Fiscal drag in theory and in practice: A European perspective

Budget Perspectives 2027

Tara McIndoe-Calder*, García-Miralles, Freier, Riscado, Leventi et al. (2026)

Agenda

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Part 1
The potential for fiscal drag

WHAT BRACKET CREEP COULD COST

Tax-to-base elasticities across 21 European countries

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What is fiscal drag?

- **Tax systems are written in cash amounts.** Brackets, deductions and credits are set as euro figures – not as a share of income
- **Incomes rise in cash terms too** – with inflation, with wage growth, or both
- **If the cash thresholds don't move, taxpayers drift upward through them.** More income gets taxed at higher rates, even though nothing real has changed
- **The result: government revenue rises faster than incomes do.** This is fiscal drag, also known as "bracket creep"

Why this matters now

- **The 2021–23 inflation surge made fiscal drag impossible to ignore.** Wages and prices rose sharply across Europe, pushing more income through unchanged tax thresholds
- **Personal income tax is set nationally.** A common euro area inflation shock can affect member states very differently, depending on each country's tax design
- **That asymmetry matters for macroeconomic stability** in a currency union without a centralised fiscal capacity
- **This paper is the first systematic, microdata-based look** at fiscal drag across all 21 euro area countries plus Hungary

A 1% rise in everyone's income, with no change to tax rules, would lift personal income tax revenue by around 1.7%-2%

That gap between revenue growth and income growth is the "tax-to-base elasticity" – our gauge of potential fiscal drag

~1.7 to 2%

Average tax-to-base elasticity

across 14 of 21 countries studied (2019-2023)

