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# SELECTED ISSUES OF PERSONAL INCOME TAXATION HARMONIZATION

*Tomasz Wołowiec*<sup>1</sup>

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## Abstract

*In the process of furthering EU integration little attention was given to the role of income taxes. Multiple income tax systems exist across the Union and their differentiation negatively impacts the European labor market, investments and savings, inhibiting economic growth. Individual nations have little motivation to harmonize as they can engage in tax rate competition and income taxes are interwoven with social security systems that make any attempts at reform extremely complex and politically unpopular. Much of current harmonization is “silent”, paralegal, and occurs in response to market forces rather than following a formal plan and through intergovernmental cooperation.*

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## Introduction

The idea of a single economic and currency area is based on enabling the free flow of goods, capital and people (labor) while subject to a single currency regime. The idea deals effectively with currency risk, trade barriers, assures easy access to the labour market and provides opportunities for investing in all member states.

Full economic integration requires consideration of taxes as an important factor in the furthering of integration processes, since EU member states are tax nations, e.g. countries where budgetary incomes come primarily from taxation. EU member state tax systems are strongly diversified, due to individual developmental paths shaped by national history of various lengths, civilisational development, culture, value systems, social and economic policy, which also define the state's current financial needs. Even in a single state, taxes cannot remain neutral towards economic and social processes. Therefore, the challenge faced by EU creators was not the outright neutralisation of the impact that taxes had on the integration process, rather they worked towards limiting the negative consequences of overly diversified national tax systems. Gradual, long-term harmonization emerged as a continent-wide process. During the development of the Treaty of Rome it was decided that, to assure a common market, it was enough to harmonize indirect taxes and remove trade barriers as they were the prime inhibitors to the flow of goods and services. The harmonization of direct (income) taxes was not considered as they were seen as not significantly affecting the single internal market. Problems tied to direct taxation became visible as integration proceeded, the EU grew, its citizens began to migrate, multinational enterprises increased in size and scope and their financial flows (capital and profit transfers between headquarters and subsidiaries in different EU countries) became seriously affected (Mintz, 2004).

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Because the Euro zone is relatively young and many integrative processes have not yet reached their end, we can look for analogies elsewhere: of nations that have a single currency but maintain differentiated tax systems in different parts of the country (Oates, 2001). Canada and the United States are good examples of federal states that have a single currency and where attempts at harmonization of taxation were unsuccessful (Baldwin, Krugman, 2004). Both countries are experiencing tax rate competition between different states (provinces) and research done on this topic is seen as extremely important for the furthering of harmonization policies in the European Union as seen in the works of G.R. Zodrow (Zodrow, 2003). It is worth mentioning that most works present controversies regarding the possibilities and need for tax system unification as well as positive and negative consequences of tax rate competition and its impact on the behaviour of individuals and firms. Nonetheless, income tax harmonization is seen to be rather inevitable and should be understood as a natural effect of progressing unification that follows the removal of trade barriers, restrictions to the flow of capital and labor and the acceptance of a single currency. In the theory of a single economic area, virtually no work was done on income taxation, its characteristics and differentiation, variation of tax rates, rules governing tax setting and preferences.

Two major issues should be pointed out about European integration:

- 1) Union creators assumed that income taxes will be neutral towards integration processes,
- 2) there will occur a natural convergence of tax systems of nations belonging to the economic and currency union (Davidson, 2007).

The article aims to draw attention to the Personal Income Tax in EU member states, in the context of ongoing tax harmonisation. It does not offer a definitive answer whether income tax harmonisation is legally permitted nor whether it makes sense from the perspective of tax economics. The article focuses on the problems related to the EU common market as well as identifying and evaluating the overall perspectives and barriers to an eventual PIT harmonisation. When considering the complexity of PIT construction, the author has omitted the issues related to national insurance contributions, as an element integrated with the PIT, and thus jointly creating the total costs of labour.

### **Globalization and tax competition**

It is a fact that the high and increasing international mobility of capital is not only a European but also a global phenomenon, associated with the ongoing globalization process. Thus, the current tax competition issue in Europe is part of a wider question of economic policy in a constantly changing and integrating world economy. Yet in view of EMU and EU enlargement, there is a question of how the present applied regulations in the field of EU taxation could be further developed so as to, on the one hand, face the increasing pressure of globalization and tax competition, and, on the other hand, remove another obstacle to free cross-border activity in the SEM (thus completing the integration of the market) and foster economic integration in Europe. A satisfactory reply presupposes the examination of at least two issues, namely:

- 1) whether globalization and European economic integration are in some sense complementary or rival to each other, and
- 2) whether tax competition in Europe subserves the integration or disintegration among EU states.

