TAX HARMONIZATION POLICY IN A CHANGING EUROPEAN UNION

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ABSTRACT

L'ampio dibattito su concorrenza o armonizzazione tributaria (AT) ha trascurato il fatto che quest'ultima non ha un carattere univoco. L'esperienza europea mostra che l'AT può essere causata da fattori molto diversi e assumere forme molto differenziate. I fattori principali che influenzano l'AT in Europa sono i mutamenti nell'ambiente di mercato, le esigenze di finanziamento del bilancio comunitario, e i meccanismi decisionali in materia tributaria. In ogni caso, l'AT comporta una maggiore uniformità della tassazione tra paesi diversi, ma ne riduce la generalità strutturale, moltiplicando i trattamenti differenziati e speciali per soggetti, settori, operazioni. Le prospettive dell'AT alla luce delle recenti disposizioni del Trattato Costituzionale appaiono ambigue.

The tax competition – tax harmonisation (TH) debate has often overlooked the fact that TH is not a simple and unitary phenomenon. A brief survey of the European experience shows that actual TH is founded on various reasons and takes many different forms. Three factors have an important influence on the timing and content of TH: the main changes in the competition environment, the financing needs of the European budget, and the decision-making rules in tax matters. TH usually implies more international tax uniformity at the cost of less structural tax generality. The prospects for TH in the light of the provisions of the new Constitutional Treaty are ambiguous. [JEL Code: H87]

1. The debate on Tax Competition – Tax Harmonisation has been revived by the prospects of a Constitution for Europe. Since the beginning of the Common Market there has been a lively debate on the reasons for and the consequences of tax co-ordination. In the last few years, increasing economic and financial integration, the process of trade and currency liberalisation, and the freer movement of firms and capital at both European and global levels, have raised the problem of "taxation in an integrating world" to recall the title of a book by Vito Tanzi (1995). The huge literature on the topic of tax competition – tax harmonisation has thoroughly examined most

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aspects of the problem, and has pointed out the many different implications that the various analyses may have for tax policy (Eusepi, 2003; Keen, 1999; Sinn, 1990; Wilson, 1999). Unfortunately, in many cases the results are ambiguous or strictly dependent on the often restrictive assumptions made in the analytical models. Even the empirical analyses do not reach unambiguous conclusions as regards the direction and the size of the effects of tax competition (or of its limitation) on the behaviour of taxpayers and governments.

In this note, analysing the experience and prospects of tax harmonisation policy in Europe, I will not add a new model to the many already available. I will however take from that literature what seem to be the main factors on which judgments about the desirability of tax harmonisation/competition depend. These factors are:

- The model of government used – whether totally electorally constrained or, if unconstrained, whether 'benevolent' or 'Leviathan':
- The strategic interactions between governments;
- The elasticity of supply of the productive factors, and the degree of their interjurisdictional mobility;
- The differential advantages, if any, of "large" versus "small" countries;
- The various taxation criteria (source-residence, origin-destination) prevailing, and the role of the international bilateral or multilateral tax conventions;
- The extent of imperfections in product and factor markets.

In the next two sections, I will recall the European experience of VAT harmonisation and Direct Taxation harmonisation, trying to identify: the main factors that have shaped the proposals and the decisions on tax harmonisation, and its extent and content; and the main features of the tax harmonisation process in the different cases. As regards the main factors shaping tax harmonisation, we will observe that tax harmonisation has become a high priority issue on the occasion of (expected or implemented) large changes in the economic and financial competition environment (common market, single market, European Monetary Union) on one side; and of correspondingly large changes in the size, functions, and financing rules of the European budget, on the other.

The content and the main features of TH, as well as the strategy and the techniques employed, have been various.

In the final section, the prospects for European TH policy are examined in the light of the draft Constitutional Treaty. I offer a provisional assessment of the likely effects on the future European TH policy of the three aspects that have had an important influence on the timing and the content of TH policy in the past: the EU budget, the decision-making rules in tax matters, and the internal market.