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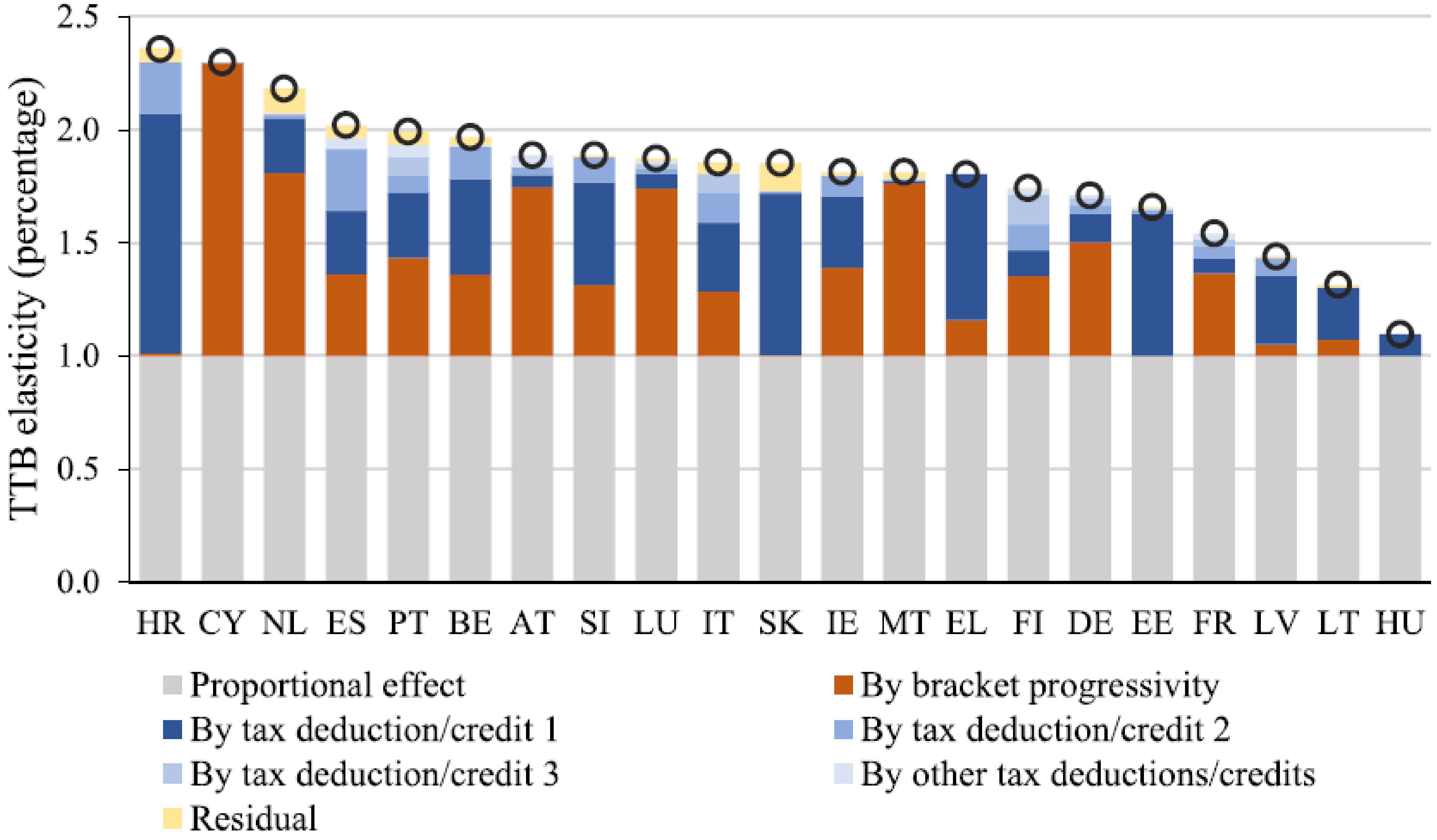
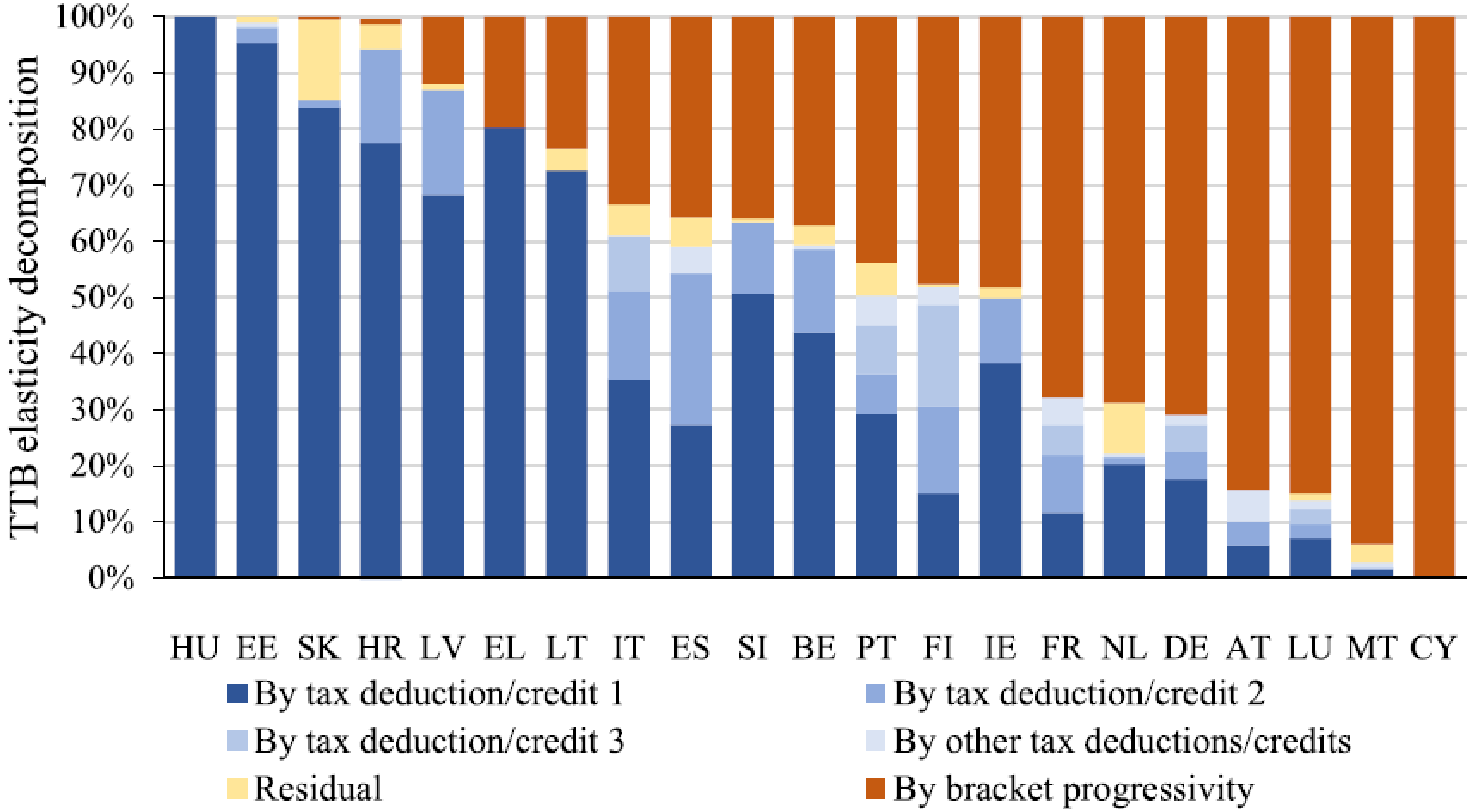
Where does the elasticity come from?

- Fourteen of 21 countries cluster between 1.7 and 2.0 despite very different tax designs
- Hungary (1.1) and Croatia (2.4) are the outliers



Brackets, or deductions?