An evaluation of these two problems is based on a literature review and personal analysis of the processes of tax harmonisation and competition. The analysis is devoid of statistical analysis nor hypothesis testing. Due to the wide differentiation of PIT solutions in various EU



member states, only general EU trends and processes were subjected to analysis, ones that can imply further harmonisation processes of EU member states in relation to the Personal Income Tax.

Although it may seem that globalization – as a process of global economic integration – includes European integration, the latter is a process of regional economic integration with objectives such as the avoidance of the "adverse effects" of globalization and international competition for members via the enlarged and more favorable economic space (which is institutionally assured), and the continuous deepening of economic integration, co-operation and socio-economic cohesion among member countries. It is obvious that, on the one hand, economic integration in Europe exhibits a much higher degree of integration and moves towards a deeper and more complete form of economic integration than the globalization process induces, and, on the other hand, that the objectives of those two integration processes are quite different for a number of issues.

Particularly, this means that tax competition is not a problem for the globalization process itself, where the integration among the world's economies is much weaker. By contrast, within the European Union fiscal externalities arising from intra-EU tax competition are more significant. Furthermore, tax competition among EU states is in contrast with the objectives of European economic integration as indicated by official EU documents and treaties. The tax competition phenomenon and the recent trend of undercutting corporate tax rates in the EU have not been induced by the requirements of the European economic integration process. It is rather the result of the general trend of falling corporate taxation in the world economy.

From the preceding discussion it should become clear that the current EU tax system – for both indirect and direct taxation – constitutes a temporary solution and it is at transitional stage. In fact, the different tax systems in the SEM create a diverse and chaotic picture in the field of EU taxation, which cannot be in accordance with the current state of integration. On the other hand, the response to increasing economic integration and tax competition in Europe cannot be simply tax harmonization. As emphasized by the literature, in certain cases such a development would have negative welfare effects for some members and does not fully address the fiscal aspects of the integration process. However, it lays the foundation for closer co-operation in the tax field and paves the way for fiscal integration in the EU (Vogitzoglou, 2004).

### **Differentiation of personal income taxation across the Union**

Personal income taxes are strongly differentiated in EU member states in terms of setting the size of tax brackets and taxable income level, where the differentiation focuses on different perceptions of what should constitute the basis of taxation, different tax scales, tax credits and allowable deductions. This process erodes the tax base (EC, 2008, OECD 2006, IBFD, 2009). Most nations have a tax-free income that represents the expenditure for minimal biological survival. Tax credits and allowable deductions are not only differentiated country by country but also are subject to fluctuations due to a changing social and economic national environment, the preferences of ruling political parties, phase of the business cycle (Zee, 2005).



**Table 1: Diversification of tax progression and number of tax brackets and regulations on taxation of married couples (spouses) through PIT In the European Union, in the period 2002 – 2007**

Country	Highest and lowest tax rates (in %)	Number of tax brackets	Taxation of spouses
	2002 / 2007	2002 / 2007	2007
Austria	21-50 / 0(23)-50	4/4	independent
Belgium	25-55 / 25-50	6/5	independent
Cyprus	0-30 / 0-30	4/4	independent
Czech Republic	15-32 / 15-32	4/4	independent
Denmark	5,5-59 / 5,5-59	3	independent
Estonia	26(10) / 24(10)	1(2)	optional
Finland	0-37 / 0-33,5 + 16-20	6/6	independent
France	9,5-54 / 6,83-48,09	6/6	joint
Grece	5-42.5 / 0-40	4/4	independent
Spain	15-45 / 15-45	6/5	optional
Holland	32-52 / 34,40-52	¾	independent
Ireland	22-44 / 20-42	2/2	optional
Lithuania	33 lub 15	1/1	independent
Latvia	25/25	1/1	independent
Luxemburg	(0)14-42 / 0-38	16 / 17	joint
Malta	0-35 / 0-35	6/6	joint
Germany	(0)25-51 / (0)15-42	4/4	joint
Poland	19-40 / 19-40	3/3	optional
Portugal	14-40 / 12-40	6/6	joint
Slovakia	10-38 / 19	4/1	optional
Slovenia	16-50 / 16-50	5/5	independent
Sweden	0-25 + 27-34	3/3	independent
Great Britain	10-40 / 10-40	3/3	independent
Hungary	20-38 / 18-38	2/2	independent
Italy	18-45 / 23-39	5/3	independent