2. The VAT adoption was the result of a provision of the Treaty of Rome that prohibited the use of internal taxes as a means of discrimination against products of other Member States. The establishment of a free trade area required that turnover taxes should be neutral in relation to international transactions. In theory, neutrality was assured by the destination principle. Under the destination principle, exports are freed from tax: the exporter pays zero tax on exports and receives a refund of all prior-stage taxes imposed in the production cycle of the exported commodities, and imports are taxed at the same rate as domestically produced goods. But, in fact, the multi-stage turnover tax then applied in all but one of the six Member States, made it very difficult to measure exactly how much of the final value of commodities was made up of taxes. Consequently, there was a tendency to overvalue the tax rebates to exports and the taxes to be applied on imports. Moreover, since such rebates were calculated on an average basis, they inevitably provided some exporters, especially those that were vertically integrated, with hidden subsidies, and provided some domestic producers with some degree of protection. For all these reasons, the multi-stage gross turnover tax was an obstacle to the European economic integration. The initial tax harmonisation was then limited to the type of turnover tax to be applied (a multi-stage VAT of the consumption-type), and to its general structure (Aaron, 1981). Individual Member States were free to determine VAT rates and, to some extent, to apply special regimes and to have their own administrative arrangements.

The second important step in the VAT harmonisation process related to the changes in the financing rules of the European budget. In the first years of the Community, the European budget was financed, like the budget of any international organisation, by

fixed share contributions from the Member States. Due to the large increase of agricultural spending in the Sixties, it was decided to assign the European Community access to its “own resources” to finance a unitary budget (CNEL, 2003; Nava, 2000). In 1969, it was decided that the own resources are the revenue of custom duties and agricultural levies, to which in 1970 were added the contributions by Member States calculated on their respective standardised VAT base, and in 1988 a contribution calculated on GDP (on GNI from 2002). So, it was decided that as from 1975 Member States would have to pay a proportion not exceeding one per cent of their VAT base uniformly assessed. The sixth VAT directive, which is still the basis of the harmonised VAT, was submitted by the Commission to the Council in 1973, but was approved by the Council only in 1977 and applied in the Member States as from 1979-80. However, the VAT base on which the national contributions to the European budget are computed is not derived from the VAT actually paid. In fact, the amount of the VAT own resources to be paid to the European budget by Member States is determined on a tax base artificially derived as to take into account the special derogations to the general VAT regime applied at the national level. In any event, the sixth (and its successive) VAT directives involved the harmonisation of many aspects of the VAT structure (not the rates), even though such harmonisation was not strictly necessary in a system in which there were still border tax adjustments.

The next important step in VAT harmonisation was made on the occasion of the introduction of the Single Market, ending intra-EU frontier control. The abolition of border tax adjustments made monitoring of cross-border shopping (induced by rate differences) impossible and significantly increased the administrative cost of monitoring most other cross-frontier transactions. In a 1987 package, the Commission proposed an origin based common VAT system, in which intra-Community sales and purchases would be treated in the same way as those taking place within each Member State. The origin based VAT system would work better with uniform tax rates, and in any case it would alter the distribution of VAT revenues between Member States (a VAT Clearing House was proposed to provide for periodic offsetting revenue adjustments between Member States). The proposal was not approved by the Council, and from 1993 a “transitional” system involving taxation in the country of consumption (without trans-border adjustments) has been adopted.

The transitional system added new complications to a tax structure that already had special provisions for many types of transactions (taxable, excluded, exempt, non-taxable or zero rated) and for many special regimes (agriculture, small enterprises) and derogations. There are now three different general tax regimes, depending on whether the transaction takes place inside a Member State, or between Member States, or with a non-Member State. And there are now at least 25 ways to settle the place where a transaction should be taxed (Maré, 2003). The administrative and compliance costs are very high, as are the opportunities for fraud (Di Pietro, 2003). *Pursuing international uniformity, VAT harmonisation has reduced tax generality*. Although more international uniformity does not necessarily imply less generality, this usually happens because the actual implementation of tax harmonisation guidelines is made by committees of experts under the influence of well-organised pressure groups.