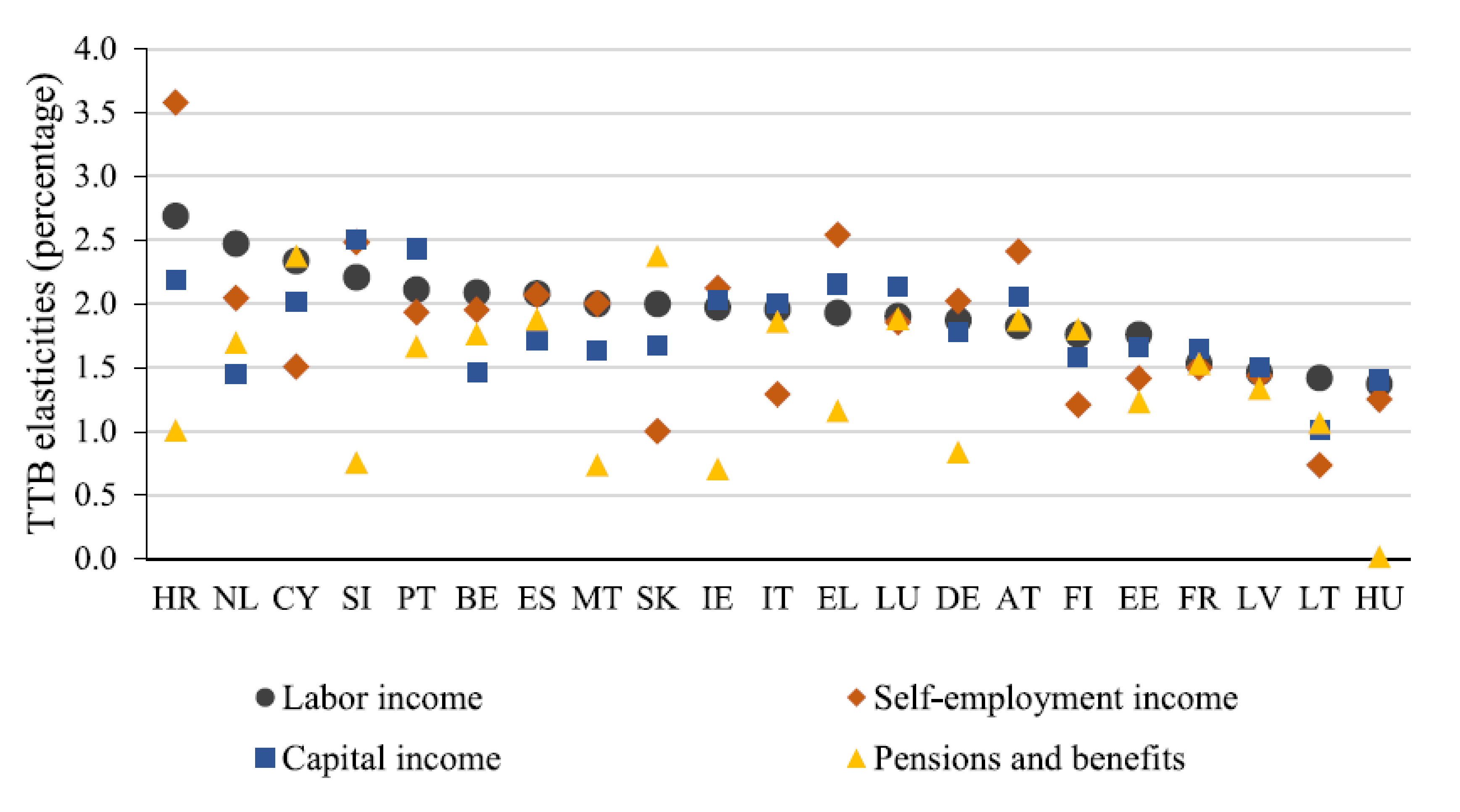
- Both mechanisms matter about equally on average – but the mix varies enormously by country



