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Fiscal harmonisation trends in the european union: Challenges for Romania

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European Institute of Romania

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Study no. 5

**FISCAL HARMONISATION TRENDS IN THE EUROPEAN
UNION. CHALLENGES FOR ROMANIA**

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I. General presentation of the *acquis communautaire* in the area of taxation

I.1. The *raison d'être* of Community rules

The adoption at Community level of rules concerning the nature and use of fiscal instruments cannot be seen, like it seems to be the reflex in some quarters, solely as the expression of a process of continuous expansion of the borders of the *acquis*. In fact, it is based on strong and persuasive considerations, linked not only to the essence of the European integration process *as foreseen by the Founding Treaties*, but also to the requirements that a fiscal system should ideally fulfill: collecting the necessary revenues; through the least costly ways; ensuring equity in the distribution of the fiscal burden; and generating the minimum distortions in the allocation of resources.

I.1.1. Thus, to begin with, the Community *acquis* in taxation is needed in order not to hamper the exercise of the „four freedoms” which give substance to the concept of „single market”.

There are two kinds of obstacles, segmenting the single market, which can derive from the use of fiscal instruments by the Member States. First, there is the **discrimination**, which may arise in three situations: applying different rules to comparable situations; applying the same rule to different situations; or applying very different treatments to non-very-different circumstances. Discrimination may be overt (explicit), when the differentiation of treatment is triggered by the nationality or residence of the taxpayer, or indirect (implicit).

Discrimination is deemed incompatible with the EC Treaty, but this incompatibility is not absolute, since it may be acceptable in special cases. In tax matters, the situations when the non-discrimination requirement may be considered excessive and inopportune are more frequent than in other areas. In practice, as well as in literature, several circumstances have been identified which may make admissible a certain dose of discrimination among taxpayers:

a) in order to avert the loss or diminution of budget revenues ;

Such justifications have been judged, at least until now, as non-acceptable: the Member States are to assume the costs deriving from the abolition of barriers within the single market, including those of a fiscal nature.

b) in order to preserve the „internal logic” (the „cohesion”) of national fiscal systems;

The underlying principle of this justification is that a taxpayer engaging in cross-border transactions cannot claim a fiscal treatment as favourable as that of a taxpayer acting solely at national level, because the latter has contributed to a larger extent to the creation of the budget resources rendering the more favourable treatment possible. Otherwise, all taxpayers could avoid contributing to the formation of budget resources while claiming nonetheless the right to benefit from the existing advantages. In order for a discriminatory treatment based on the need to safeguard the cohesion of a fiscal system to be acceptable, no other modality should exist for linking allowances reducing the tax base to the possibility of taxing the revenues accruing thanks to the allowances granted. Thus, for

instance, a state may deny the deductibility of insurance premiums paid in another country if the payments made subsequently by the insurer cannot be taxed in the first state. It should be noted, however, that the acceptability to the European Court of Justice (ECJ) of such justifications is diminishing.

c) in order to countervail fiscal evasion or fiscal avoidance;

So far, such a justification has never been rejected outright, the ECJ holding that this is a legitimate goal, defensible from the point of view of Community legislation.¹ The ECJ's approach to gauging this justification lacks consistency and is based on negative reasonings: the mere „risk” of tax evasion/avoidance is not enough to allow a departure from the generic principle of non-discrimination. The examination of the case law warrants the conclusion that such justifications have come to be allowed more often than by the past, without however enjoying an automatic acceptance. The cases of this nature are assessed through the lenses of the proportionality principle.

d) measures not infringing the provisions of bilateral treaties (usually, for the avoidance of double taxation) with the countries whose nationals are the taxpayers discriminated against;

The ECJ has consistently rejected this justification, which is a logical outcome of the existence of a Community law, distinct from and prevailing over national legislations.

As a general rule, invoking any exception justified by the preservation of the public interest is subject to demanding conditions, in the sense that the national authorities must demonstrate that they are appropriate for the goal pursued and this cannot be reached via measures less onerous for the taxpayer. This position of the ECJ is seen as contrasting with the far lighter standard that taxpayers have to meet in order to demonstrate that their interests are affected: „The taxpayer does not need to show an absolute restriction to the exercise of a particular freedom, but merely that the fiscal measure contested merely limits, discourages, hampers or renders less attractive the exercise of a fundamental freedom”.²

The discriminatory nature of a fiscal measure is easier to determine in the case of indirect taxes. When it comes to direct taxation, though, the place of residence of the taxpayer is the main and unavoidable element determining the extent of a state's jurisdiction in fiscal matters. Consequently, the differentiation of treatment based on residence cannot be avoided. Since the existence of a discrimination is more simple to identify for indirect than for direct taxes, the fiscal barriers to the free movement of goods are easier to see and ascertain than those barriers limiting the free movement of services, capitals and persons.