*Source: Own work on the basis of J. Kesti, European Tax Handbook 2006-2009, IBFD, Amsterdam 2007-2010*

EU member states have to consider the taxpayer's ability to pay (occurring jointly, separately or as selected elements) when creating different components of Personal Income Tax (PIT) policies, which may include:

- 1) setting a tax-free level of income that is offered to an unemployed spouse (e.g. in Slovakia), offered for each child being supported by the parents (e.g. Belgium, Czech Republic, Estonia, Holland, Germany, France, Greece, Slovenia, Lithuania),
- 2) joint taxation of married couples (e.g. in Ireland, where we can find separate tax scales for single taxpayers and married couples),
- 3) specific and unique taxation of family income (France operates family quotient taxation that considers the number of children in the family),
- 4) constructions that permit the deduction of certain costs incurred while bringing up children (e.g. France) or even when supporting the family (e.g. Germany),
- 5) size and breadth of tax brackets,
- 6) systems defining the permissible and deductible expenses,
- 7) systems of preferences depending on the family's situation.

When analyzing tax credits and allowable deductions present in EU member states (as subject-specific credits, deductions from tax and tax base), four main categories can be identified:





- 1) compensation-type preferences: equivalency and compensation payouts for used tools, clothing, travel costs, refunding travel-to-work expenditures, etc,
- 2) social-type preferences: deductions for social support for foster families, support for foster families, war veterans, victims of crime, handicapped, elderly, etc,
- 3) stimulation-type (economic) preferences: aimed at stimulating the taxpayer to engage in specific activities or modifying their behaviors. We can include deductions for housing (development and renovation), preferential treatment of savings, purchasing of stocks and bonds, educating children, professional development, health expenditures and retirement fund investments,
- 4) differentiated incomes, for example gambling wins, research grants, rewards for scientific activity, scholarships, contributions towards professional associations, etc.

### **Downward trend in top personal income tax rates since 1995**

Currently, the top personal income tax (PIT) rate (2) amounts to 37.5%, on average, in the EU. This rate varies very substantially within the Union, ranging from a minimum of 10% in Bulgaria to a maximum of 56.4 in Sweden, as Denmark, which levied the highest PIT maximum rate until last year, has cut it to 51.5% (Taxation Trends 2009). As a rule, as has been the case in recent years, the new Member States, with the exception of Slovenia and Hungary, display below-average top rates, while the highest rates are typical of Member States with the most elevated overall tax ratios, such as the Nordic countries, although the Netherlands show the third highest top personal income rate while ranking 15th in terms of the tax ratio (excluding social security contributions). The lowest rates are found in Bulgaria, the Czech Republic and Lithuania. In the latter two the overall tax ratio (excluding SSCs) is among the lowest in the Union, which is however not really the case in Bulgaria (Taxation Trends 2009).

For the first time in several years, the top PIT rate has increased, on average, in 2010, despite the sizeable Danish cut, as several EU Member States enacted increases (the UK introduced a new 50% rate, ten points higher than the previous maximum, but Greece and Latvia too hiked their top rates). It is plausible to attribute this reversal to the effect of the economic and financial crisis as until this year, there had been a clear, steady and widespread downward trend in the top rate. From 1995 to 2009, almost all EU Member States cut their top rate, with only three keeping it unchanged (Malta, Austria and The United Kingdom) and one (Portugal) increasing it slightly. Even taking into account the subsequent 0.4 average rate increase in 2010, all in all, the EU-27 average has gone down by 9.9 percentage points since 1995, accelerating after 2000. The post-2000 acceleration is most noticeable in the Central and Eastern European countries, with the biggest cuts having taken place in four countries that adopted flat rate systems, Bulgaria (– 30.0 percentage points), the Czech Republic (– 17.0), Romania (– 24.0) and Slovakia (– 23.0); the acceleration was, however, visible also in the old EU Member States (Taxation Trends, 2008). One should nevertheless note that the increase in the average in 2010 is due to sizeable hikes in a small number of countries, while the overwhelming majority of Member States, including several that have been amongst the strongest hit by the crisis, have kept their top PIT rate constant. Lower PIT top rates do not necessarily imply a trend towards lower PIT revenues, because in systems with several tax brackets, the percentage of taxpayers taxed under the highest rate is typically quite limited. In addition, changes in the tax threshold can have important effects on the tax liability, even at unchanged rates; for example, in 2009, Austria increased the threshold for the top 50% bracket by around 18%, reducing the tax liability, but this is not visible when looking only at the rate. Several countries, however, have moved towards systems with fewer brackets, or to



flat rate systems, which are characterised by a single PIT tax rate, so that any reduction is immediately reflected in the tax revenue. Furthermore, cuts in the top PIT rate typically do not occur in isolation, but are part of balanced packages which may include tax reductions for lower-income taxpayers or measures to offset the loss of revenue.