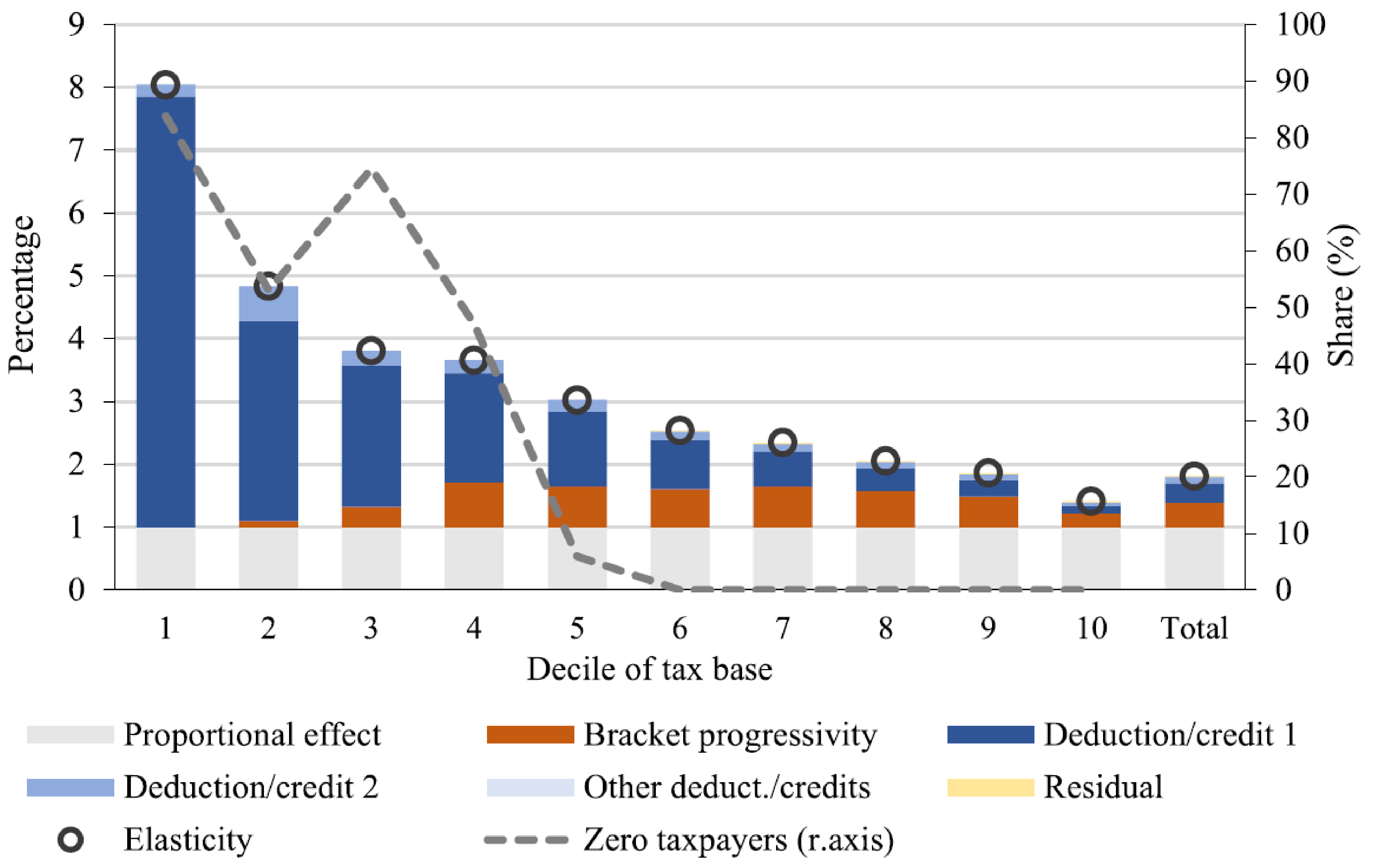
Both mechanisms matter about equally on average – but the mix varies enormously by country.