The current attitude of the European Commission on VAT harmonisation testifies to the present deadlock. Having noticed that Member States "are not prepared, at this stage, to accept any further harmonisation of rates and structures, or the re-distribution of tax receipts, which the definitive system would require, for fear of suffering a loss of tax revenue", the European Commission current strategy "focuses on simplification, modernisation and a more uniform application of present arrangements, and closer administrative co-operation. These will both encourage legitimate commercial transactions within the Internal Market and prevent fraud. So long as the present system of VAT-based Community own resources is in existence, closer administrative co-operation and the other measures aimed at preventing fraud will help to maximise the VAT base and thereby ensure that this tax plays the full part in providing income that Community budgetary rules intended". (European Commission 2001, 11). This final observation serves to confirm that among the main forces shaping VAT harmonisation policy are European budgetary needs.

3. The many attempts at harmonising direct taxes have foundered on the variety of legal, economic and political underpinnings. Unlike indirect taxes, the treaties do not contain explicit directions for harmonisation of direct taxes. Only the provisions on intergovernmental co-operation "for the approximation of such laws, regulations or

administrative provisions of the member states as directly affect the establishment and functioning of the common market" can be employed. Notwithstanding the lack of a specific legal base for direct tax harmonisation in the treaties, there have been many proposals since the mid-'60s to harmonise direct taxes, particularly corporation taxes and taxes on interest income.

In 1966, proposals were presented to reduce the double taxation of dividends at the corporation and individual income tax level, to rationalise withholding taxes, and to implement a common tax base. In 1969, beginning a long and persistent tradition, the Commission didn't devote any attention to the main conclusions of the Van den Tempel report on the harmonisation of company taxation. But in 1975, in a proposal on the harmonisation of corporate income tax, the Commission went so far as to favour a common range of rates for corporate taxes. The proposal was not accepted by the Member States (Cosciani, 1982).

The driving force behind the harmonisation of company taxation continued to be the international business community. In the light of the single market, the focus shifted to the removal of tax obstacles to the free movement of goods, services and capital. The many possible combinations of different treatment of cross-border cost and profit payments between the parent company, branches, subsidiaries, and individual shareholders, can give rise to double taxation as well as to tax loopholes. In many cases, conflicting claims by different jurisdictions and long decisional delays can arise. So, the objectives of more efficient and neutral tax arrangements looked very attractive to both business and governments: to business, because such arrangements reduced double taxation; to governments because they closed tax loopholes. In practice, the only result was the approval in 1990 of two directives and a convention. The parent-subsidiary directive eliminated withholding taxes on intercompany dividend payments. The merger directive suspended the taxation of capital gains on the cross-border transfer of assets for international mergers and acquisitions. The convention provided for arbitration in international tax controversies regarding transfer pricing adjustments by multinational companies.

Many other proposals by the Commission on the harmonisation of direct taxes were ignored by the Council, just as the Commission had ignored the main conclusions of the Ruding Committee (1992). The fact is that "a 'supranational' coalition, composed of the

Commission, an international community of policy experts and multinational companies emerged. The key belief was that the single market required Community action only when neutrality was in jeopardy. However, an alternative 'intergovernmentalist' coalition, recruiting its members across ministers of finance and revenue authorities, was less than willing to abolish taxes, however distortionary they might be… The proposals and the good economic arguments were firmly in the hands of the 'supranational' coalition. However, the lack of treaty base for EU direct tax policy made non-decision-making an easy route of escape for the Council. To dominate the process, the 'intergovernmental' coalition did not have to do anything else but left the corporate tax dossiers gather dust. Year after year, direct tax policy remained an issue with very low political salience." (Radaelli, 1999, 667-8)

Since mid-'90s, proposals for direct tax harmonisation have accelerated again after a long period of quiescence, fuelled by the prospect of disorderly tax competition in the new climate of full capital movements liberalisation, and of the single currency. The limits on budget deficits imposed by the Maastricht Treaty, and the loss of exchange rate policy as an instrument to retain economic competitiveness, made the governments of most Member States more sensitive to changes in the level and distribution of tax burdens. The increased mobility of capital flows increases their sensitivity to tax rate differentials, implying a reduction in tax revenues either because of the shrinking of tax base or because of the lowering of tax rates in an attempt to retain tax bases. This revenue-reducing effect faced most countries with a difficult choice, even where the benefits of tax competition as a rent-reducing and an efficiency-enhancing device were fully appreciated. There were two options to compensate for the potential revenue loss of the taxes on capital income. On the one hand, countries could raise taxes on less mobile factors, mainly labour income, thereby increasing production costs, losing competitiveness, depressing growth and employment (which, in turn, would require more welfare expenditure to be financed). Alternatively, they would accept higher budget deficits or impose severe cuts in public expenditure.