The particular nature of direct taxes triggers another peculiarity: *reverse discrimination* (against one's own nationals), which is not considered contrary to the Treaty as far as indirect taxes are concerned, has sometimes been held by the ECJ as not acceptable in the case of direct taxation. A controversial issue is whether the prohibition of discrimination is limited only to the discrimination by the authorities of the country on whose territory

¹ Violeta Ruiz Almendra: *Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?*, INTERTAX, 33:12, 2005; p.571

² Alistair Craig: *EU Law and British Tax. Which comes first?*, Centre for Policy Studies, 2003; p.31

the non-resident carries out his activity or encompasses also the fiscal measures applied in his home country. If, initially, the ECJ has censored only the former category of measures, this rejection has lately come to concern also measures pertaining to the latter category.

Apart from discriminatory measures, the single market may be segmented also by other ***restrictions not entailing elements of discrimination***. Such is the case of aspects as:

- the costs of complying with 27 sets of national fiscal laws and 27 administrative systems for the implementation of these rules; such costs derive not only from the obligation to fulfill fiscal reporting requirements, but also from the need to identify the fiscal implications of various business opportunities. There are estimations according to which the costs of complying with a diversity of fiscal rules amount to 2-4% of the value of corporate income taxes. A comprehensive survey recently commissioned by the European Commission, with the participation of 700 companies from 14 Member States, suggests a level of compliance costs equivalent to 1.9% of the taxes paid.³ The survey also shows that the companies with foreign subsidiaries are experiencing higher compliance costs and that their level increases as the number of subsidiaries grows.

One should mention the opinions according to which this diversity of fiscal regimes also provides taxpayers with more opportunities to engage in tax planning activities, as the discrepancies between rules can be taken advantage of in order to minimize the tax burden. However, such practices, although widespread, bear significant costs linked to the procurement of the legal, accounting and fiscal consulting services which are needed for finding the ways for limiting the tax payments, i.e., something tantamount with the expenditure of real resources for ends totally deprived of usefulness for the economy at large.

- the risk of double taxation, against the background of underdeveloped mechanisms for tackling this problem within the EU, while the few that have been put in place do not function effectively;
- the very limited possibility of fiscal compensation of losses at another level than the national one (as opposed to, ideally, the Community level);
- national fiscal systems incorporating features that favour domestic investors;
- fiscal costs linked to cross-border corporate restructuring even if strictly circumscribed to the Community level where – in principle – a single market is in place.

The mere differences between domestic tax systems, tax bases or tax rates do not amount, in themselves, to restrictions or discriminations. In other words, the „four fundamental freedoms” may not be used as a pretext for a complete (or even very widespread) harmonization of the national fiscal systems. The decisions linked to establishing certain types of taxes, the level of tax rates and the structure of the tax base pertain to national sovereignty, as long as it is guaranteed that the citizens of other Member States dealing with similar circumstances will be treated similarly, and market

³ Jens Brochner, Jesper Jensen, Patrik Svensson, Peter Birch Sorensen: *The Dilemmas of Tax Coordination in the Enlarged European Union*, IFIR Working Paper no.2006-11, October 2006; p.21

access is not disproportionately restricted. To put it in other words, „there is no such thing as the right to be subjected to the same level of taxation across the Community”.⁴

The above considerations can be best illustrated by a series of landmark cases from the jurisprudence of the ECJ concerning direct taxation, all of which have resulted in the condemnation of the fiscal rules applied by the Member State asserting jurisdiction.