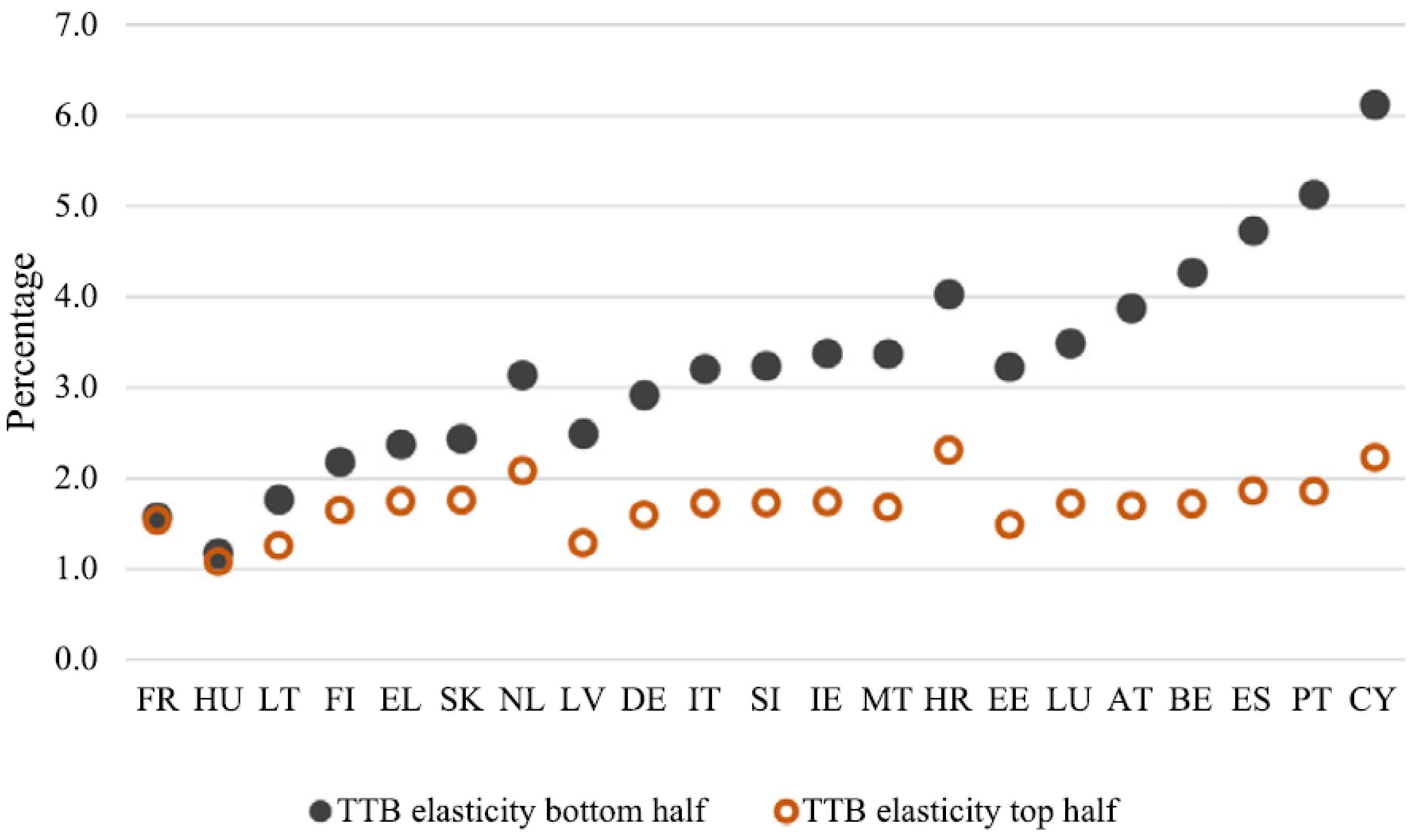
It depends on the source

- **Labor and self-employment income** see the highest elasticities – they make up most of the tax base and face the full force of progressive brackets
- **Capital income is more lightly affected** in most countries, since it is often taxed at flatter, separate rates
- **Pensions and benefits drift the least.** Exemptions and allowances mean nine countries have an elasticity at or below one for this income source
- **Why it matters:** when wage growth outpaces pension growth (or vice versa), a single economy-wide elasticity will mis-forecast tax revenue



Low and middle incomes feel it most





- Ireland (LHS); Top and Bottom half TTBs (RHS)
- The **lowest decile is mostly untaxed**, so its elasticity barely registers despite a high theoretical value

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The surprising twist: even as fiscal drag erodes progressivity, inequality still falls in about two-thirds of countries

Why: low-income, zero-tax households stay untaxed even as their income rises – while everyone above zero pays a bit more

But not universally: inequality rises in roughly a quarter of the countries studied

Part 2
Fiscal drag in practice, 2019–2023

WHAT ACTUALLY HAPPENED

Inflation, indexation, and the policy response

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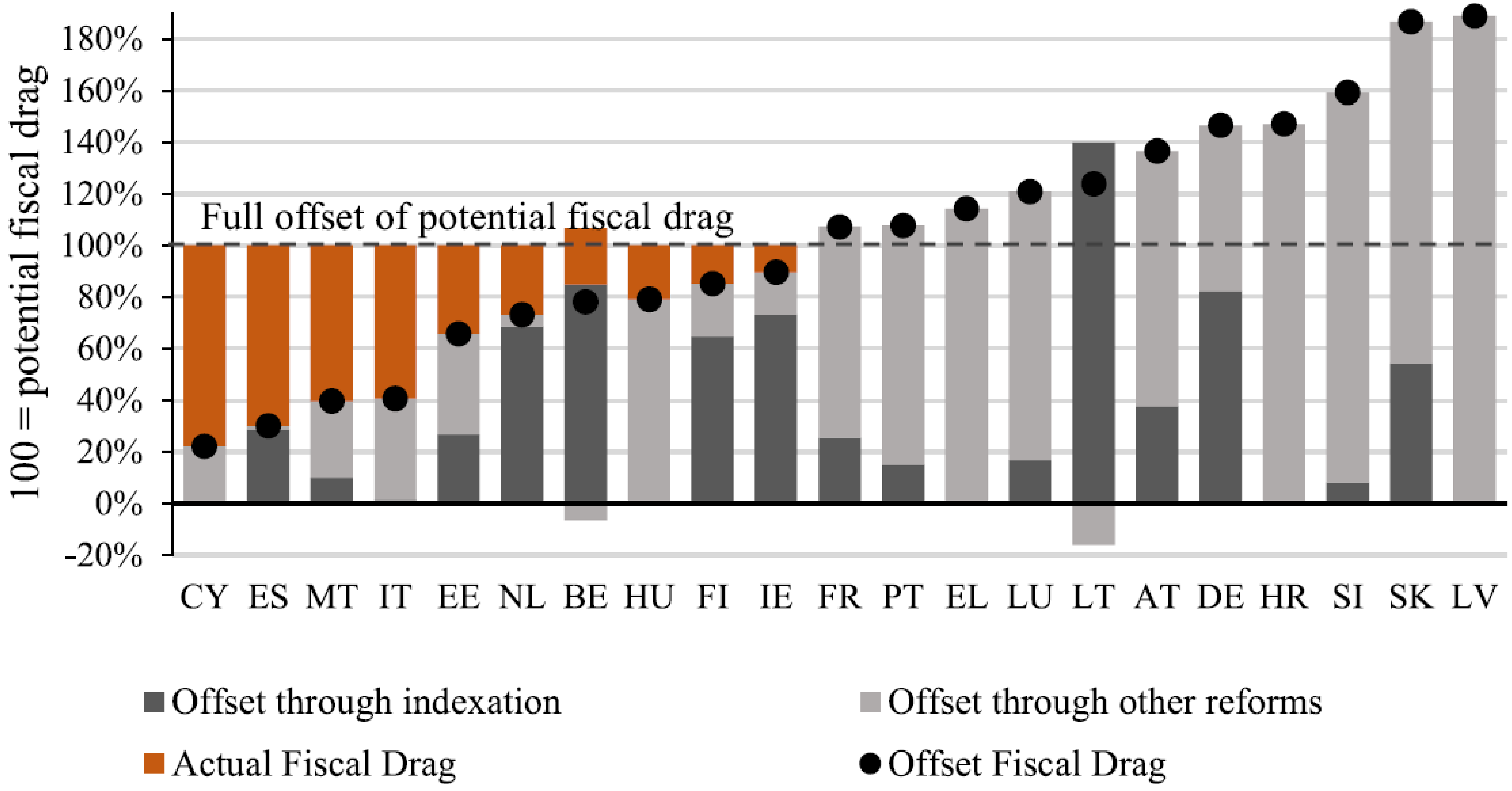
How we measure what actually happened