This line of reasoning, enriched by data showing the continued increase of the tax burden on labour incomes and the loss of competitiveness of the European economy, was at the core of the analysis put forward in April 1996 at the Verona informal Ecofin meeting by Commissioner Monti. The Monti package approved in December 1997

highlighted a radical change in both the objectives of TH strategy and the methods employed. The objectives changed from more ambitious plans for general TH to looser forms of tax co-ordination on specific measures. The new method employed was the proposal of a tax package made of different balancing measures on which a compromise between Member States with conflicting interests could be reached, and for which the voluntary co-operation of the Member States rather than the imposition from the Commission was required (Ceriani, Giannini, 2003).

The four elements included in the tax package agreed on in 1997 are at the basis of current day efforts at direct taxes harmonisation, and each of them has been the object of critical analysis by a growing literature (Cnossen, 2003). I will simply list the four elements, just to underline the fact that their full implementation is still open. The first element of the 1997 agreement is the adoption of a voluntary code of conduct on business taxation that provides a standstill on special tax regimes, and later a rollback of harmful tax measures. The questions raised are many and some of them still await a satisfactory answer: how is 'harmful tax competition' to be defined? In terms of an analogy with unfair trade practices? Apart from the theoretical definition, how would harmful tax competition be measured empirically? Can the criteria listed in the code of conduct by the Primarolo Group be considered exhaustive and satisfactory? What powers are available to implement the rollback of harmful tax regimes in, for example, the dependent territories of EU countries?

The second element of the 1997 agreement was "to ensure a minimum of effective taxation on savings income in the form of interest payments within the Community", and to this end it outlined the guidelines for effective taxation of interest paid to non-resident EU citizens. Since the end of the 1980s the removal of foreign exchange controls had made it impossible to effectively monitor and tax foreign-derived savings income. In 1989, the first proposal for "a common system of withholding tax on interest income" (at a rate of 15%) was contained in a draft Directive by the Commission, but this proposal was later withdrawn. On the basis of the Monti package, the new draft Directive published in 1998 was based on the so-called "coexistence model": Member States would either levy a 20% withholding tax or provide information to other Member States (or accept a Certificate of Notification proving that the interest had been duly declared to the appropriate authorities). The discussion of the coexistence model wasn't

peaceful, and in 2001 the Commission presented a revised and detailed proposal in which the exchange of information model would be the ultimate objective, with transitional provisions for Austria, Belgium and Luxembourg, and the introduction in the meantime of a withholding tax. The most important point was that the implementation of the directive was made conditional upon "equivalent" measures being introduced in key third countries. The agreement reached by the Ecofin Council on January 2003 provides that – subject to the conclusion of agreements with Switzerland, Liechtenstein, Monaco, Andorra and San Marino – a coexistence model would be implemented within the EU itself until a new vote by unanimity in Council. To "focus" on the conclusion of such preliminary agreements is one of the priorities of the present Italian Presidency of the Ecofin Council.

The last two elements of the 1997 tax package (concerning the cross-border payments of interests and royalties, and the special tax regimes that may be considered as state aids) link the first two elements to the traditional single-market tax measures on the one hand, and to the state aid policy (on which the Commission has a direct intervention power) on the other hand. This Commission power can be exercised in different ways in relation to the progress made in the implementation of the first two elements, even though it is widely recognised that the removal of harmful tax competition measures doesn't solve the problems of the companies operating in the internal market. In any case, companies incur high administrative and compliance costs in dealing with the many different accounting and tax systems prevailing in the 15 (to be 25 from 2004) Member States. In a 2001 study on company taxation, the Commission (European Commission, 2001) tackled this more general problem of harmonisation of direct taxes. In this study the Commission analyses the main qualitative and quantitative differences of the company taxes between Member States, estimates how such differences pose barriers to cross-border transactions, stresses the importance of co-ordinating the tax base rather than bringing the tax rates closer into line, outlines a short-medium term strategy for the adoption of the most urgent measures and a longer term comprehensive solution for which various options are reviewed. The harmonisation of capital income taxes seems thus on a two-track approach, with undefined routes and timetables, and still a long way to go.

