has been a move from joint towards individual taxation. However, joint taxation, whereby the income of a couple in a household is fully split between them or aggregated in determining the income tax liability, is still present in the US as well as some EU countries, such as Luxembourg, despite the fact that this system imposes much higher marginal tax rates for the secondary earner in the couple. As women are generally the secondary earners in a couple household and, as they typically have more elastic labour supply, theory predicts that the optimal taxation model for labour supply should not impose higher marginal tax rates on women. In fact, lower marginal tax rates might be considered for this group if the primary objective is to increase labour force participation.[2]

The literature indicates that income tax heavily influences the decision of women to work (Blundell, 2014). There is a well-documented cross-country correlation between the average tax rate facing secondary earners in households and the female labour market participation rate (Jaumotte, 2003). Recent work by Bick and Fuchs-Schündeln (2017), which studies the US and 17 EU countries, also finds large disincentive effects of joint taxation on the hours worked of married women. The disincentives for labour force participation become particularly apparent if we compare market work (yielding highly taxed earned income) with non-market work in the household (yielding household goods which are not burdened by any tax). It is not surprising, therefore, that many women substitute their market work by non-market work, taking advantage of the favourable tax treatment of household good production (Kabátek et al, 2014).

A shift from joint to individual taxation, which would equalise the marginal tax rates of the primary and secondary earner, is an obvious policy route to take from the perspective of increasing female labour supply and reducing gender disparities in the burden of household production. It is a policy measure which could also decrease the administrative burden of the tax authorities, given that modern couples are less likely to marry and more likely to separate than the previous generation.

However, individualising the taxation system in Luxembourg is unlikely to achieve the Europe 2020 goal of 75% labour force participation. It is also unlikely to encourage part-time workers to switch to full-time work without accompanying measures, an outcome which would further advance equality between the genders in a number of ways. Further policies which could aid this target are more flexible and later retirement; decreased progressivity in the income tax system; extra tax credits for employing domestic help or childcare and taper rates in means-tested benefits which are set according to the age of the youngest child.

[2] The same argument can be made about young workers, older workers and the low educated, groups whose extensive labour supply is known to be most responsive to incentives (Blundell, 2014).

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