- **Start with actual 2023 tax revenue** in each country – what governments actually collected
- **Build two counterfactual worlds for 2023.** One keeps 2019 tax rules completely frozen ("no indexation"). The other fully updates 2019 rules in line with inflation or wage growth ("full indexation")
- **The gap between those two worlds is the potential fiscal drag** – the most revenue that fiscal drag could have generated over 2019–23
- **Comparing actual revenue against both benchmarks** shows how much of that potential drag was actually offset by government policy – and whether it came from indexation or other reforms

Who offset fiscal drag – and who didn't?

- **All countries offset fiscal drag to some extent**
- 8 countries offset <80%
- 6 countries offset almost all fiscal drag (incl. IE)
- 7 countries overcompensated for fiscal drag
- **Indexation or other reforms?**



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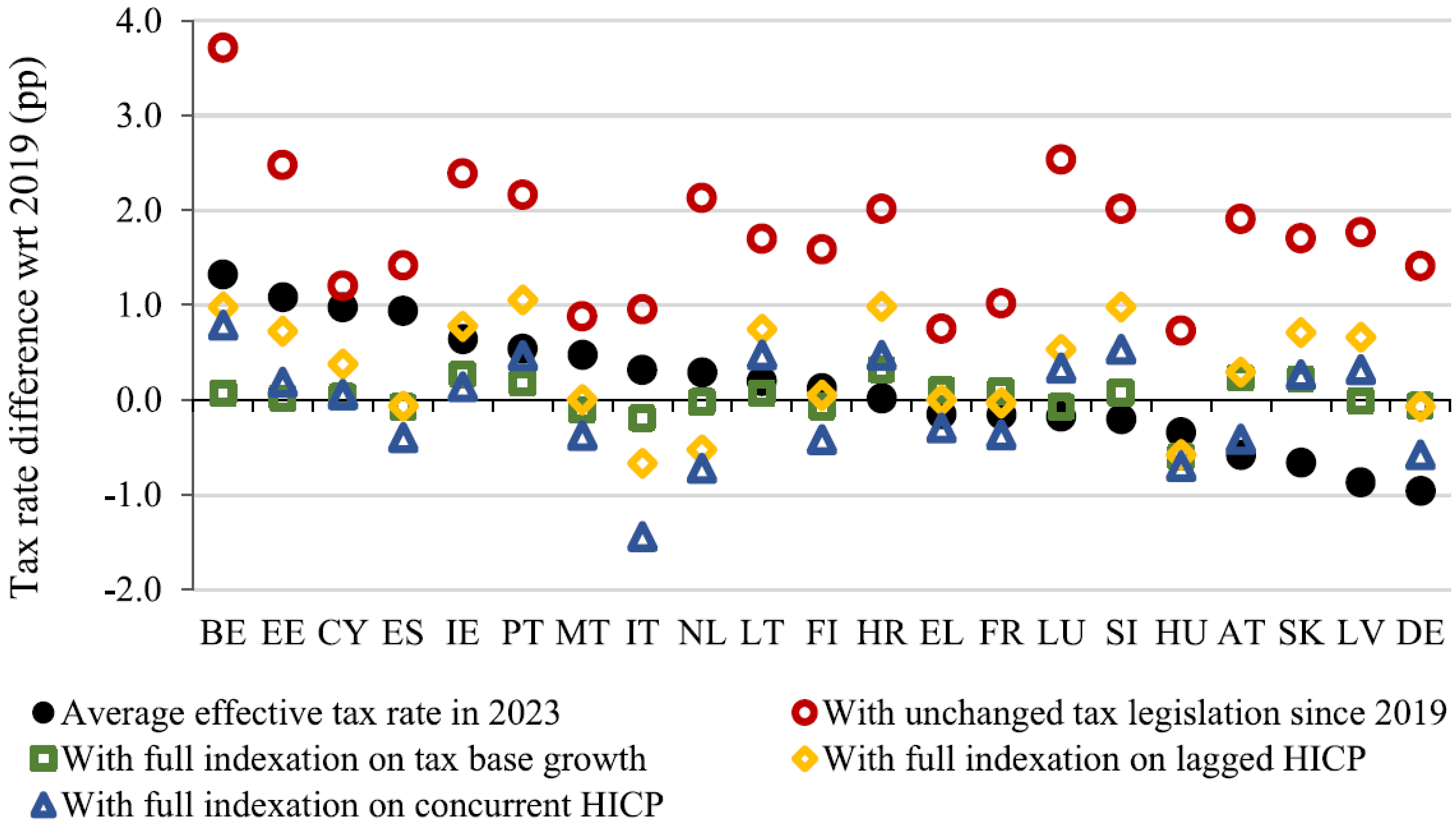
Impacts on average tax rates