As of 2010, these Member States comprise Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Romania, and Slovakia. As can be seen, all flat rate systems in the EU were introduced by new Member States, the latest two being Bulgaria and the Czech Republic in 2008. All of these show a lower than average revenue from the PIT, although the distance from the EU mean value is not very marked for the three Baltic States (Taxation Trends, 2009, 2010).

### **Theoretical foundations of income tax harmonization**

Income taxes are characterized by a clear link between the taxpayer's situation (income, wealth) and the tax burden placed upon him (Alworth, Arachi, 2008). As such, income taxes can have a negative impact, be de-motivating, as the tax will inhibit income-generating and investment activity and that will negatively impact the speed of economic growth (Caroll, Holtz-Eakin, 2000, Widman, 2001). This means that not only the sheer size of the tax burden is important, but also we have to consider the entire structure of the tax system, each tax and the definition of tax scales/brackets (Meghir, Philips, 2008, Sabrinova, Buttrick, Duncan, 2008).

Inadequacies of tax theories combined with a polarization of opinion makers' positions concerning personal income taxes impact even the microeconomic approach, where it should be easy to establish a causal link between the tax burden, the tax scale and the taxpayer's economic situation and resulting decisions. This is a result of multiple interacting factors affecting the taxpayer, therefore isolation of the tax factor is difficult, if we bypass highly abstract analyses. The situation becomes even more complicated when the subject of analysis becomes the impact of a given tax on a specific group of taxpayers or of a specific tax on the entire economy (e.g. automatic stabiliser theory) (KMPG, 2008). We have to add the fact that income taxes are only part of a wider burden, since they are combined with national security contributions (social insurance) and often it is those social security contributions that are modified to increase governmental revenues, while maintaining an illusion of tax rate stability.

The complexity of tax analysis from the perspective of income tax impacting a taxpayer and the wider economy increases when we take the analysis beyond the borders of a single country. Tax relations become increasingly complex, and the impact of particular income taxation becomes extremely difficult to evaluate or quantify. This statement can be taken as the explanation for existing tax controversies: tax harmonization between nations versus the freedom to engage in unlimited tax competition.

A theoretical analysis of the effects of tax differentiation can occur on several axes, including:

- 1) impact of PIT on costs of labor. High taxes increase labor costs since after-tax income (disposable) is low and thus causes pay-increase demands from the workers and this in turn complicates the company's competitive standing and affects its profitability (when compared to companies operating in other, more beneficial tax environments),
- 2) taxes as a burden. They force a defensive response from the taxpayer in the form of seeking opportunities to transfer the burden onto other entities. Centuries long observation of taxpayer reactions to tax burdens show that, even if desirable, burden shifting is much easier in the case of indirect taxes than direct ones (in this case the most common technique involves limiting economic activity) (James, Nobes, 1995),



- 3) tax burden transferability is different for employees and employers. Increased labor costs will affect production costs and this affects final product/service prices. Opportunities open to the employer will depend on the type of the good/service under taxation and the state of the market (competition), which is defined through elasticity of demand. Inelasticity of demand for a good will assure easier transfer of tax burdens by the employer onto the client. A second possible reaction is to transfer the burden onto the employees by lowering their wages. Opportunities here will be defined by the current state of the labor market, its openness, level of unemployment and elasticity of labor supply,
- 4) measuring the transferability of the tax burden. The process is difficult even in the case of a closed economy because the effects of increasing taxes can be hidden in prices, non-wage production costs, producer's profitability. These difficulties are multiplied in an open economy where the mechanism of transferring the tax burden affects the society and economy of a different nation. In a theoretical sense, "tax dumping"<sup>2</sup> leads to a redistribution of income between different societies as it assures that part of the income is transferred to nations with lower taxes through transfer pricing or through the transfer of company operations to locations with favourable tax regimes. The impact on nations not operating "tax dumping" policies is a need to increase tax rates to maintain governmental revenues (for those taxpayers that remain) or reduce governmental expenditures (politically difficult) or increase national debt (finding lenders willing to fund continued expenditures)<sup>3</sup>.