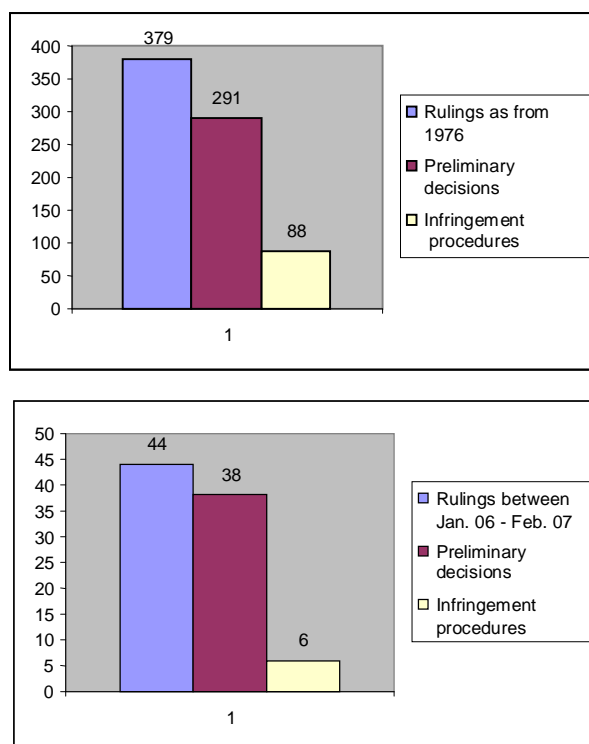
- ♣ *Avoir fiscal (1983)*, France: The permanent establishments (branches or representative offices) in France of foreign companies, although subjected to the same taxes as the residents, were being denied access to the fiscal credit granted for dividend gains which were otherwise accessible to resident companies.
- ♣ *Commerzbank (1991)*, Great Britain: The refusal of the fiscal authority to pay interest for the amounts reimbursed to a non-resident taxpayer who had made payments in excess of his final fiscal obligations, whereas interest was being awarded to resident companies.
- ♣ *Futura (1995)*, Luxembourg: Granting the possibility to benefit of the carry forward of fiscal losses only to companies keeping separate accounting, thus excluding from this faculty the branches of foreign companies availing themselves of the right not to keep their books separate from those of their parent companies.
- ♣ *Royal Bank of Scotland (1997)*, Greece: Applying a higher tax rate to the revenues of the subsidiaries of foreign banks than to the revenues of Greek banks, based on the justification that domestic banks were subject to global taxation.
- ♣ *Lankhorst-Hohorst (2002)*, Germany: Limiting the fiscal deductibility of interest paid by a resident company to another company, this measure affecting, first and foremost, the payments towards related companies established abroad.
- ♣ *Bosal BV (2003)*, Holland: The impossibility to fiscally deduct the expenses linked to the holding of shares (e.g., the interest for the funds borrowed in order to capitalize a subsidiary or to manage it) if the gains from holding those shares were not taxable in Holland.

Even in the field of indirect taxation, where the secondary legislation is more comprehensive, clearer and better organized, the recourse to the ECJ in order to safeguard the principles of the single market is very frequent. The Court has issued until 2006 no less than 450 rulings concerning cases involving the application of VAT. A similar situation can be observed as concerns excise duties which, alongside VAT, are otherwise part of what is called „positive integration”⁵ because regulated through EU Directives and Regulations which should greatly simplify the application of indirect taxes at national level.

⁴ Wolfgang Schon: *Tax competition in Europe – the legal perspective*, EC Tax Review 2000-2, p.99

⁵ Pentru o abordare teoretică a dihotomiei integrare pozitivă – integrare negativă vezi Fritz W. Scharpf: „*Balancing Positive and Negative Integration: The Regulatory Options for Europe*”.

ECJ VAT rulings, 1976 - 2007



Source: *European Court of Justice*

Below are listed several landmark cases adjudicated by the ECJ in indirect tax matters:

- ♣ *Tolsma* (1994), Holland: Determining the exigibility of VAT on the basis of the direct link between the supply of goods and services and the amount received in counterpart.
- ♣ *Recaudadores* (1991), Spain: Determining the exigibility of VAT for persons acting independently while exercising a public duty.
- ♣ *Charles* (2005), Holland: The deductibility of VAT in the case of capital assets used for dual purposes.
- ♣ *Optigen* (2006), Great Britain: The „caroussel-type” fraud.
- ♣ *Evangelischer* (2000), Austria: The distinction between the application of excises to alcoholic and non-alcoholic drinks, respectively.
- ♣ *Braathens* (1999), Sweden: Harmonisation of the system of excises levied on mineral oils by allowing an exemption for mineral oils supplied as fuel for aerial navigation, other than leisure flights.
- ♣ *De Danske Bilimportører* (2003), Denmark: Applying taxes to automobiles at the level established by the authorities without inducing discriminatory treatments.
- ♣ *Nunes Tadeu* (1995), Greece: Setting a car registration tax, but conditional upon not inducing discriminations prohibited by Article 90 TEC. This case was the object

of a very recent ruling by the ECJ (20 September 2007), as a result of an infringement procedure initiated by the European Commission against Greece.

1.1.2. Fiscal rules adopted at Community level are needed also in order to limit the distortions that may arise in the allocation of fiscal revenues among EU Member States (and, in particular, of those distortions induced by the „harmful tax competition”).

The legal and factual conditions for business in the various Member States are converging as a result of integration. As a result, non-harmonised national tax systems have become a major factor influencing investment decisions. The relocation of economic activities from one Member State to another, based solely on differences of fiscal treatment, have huge effects on the tax bases over which the national authorities are acting in order to extract budget revenues.