- **Average tax rates rose for 11 countries**
  - 8 countries that did not fully offset fiscal drag
  - 4 additional countries that got very close to offsetting (IE, PT, LT, FI)
- Countries that overcompensated, saw average tax rates fall
- Reassuring: full indexation >> average effective tax rates would not have changed



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Every country kept its 2023 effective tax rate below what frozen 2019 rules would have produced

But where offsetting fell short, households still paid noticeably more than in 2019

2.5pp

The maximum effective tax rate increase any country would have faced with no policy response

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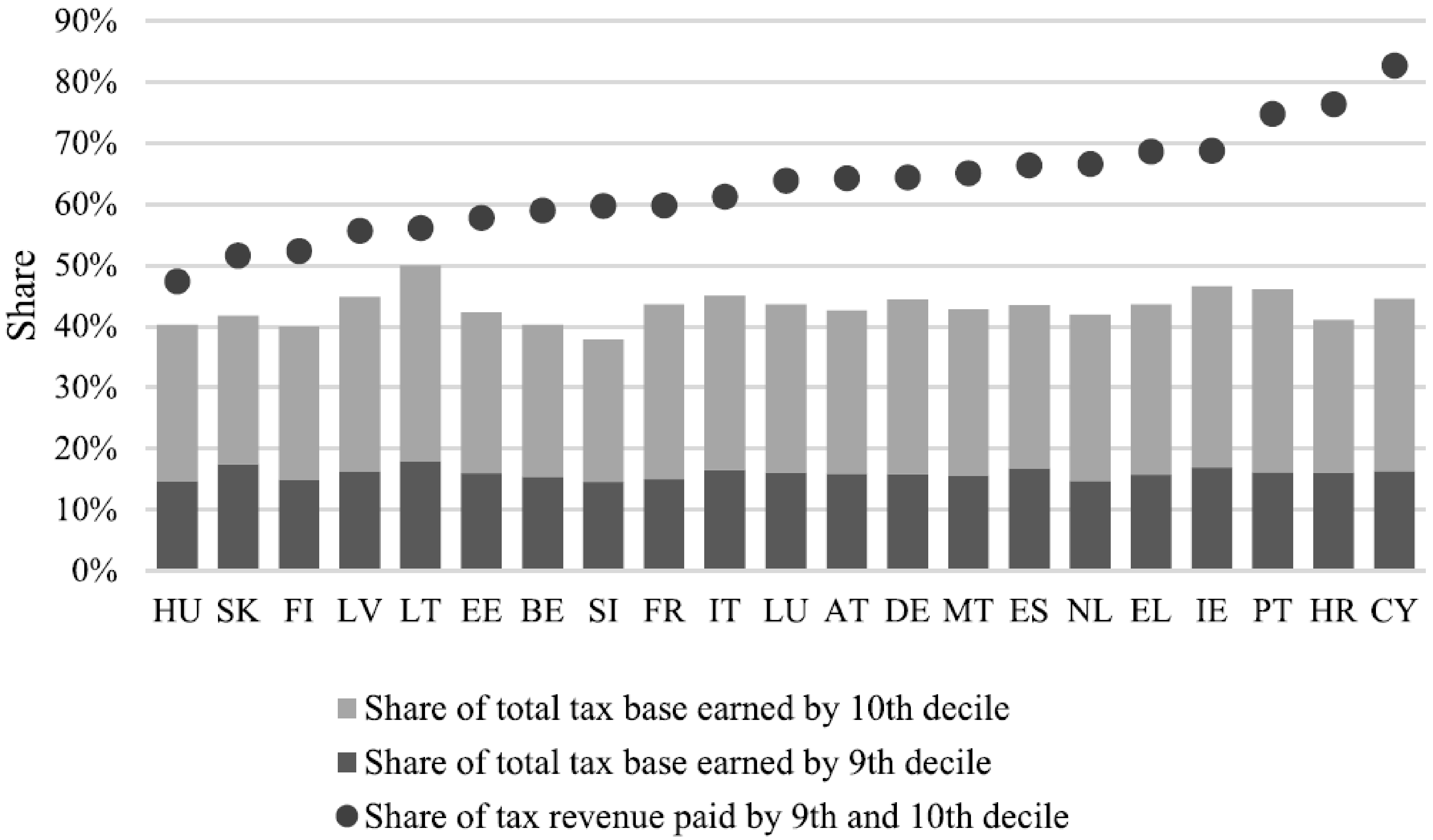
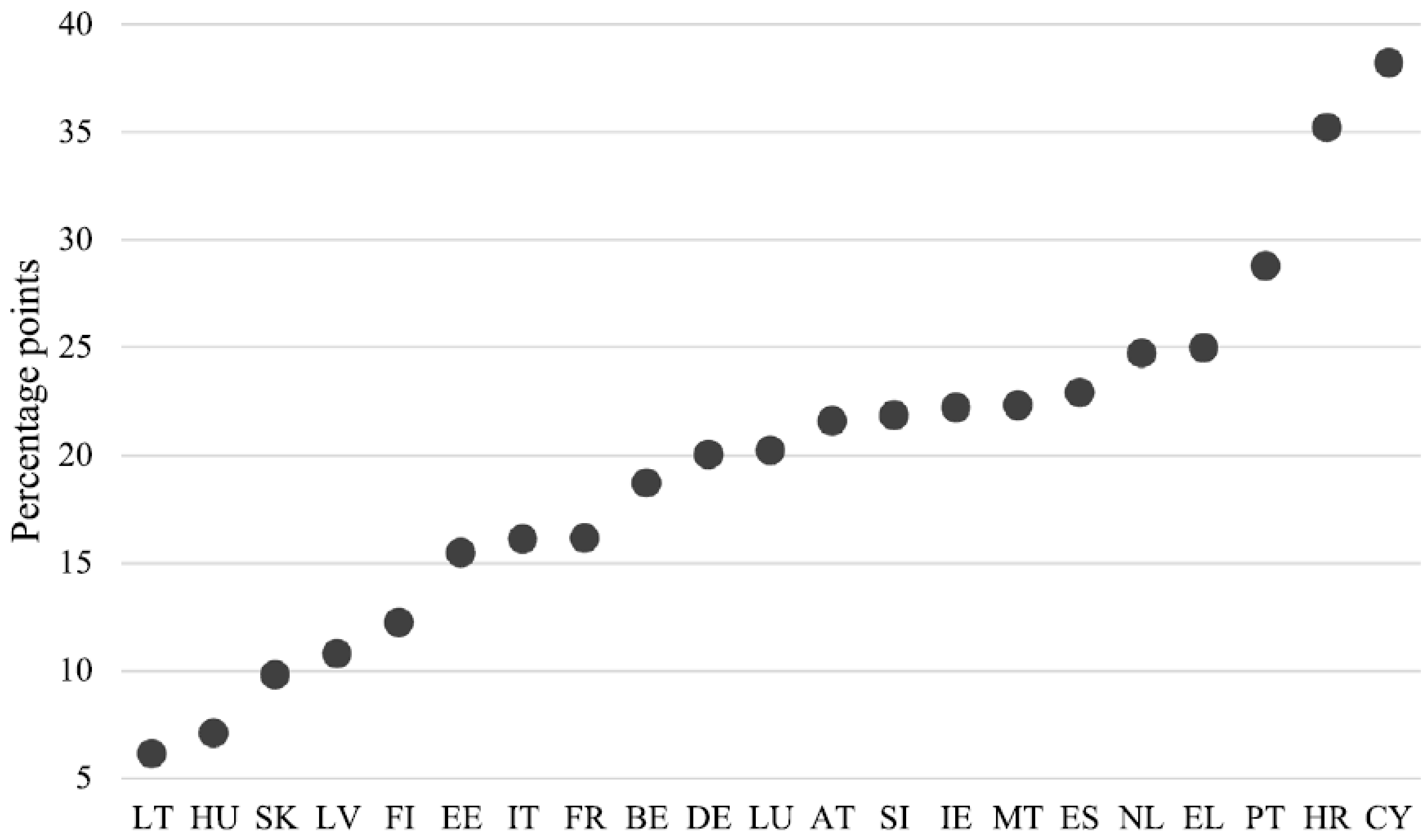
PIT revenue is concentrated





- Share of tax base earned and tax revenue paid by top 20% (LHS)
- Difference between share of tax paid and share of income earned by the top 20% (RHS)
- Gap for all countries: for 11 countries the gap is between 15% and 25%

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Conclusions and policy takeaways

- **Fiscal drag is built into most European tax systems.** A 1% income rise with no policy change would lift tax revenue by 1.7–2% in most countries studied
- **It hits low and middle incomes hardest,** reducing progressivity – though zero-tax thresholds mean inequality still falls in most countries
- **Every country acted on it between 2019 and 2023** – but how much, and how, varied enormously: from partial offsetting to substantial overcompensation
- **Formal indexation rules are only part of the story.** More than half of all offsetting came from other reforms – new deductions, rate changes – not automatic adjustment
- **For policymakers:** fiscal drag is a powerful, often invisible revenue lever – one that deserves an explicit choice, not silent drift

Thank you

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