In the era of internationalization of economic relations and integration, the tax burden transfer mechanism becomes international, in terms of taxation on incomes, labor, economic activity, interest, capital returns, etc. Personal decisions regarding where to undertake paid employment (with the assumption that there are no restrictions on the movement of labor) will be affected by offered wages and required taxes. Income migration therefore becomes natural as people gravitate towards locations where incomes and taxes are the most beneficial. Of course, changing the location of activity is much easier for an employee than for an employer and entrepreneur as the latter two have to adapt to the requirements of the host country to where their activity is being transferred (for entire company or its part, subsidiary). Both labor and capital would therefore benefit from tax harmonization as it would simplify operations and create a more balanced environment that would reduce the need for mobility oriented purely on seeking tax benefits.

Both tax rate harmonization and tax rate competitiveness require additional consideration of:

- 1) impact of PIT rate harmonization upon the state budget and possible imbalance of public finances (harmonization worsening national budgets, e.g. through downward integration of tax rates),
- 2) impact of labor mobility upon the nation's economy (income migration further enhanced by PIT rates),
- 3) impact of changes in the tax system, which affect the ratios of: indirect-direct taxes, CIT-PIT, when they are intended to draw in foreign investments.

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<sup>2</sup> The term "tax dumping" was popularized by Chancellor Gerhard Schroeder in 2004, when he challenged new EU member states and their tax reforms that were aimed, as Schroeder claimed, at affecting fair competition policies in the Union by offering good operating conditions for companies from the "old" Europe.

<sup>3</sup> On 26<sup>th</sup> May 2004, Ministers of Finance from Germany and France, worried that their countries would suffer the most from tax-benefit-seeking company migration, proposed the first unification of corporate (CIT) tax rates: minimal rates, formalizing the methods of calculating incomes, profits, defining expenses.





In small open economies that seek new/additional capital resources these issues are further differentiated: in the case of transforming economies and developing nations their situation is much more difficult than of countries with a strong position within an economic grouping or the entire global economy.

Economic aims of tax harmonization may be unachievable due to legal reasons, since a tax is not only an economic category but also a legal one, and its legal side is affected by:

- 1) relationship between national and Community law, and when considering the supremacy of EU law over national rules, many issues emerge (e.g. conflicting regulations, different interpretations),
- 2) problems of applying (and in what measures) unlimited tax duty<sup>4</sup> in one country compared to applying unlimited tax duty in one country with a limited duty in the second country and, finally, how to apply unlimited tax duties in both countries,
- 3) how to formulate and agree upon treaties on avoiding double taxation (not only achieving consensus between nations but also following local political patterns, taxation trends),
- 4) problems in whether to collect the tax in country of residence or non-residence and in what proportions.

### **Legal foundations of harmonization**

The notion of harmonizing direct income taxes, especially on corporate and capital returns appeared in an early stage of Community creation. This was pursued, although harmonisation was not included in the Treaty, whose creators focused instead on harmonisation of indirect taxes. Nonetheless, the Treaty contains Article 94, which calls for the harmonisation of legal regulations that directly impact the operations of the internal market. This can be seen as the beginning of efforts aimed at direct tax harmonisation (Szeląg, 2002). Article 308 allows the Council, based on a request for the European Commission and after consulting with the EU Parliament, to undertake activities aimed at achieving an objective within the common market. This requires unanimous approval of all member states, which will be extremely difficult to achieve, seeing that personal income taxes are the most “political” of taxes and are a major fiscal tool for all EU nations.

The problem of taxing personal incomes and their impact on the free movement of labor and capital was only partially visible to the Union. Below is a list of documents in which the topic of taxing personal income appeared in various contexts and partial manner:

- 1) Neumark Report, 1962,
- 2) EU Commission Memorandum, 1967,
- 3) EU Commission Memorandum, 1969,
- 4) White Book on the Creation of the Common Market, 1985,
- 5) Ruding Report, 1992,
- 6) White Book on integrating associated nations of Central and Eastern Europe with the EU internal market that was approved at the EU Council meeting in Cannes, 1995,
- 7) Code of Conduct for Business Taxation,
- 8) Council Directives in various years covering avoidance of double taxation, taxing savings, dividends, shares and entities operating in various member states.

Tax problems for individuals who change their place of work and residence are not new, especially when we consider the notion of avoiding double taxation of income. Currently, the majority of nations have signed bilateral agreements on avoiding double taxation, based on

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<sup>4</sup> Unlimited tax duty applies to those residing in a country for more than 183 days of a tax year, while limited tax duty is applied to those who spend less than 183 days.



early work by the OECD that had developed a “model agreement” intended to ease negotiations, with the newest model proposed in 1996. Only the Nordic Treaty between Denmark, Finland, Sweden, Iceland and Norway is not bilateral in nature and should be seen as a precursor of things to come in providing precise multinational solutions. The OECD Convention is still the prime example and has affected the development of similar policies in the Union. It predicts three possibilities for taxing income gained in different nations:

- 1) taxing the entire income or wealth created in a different country,
- 2) nations share the income from taxation in varying proportions depending on the subject of taxation (dividends, interest on savings, etc),
- 3) nations, on whose territory the income or wealth was created cannot tax them (sale of shares, license fees, scholarships).