1.1.3. The proper functioning of the single market requires undistorted competition within its borders, meaning that decisions governing the movement of persons and capital (such as the location, form and financing modalities of investments) are not to be influenced by the applicable tax regimes, a commandment known as fiscal neutrality. Indeed, as aptly noted, „generating benefits deriving from nationality or residence perpetuates the segregation of national markets”.⁶

Competition distortions may affect the decisions concerning the location, as well as those of the object of an investment. If differences between the tax liabilities potentially facing a company trigger an alteration of its decisions concerning the place of its investment, the chosen location will be the one where production costs are higher, albeit compensated by lower taxes. Also, if the fiscal treatment varies according to the investors’ residence, it becomes possible for a less efficient company to produce a good solely because its investors are lighter taxed than those of the company which would have been the most efficient in producing that good.

In literature, a distinction is made between the export neutrality of capital (ENC) and the import neutrality of capital (INC). The former is ensured whenever the effective rate of taxation on an investment does not affect its location. The latter occurs when investors derive the same post-tax return for their savings irrespective of the countries where they invest.

1.1.4. An important advantage of economic integration (triggering both static allocative effects and dynamic „learning effects”) is the generation of economies of scale. Fully exploiting these, however, could be hampered by such measures as the generation of fiscal obligations solely because of carrying out cross-border economic concentrations or as a result of double taxation.

The degree of priority attached to each of these objectives has varied over time. Originally, at the same time as facilitating the free movement of goods and services through the harmonization of indirect taxes, the European Commission has focused its initiatives on the improvement of resource allocation and, hence, on ensuring „fiscal

⁶ Jean-Philippe Chetcuti: *The Process of Corporate Tax Harmonisation in the EC*, 2001, p.2-2/8

neutrality”. With the launch of the Single Internal Market project, the Commission has explicitly moved its emphasis, explicitly stating that fiscal harmonisation is „not an attempt to devise an ideal fiscal system for the Community, but a way of abolishing fiscal frontiers”.⁷ Starting with the 1990s, the Commission has pursued more insistently the goal of curbing harmful tax competition, while also promoting initiatives for the reform of corporate income tax systems with a view to eliminate obstacles to the right of establishment and the movement of capital, first in a discrete manner, and more recently, through comprehensive proposals, of obvious systemic dimensions.

1.2. Brief presentation of Community rules in fiscal matters

The EC Treaty, whose provisions constitute the so-called „primary legislation” of the EU, sets a number of fundamental rules, as enumerated below.

- a) the prohibition of subjecting imported products to indirect taxes that are higher than those applied to like domestic products (*Art.90*);
- b) the prohibition of granting, for the export of products towards other Member States, refunds of indirect taxes in excess of those to which the said goods had been effectively subjected (*Art.91*);
- c) the harmonisation, solely on the basis of the unanimous decision of Member States, of indirect taxes, to the extent that such harmonisation is required for the proper functioning of the internal market (*Art.93*);
- d) while there are no explicit provisions concerning the harmonisation of direct taxes, this is not excluded, as it may be covered by *Art.94*, in accordance to which the Council, acting unanimously, can adopt Directives for the purpose of harmonising the regulations of member states which have a direct bearing on the functioning of the common market;
- e) the possibility of Member States to differentiate between residents and non-residents from the point of fiscal regulations, provided that this differentiation does not amount to an „arbitrary” discrimination (*Art.58*);
- f) the obligation of Member States to conclude among themselves bilateral treaties for the avoidance of double taxation (*Art.293*);

There are, moreover, several articles of the EC Treaty with a generic coverage, which include provisions whose relevance for the area of taxation is certain and has already been confirmed on a number of occasions. Such is the case of:

- a) the explicit prohibition of any discrimination based on nationality, which is clearly stipulated in *Art.12*;
- b) the prohibition, except in strictly circumscribed circumstances, of granting State aids (*Art.87*);
- c) the obligation to co-ordinate the economic policies of Member States, in view of the fact that they represent a „common interest”, and the multilateral surveillance of this obligation, through broad economic policy guidelines adopted by the Council (*Art.99*); until now, however, these documents have fallen short of dealing with taxation issues in

⁷ Theo, Hitiris: *Tax harmonization*, in “European Community Economics”, Harvester, 1994; p.112

the strict sense of the word, focusing instead on macroeconomic, and sometimes structural, aspects;

d) the generic possibility of the Council, acting unanimously on a proposal by the Commission and after consultation of the European Parliament, to adopt the measures needed for the realisation, within the functioning of the common market, of a Community objective, whenever the Treaty does not confer the necessary powers to this end (Art.308).