4. What are the prospects for European TH policy in the light of the draft "Treaty establishing a Constitution for Europe" submitted to the European Council in June 2004, and signed in Rome on October 29? It is very difficult, at this stage, to assess the likely influence that the main changes introduced by the Constitutional Treaty (CT), if and when it will be ratified, may exert on the European TH policy. The reasons for this uncertainty are various. The CT confirms and emphasises the unique and hybrid nature of the EU: something more than a confederation, something less than a federation. Following tradition, the CT is a compromise between different views of the future of the EU, and leaves its final evolution open-ended. The CT introduces significant but not radical changes of the institutional architecture of the EU, of the allocation of tasks between Member States and the EU, and of the decision rules and procedures to be followed. Those many changes will come into effect at different times in the future, and their effects will depend on the method of implementation. For example, to what extent economic policy co-ordination, and particularly fiscal policy co-ordination, may entail tax policy co-ordination depends on how "closer co-ordination of economic policies and sustained convergence of the economic performances of the Member States" is interpreted. The effects on TH policy of the institutional and decisional innovations envisaged in the CT will depend on how and when those innovations will be implemented and interconnected. For the moment, I will briefly discuss the likely effects of three aspects that have had an important influence on TH policy in the past: the EU budget, the decision rules in place, and the internal market.

As regards the EU budget size, functions and financing rules, some basic principles and criteria are reaffirmed in the CT. The decentralisation bias is apparently strengthened by both protocols on "the role of National Parliaments in the EU" and on "the applications of the principles of subsidiarity and proportionality". These provisions should ensure that each legislative proposal by the Commission is subject to an in-depth scrutiny at a decentralised level. Even ex post, when legislation has been enacted, the enforcement of subsidiarity is assured through appeals to the Court of Justice. The strengthened subsidiarity principle looks to be a strong defence of decentralised decisions, but it shouldn't be forgotten that often subsidiarity in tax matters has been

intended as administrative autonomy and the freedom to set tax rates locally in relation to an agreed common definition of the tax base.

The CT reaffirms also that "the revenue and expenditure shown in the budget shall be in balance" (Article I-53), and that "a European law of the Council shall lay down the limit of the Union's resources" (I-54). In addition, the Multiannual Financial Framework, established for a period of at least five years, "shall determine the amount of the annual ceilings of appropriations for commitment by category of expenditure" (I-55). Changes in the structure of the EU budget expenditures will be made possible in the future, with the abolition of the category of the so-called compulsory (mainly agriculture) expenditure which could make room for some allocation functions at the EU level. The CT "introduces some important innovations that could enable the Union to gradually become an effective provider of public goods in the realm of the foreign and security policy… creating some new instruments and institutional provisions that could make this possible" (Tabellini 2003). But the assignment of allocation tasks to the EU may weaken the ceiling on expenditure and call for a change in the nature of the EU's own resources. Some signals may be noted. For example, some administrative and operating expenditure related to the common security and defence policy "shall be charged to the Union budget" (III-313). And other expenditures for the Union budget or for the Member States' budgets may derive from European decisions to fulfil some of the many open promises embodied in the CT.

When new tasks are conferred on the EU, as the CT in some way allows, it will become necessary to revise the system of Union's own resources. Past experience shows that when a new task or competence is assigned to a higher (federal) level of government, sooner or later an autonomous power to tax comes with such an assignment (Einaudi, 1945). Perhaps, such an opportunity is provided by Article 54 of the CT, according to which a European law of the Council of Ministers, acting unanimously, after consulting the European Parliament, "may establish new categories of resources or abolish an existing category". This could lead to the financing of European public goods through an 'European tax', for which many proposals have been advanced (Majocchi, 2003; Sapir, 2003). But, in a unitary EU budget, the revenue of such a European tax could also go to finance redistributive expenditures which are felt

much needed by the new accession Member States. In short, the debate about EU taxes and tax assignment within the EU will proceed alongside the debate about TH.