The current investor-friendly culture assures that increasing numbers of EU citizens invest their money in multiple companies and expect to gain a profit that is later taxed. The broad rules for taxing dividends and profits from business operations of multinational businesses are defined by EU directives. Yet, individual countries, have certain freedom in this respect, for example by differing in the way such taxes are collected. Two methods exist: taxing the profits of the company and foregoing taxing shareholders and partners or allowing the company not to pay a tax on the paid-out profit and the tax obligation rests on shareholders and partners. Countries differ in the preferred method.

Harmonizing the taxation of savings residing in bank accounts has focused on preventing any restrictions to the flow of capital between member states that could be imposed by national tax laws. The key to such harmonization is therefore not to enforce a single tax rate for all states: every state is free to set its own taxes (level, differentiation) and profits from savings can be separated from other personal income and taxed with a separate rate or included in total incomes.

### **Taxing individual incomes for those not conducting business activity**

The main characteristic of direct taxation is the small extent to which it has been normatively harmonised. Since direct taxes are seen to have less of a negative impact on the operations of the Common Market, therefore work on their harmonisation has begun late and has not progressed as far as the work done on indirect taxes. Nations have been left to define their own internal policies but are required to assure fair treatment to local and international entities. The analysis of individual income taxation in EU states, the direction of its evolution and the future of tax policy allows for the formulation of two arguments: the extensive difficulties of harmonizing the construction of personal income tax and a progression of “quiet harmonization” (paralegal). The arguments presented below confirm the proposed arguments.

EU member state tax systems created since the Second World War, were strongly influenced by the ideas of John Maynard Keynes who moved away from the notion of tax neutrality and placed specific parafiscal functions on the tax system. Taxation of personal income is one of the most fundamental techniques for redistributing income, allowing for the realization of principles of equality and justice and taxing of “pure income” (all three rules are expected of every tax system in the union), and stimulating desirable behaviours in the spheres of production and consumption. As such, direct taxes have a much different impact upon the division of income and wealth than indirect taxes. Income taxes possess an “inbuilt stabilizing flexibility”, e.g. in times of recession they inhibit the fall of global demand and in times of growth, slow down its expansion. Progressive income taxation of individuals leads to a much faster fall in governmental revenues due to a fall in the citizens’ income. As such, despite



declaring intended tax system neutrality, EU member states allow para-fiscal functions to affect the construction of the PIT framework, which in turn makes harmonization extremely difficult.

The current belief is that differentiation in setting the rules governing direct taxation poses a small challenge to the functioning of the Common Market. It is based on the following assumptions:

- 1) income taxes in their pure form do not stimulate the propensity for saving and investing. Income taxes impact both the saved part of income as well as the spent one. To stimulate saving and/or spending it is necessary to introduce allowable deductions and tax credits that would be obtainable upon increasing existing savings or investments or undertaking them,
- 2) income taxes do not affect the choice of socially beneficial structure of production and selection of factors of production nor the application of technologies that will protect the environment. Achieving these aims requires the application of allowable deductions and tax credits,
- 3) income taxes do not affect the choice of socially beneficial structure of consumption. It does not seem possible to introduce appropriate allowable deductions and tax credits that would allow for guiding the expenditure of households.

Harmonization of income taxes is much more difficult than harmonization of indirect taxes from the practical, technical and legal perspective and is a result of:

- 1) when creating the Treaty of Rome it was decided that direct taxes would not have a notable impact on the operations of the internal market, and that approach led to a lack of appropriate regulations, especially in the area of personal income taxes,
- 2) income taxes, as forms of direct taxation are an important tool for fiscal policy that affects social and economic activities and it is difficult for politicians to abandon this tool for managing national policies,
- 3) directives requiring the formulation of direct tax harmonization must be agreed upon with a majority vote in the national Assemblies (Parliaments), which leads to a lack of consensus on desired aims, costs and benefits, procedures,
- 4) progress in direct tax harmonization creates an aura of challenges to the tax independence of nations and leads to entrenchment of state and elite positions,
- 5) EU member states have different rules for remunerating employees, setting incomes from retirement funds and affecting the structure of income-generating costs and expenditures that reduce the tax base.

Despite the lack of Directives to regulate the rules of taxing personal income, the rules are emerging spontaneously and tax burdens are slowly equalising. This process is the result of competition between EU member state tax systems—nations are extensively utilizing the construction of the personal income tax to take advantage of the stimulating functions of the tax system, which in turn impacts the possibilities open to spontaneous PIT harmonization. Due to the effects of “quiet” para-legal harmonization, several common PIT characteristics can be found in the EU:

- 1) placing subjectivity on the principle of residence. Rules on limited (<183 days), and unlimited (>183 days) tax duty,
- 2) the dominant concept is of a global tax. Joint taxation of all incomes obtained by the taxpayer from different sources (only the rules regarding capital interests are exempt from being combined with other incomes),
- 3) the tax is progressive and specific solutions concern different tax rates, types of scales, rules regarding progression and the size of the minimal and maximum rates,



- 4) tax burdens are designed to follow inflation through a system of automatic or semi-automatic indexation or through the change of tax brackets,
- 5) different regulations are applied to a family income, sale of real estate, assets and investment incomes,
- 6) in every construction there exists a sum free from taxation and, in varying degrees, considers the minimal level of (biological) existence and costs of obtaining an income,
- 7) tax burdens are considerate of, in varying degrees, the state of the family and capabilities to pay through a system of rebates and deductions,
- 8) multiple rebates and deductions exist that are of a simulative and social character (investment, building and renovation, health, donations).

The analysis of Union laws indicates that personal income tax harmonization is extremely difficult due to historical, political, social and technical factors. Decisions by the European Court of Justice (ECJ) concern mostly tax deductions by individuals who are not Union residents and the deductions of contributions made to retirement funds operating outside the EU. The ECJ decisions cannot affect the rules for harmonizing personal income taxes because they concern the taxing of income from savings and the exchange of tax information, while the progressing “quiet” harmonization is rather a result of inter-nation competitiveness and not of any formal ECJ rulings.

Alongside minimal lawmaking at the European level, minimal progress of harmonization is a result of:

- 1) political factors: PIT payers are the largest group in any nation. Politicians are unwilling to abandon PIT techniques in pursuing regulatory and stimulatory tax functions, that are of a political nature, e.g. any activity in this area will have an impact on the political balance of the nation. PIT setting is an important and valuable tool in maintaining relations with voters,
- 2) PIT harmonization is not an important factor in the evolution of the Common Market. It is neutral to internal trade and does not affect intra-EU competition and as such will not become a European priority for some time,
- 3) PIT taxes mainly incomes from work and retirement and the level of taxation does not increase intra-EU migration (although in the long-run this may change),
- 4) in EU member states, social support systems are funded from different sources: taxpayer contributions, direct funding from the state budget (social security contributions are then contained within standard taxes, e.g. Denmark) and as they form part of the total “tax wedge”, their harmonization will be even more difficult (while exerting sizeable influence on the PIT system),
- 5) EU member states possess different systems of labour remuneration and shaping of citizen income levels, different methodologies of designing tax progression. Therefore even creating a holistic and long-term understanding of existing complexities will be difficult.

## Conclusions

Harmonization in general is a difficult challenge, and any debate about harmonising PIT systems brings out major counterarguments:

- 1) further loss of sovereignty in national financial policies, which will inhibit the state’s ability to affect economic processes and (especially) social ones. Harmonization of the rules for calculating the basis for taxation and the acceptance of unified rates would mean the transfer of tax-setting prerogatives to a trans-national institution: the EU. In





such a situation, each nation must conduct its own analysis of costs and benefits (of transferring those competencies versus their retention),

- 2) different social models and retirement systems, when combined with varied degrees of PIT integration with retirement contributions, determine various financial needs of the state, therefore harmonization would have to reach far beyond “mere” PIT systems,
- 3) historical, cultural, social factors that have shaped national tax systems enforce claims that path-dependent process will be difficult to reverse,
- 4) competitive inequality between taxpayers who operate in one market and those that function in multiple EU member states. Depending on their primary country of residence it can be an advantage to pay taxes elsewhere (when the other nation’s tax regime is friendlier, e.g. for Poles employed and taxed in the UK) or a disadvantage (when British taxpayers operating in Poland or Poles earning in the UK are subject to Polish taxation).