The second aspect of the CT that may influence tax Harmonisation policy is the change in the EU's decision-making rules. The CT has preserved unanimity rules in all matters of tax policy, except when it comes to administrative issues having to do with the prevention of tax fraud. In particular, Article III-63 provides that "where the Council of Ministers, acting unanimously on a proposal from the Commission, finds that measures on company taxation relate to administrative co-operation or combating tax fraud and tax evasion (!), it shall adopt, by a qualified majority, a European law or framework law laying down these measures, provided that they are necessary for the functioning of the internal market and to avoid distortion of competition". In general, according to Article I-25, the European Council, on its own initiative and by unanimity, may allow the Council of Ministers to act by qualified majority in areas where the Constitution provides for the Council of Ministers to act unanimously. If the adoption of qualified majority rule (QMR) may be limited to specific issues inside a given area, it could give rise to piecemeal tax harmonisation. In any case, the adoption of QMR, even for well defined issues, should take into account the effects that the radical changes of QMR (it "shall be defined as at least 55% of the members of the Council, comprising at least fifteen of them and representing Member States comprising at least 65% of the population of the Union") proposed in the CT will have in the future. It has been observed (Baldwin and Widgren, 2003) that the new definition of QM makes dramatically easier to pass EU legislation (because it will be much easier to find a winning majority in the Council of Ministers), shifts a great deal of power to large Member States, and increases the 'first mover advantage' of the Commission in proposing EU legislation reaffirmed by Article I-26.2. Both these effects are relevant to TH, were QMR applied to tax matters, because the reduced power of (some) small countries weakens the 'small advantage' in income tax competition, and the increased power of the Commission could be abused in favour of bureaucratic centralisation.

Other forms of partial centralisation may result from the use of 'enhanced co-operation agreements' for which, according to Article I-44, authorisation "shall be adopted by the Council of Ministers as a last resort, when it has been established that the objectives of such co-operation cannot be attained within a reasonable period by the

Union as a whole, and provided that at least one third of the Member States participate in it…Such co-operation shall be open at any time to all Member States." The economics of enhanced co-operation, or of a multispeed EU, has been widely analysed (for a recent analysis with an application to the harmonisation of accounting and tax rules for corporations, see Bordignon and Brusco, 2003). What should be discussed, in the light of past experience of TH in the EU, is the influence that enhanced co-operation may exert on the degree of international tax uniformity and of structural tax generality. Most likely, both uniformity and generality will be reduced and limited to sub-groups of countries in one case and to sub-groups of special interests in the other case, but the weight of larger countries and stronger special interests will increase.

The third aspect is related not so much to the changes introduced by the CT, but to the possible extensive use of internal market policy to direct TH policy. As we have seen, the CT provides that the power to tax resides with the Member States, but its exercise shouldn't interfere with the efficient functioning of the internal market, and we have seen that, according to Article III-63, measures to combat tax evasion may be adopted "provided that they are necessary for the functioning of the internal market and to avoid distortions of competition". State aids that, according to A III-56, *may* be considered compatible with the internal market include many of the cases in which special tax provisions are usually employed. The abolition of special tax provisions considered by the Commission to be incompatible with the internal market could contribute to the establishment of equal conditions for competition. But the general purpose of eliminating tax distortions may lead to a high degree of tax co-ordination. As this process will proceed, the problem of the abolition of competition distorting tax measures will extend more and more to the relations between EU and third countries, moving the TH debate to a high supranational level (WTO, perhaps), as shown by the time long EU/US dispute about the DISC-FSC schemes, where an income tax reduction for export income was considered a prohibited export subsidy (European Parliament, 2003). If this becomes a significant trend, the conduct of European TH policy will require more extensive definition of internal organisational structures and procedures, as for trade policy; and will depend on the EU's role in the larger international tax co-ordination process.

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