Notwithstanding abovementioned criticisms, the following predictions can be made regarding income tax (primarily PIT) harmonization across the European Union:

- 1) harmonization of direct taxes is unavoidable, but it will be a long-term process and will affect CIT before PIT (reducing complexity of trans-border business operations will be a priority compared to easing the life of individual taxpayers). It is likely that the global economic crisis (2008-2009?) will negatively impact the speed of any harmonization as governments focus on surviving the difficult period and, since research suggests that speedy harmonization negatively affects economic growth, governments will remain weary of such processes, keen to defend any possible economic growth (and thus their own positions) (Kopits, 1992),
- 2) the current process of direct tax harmonization is in an early stage of progress due to existing extensive national variations. Forces promoting reform are more economic and include the unified market, common currency, need to increase competitiveness. Opposing forces are more ideological and focus on the dangers of sacrificing fiscal competencies, especially that these powers will be handed over to a supranational body. The need for unanimous voting when backed by the complexity of current tax policies are the main causes for a slow harmonization process (rationality of pure tax-related arguments comes in conflict with local political rationality),
- 3) at the very least, it is crucial to assure the enforcement and optimisation of regulations covering the avoidance of double taxation, both personal (PIT) and business (CIT). The need for speedy resolutions stems from the growth and expansion of trans-border economic activity and the removal of barriers to the movement of labor which complicate proper income taxation (calculation and collection). It is necessary to employ a holistic approach to this issue and that calls for a review of signed bilateral agreements by their signatories, introducing required corrections and signing of new agreements with EU members,
- 4) PIT harmonization should focus on achieving intergovernmental agreement on calculating the tax base, to avoid distortions in the real tax rate (tax brackets). The concept of taxable income is a result of local costs of generating the income, rebates and deductions and the current methods of setting them differ in each country. The same relates to the methodology used for defining tax progression and the concepts of minimal and maximum rates and the social aspects of the PIT,
- 5) when discussing PIT harmonization it is important to remember about the integration of this tax with social security contributions, as both contribute to the burden placed on labor. They are complementary and form the “tax wedge” (the difference between





the gross labor costs to the employer and the net income for the employee) and are important for businesses when considering the costs-versus-reward of creating new employment opportunities (positions). When PIT is coordinated with social security contributions, attempts at coordination or harmonization become extremely difficult as two different deduction systems and multiple ministries in each state become involved,

- 6) a controversial issue is the competitive lowering of PIT rates, and nations intent on lowering (“dumping”) their effective tax rates ought to consider the impact of those actions on the wider Union, especially from the perspective of affecting competitive equilibriums (Bolkstein, 2002),
- 7) it is important to approach with caution the concepts regarding the removal of the capital gains tax since this would promote speculative activity (due to resulting high profits), while discriminating against labor incomes and profits from (more laborious, productive and long-term) economic activity. Much more beneficial would be the removal of taxes on savings, as it would stimulate an increase in the rate of savings and make more capital available to fund economic growth,
- 8) it is difficult to expect that the EU will evolve into a federal state, but only such a structure would give the Union the right to set and collect taxes. Then, tax policies would be formulated and implemented in a top-down manner that would allow for the implementation of a uniform (harmonized) tax system. It is unlikely that member states will agree to such a solution, especially due to the political importance and financial role of income taxes. Therefore, we can expect that income taxes will remain decentralized, e.g. under the control of individual nations (Tanzii, Zee, 1998),
- 9) a question emerges regarding the future possibilities for the income tax to become a “European tax” and whether such an idea is realistic (Agra Facts, 2007, Kucharek, 2007). The debate about setting a European tax started with the underlining of the weaknesses of available financial resources and defining the new model of EU budget revenues. The EU Commission proposed the personal income tax as a tax that fulfils eight criteria (in three groups): budgetary (sufficiency and stability), effective (recognition, low operating costs, effective allocation of resources), just (vertical and horizontal, income that assumes that the level of this tax is in balance with economic development). When considering the PIT, the Commission proposed three possible ways of establishing the PIT as a European tax:
  - a) poll tax, set at about 260 Euro,
  - b) percentage of national PIT revenues (visible as a separate position in the annual tax declaration),
  - c) separate EUPIT (two tax declarations: national and EU). Its introduction would increase implementation and collection costs and its very creation would require a Decree by the Council (in key elements) and a Directive (in the administrative section).

The EU Commission focused on the last concept. Completed analyses indicate that EUPIT set at 10% of current national PIT rates (coupled with a matching reduction in national PIT) would provide appropriate funds to the EU. It is improbable that an EU tax will be implemented from 2014, because the decision is purely political and not economical and requires unanimous agreement by all EU member states. Considering the specifics of the PIT presented in this article, it is unlikely that the PIT will become the basic EU tax in the foreseeable future.



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