We can, thus, discern an important difference between the legal regime devised for indirect taxes and direct taxes, respectively. With respect to the latter, the regulation is mostly implicit, being mainly based on:

- generic provisions concerning the completion of the internal market;
- the possibility to have recourse to inter-governmental cooperation (hence, not to the „Community method”: the Treaty explicitly mentions „negotiations”);⁸
- the principles „distilled” by the ECJ with respect to the „four freedoms” of movement. Their relevance has been greatly strengthened by a 1985 Court decision which, while reaffirming the Member States’ exclusive competence in direct taxation matters, has held that this has to be exercised in a manner compatible with the EC Treaty.

1.3. Difficulties in formulating Community rules for taxation; ways of overcoming them

Fiscal harmonisation within the EC is hampered by two stumbling blocks which are reinforcing each other: the unanimity rule for decisions in tax matters and the absence of converging views concerning the desirability and boundaries of such an undertaking.

The preoccupation of Member States for retaining the largest possible freedom of maneuver as concerns the recourse to fiscal tools, which appears also from the way the relevant provisions of the EC Treaty were drafted, has several and non-mutually exclusive possible explanations.

There are, thus, views according to which such an important element, practically akin to the notion of statehood, as the right to impose taxes, cannot legitimately be exercised by bodies, such as the Community ones, not representative of a genuine *demos* and whose designation is left wanting from the point of view of democratic precepts.

Much more convincing is the argument of the diversity of preferences existing at the level of Member States as concerns the quantity of public goods and services which should be supplied by the State, as well as from the point of view of the instruments by which the resources making possible this supply are to be collected.

Moreover, against the background of the unification of trade policy, the gradual move towards a common currency within the EU and the limitations imposed on the use of the budgetary lever by the Stability and Growth Pact, taxation remains the only major

⁸ Claudio Radaelli, Ulrike Kraemer: *Shifting Modes of Governance: The Case of International Direct Taxation*, International Workshop, International University Bremen, June 2005, p.10

economic policy tool still placed under the predominant control of Member States, which can be used in order to promote specific goals and to deal with asymmetric shocks. As a result, the problems confronting national tax systems in the current context have a new dimension.

The political availability of Member States for co-ordinated solutions in tax matters is higher in those areas where their freedom of movement is inherently constrained. The taxation of multinational corporations (MNCs) is one such example, as substantiated by the extensive network of bilateral treaties for the avoidance of double taxation in which all EU Member States are involved.

The difficulties induced by the complicated decision-making mechanism are well illustrated by the large number of proposals forwarded by the Commission in fiscal matters which have not been adopted by the Council (18), as well as by the even larger number of proposals withdrawn by the Commission: 33! Another illustration in the same vein comes from the long periods elapsing between the moment of initiation of a legal act concerning corporate taxation and its adoption by the Council: about 25 years, on average!

The rule of unanimity in tax matters is more constraining than in other areas because of a larger heterogeneity of Member States' preferences as concerns social equity and the supply of public goods, as well as because there are fiscal matters in respect of which it is unavoidable that the interaction between national tax systems takes the form of a zero-sum game, at least from the point of view of budget receipts (the case of fiscal competition, of fiscal avoidance, or that of double taxation). This rule becomes even more constraining as the number of EU members goes up (which is tantamount to an increase of the number of, effectively, veto right holders) and, especially, as more obvious disagreements emerge with respect to the desirability of limiting the exercise of sovereignty in fiscal matters (in other words, the differentiated acceptability of federalist elements).

Even in those cases where it proved possible to issue Community legal acts in tax matters, these have tended to take the form of Directives rather than Regulations, which comes as an additional confirmation of Member States' reluctance to subject such matters to supranational rules: the Directives only prescribe obligations of results, not also of means, and have to be transposed in national legislation (not being directly applicable, as is the case of Regulations). This provides national authorities with a wider margin of discretion.

As time goes by, and because of the systematic confrontation with new episodes of impossibility to have recourse to the classical lawmaking method at EC (EU) level, several options have been tried in order to push forward the taxation *acquis*. Listed in the order of their effectivity for reaching solid solutions (and reverse order from the standpoint of the simplicity of getting to the desired result), these options are the following:

i) *moving to qualified majority voting for the decisions pertaining to some areas of taxation.*

This is the case of aspects that can be linked to provisions of the EC Treaty the enforcement of which requires the revision of fiscal norms. Since this would not be a fiscal harmonisation strictly speaking, the unanimity rule would no longer be mandatory. Such aspects include: the elimination of obstacles hampering the proper functioning of the internal market; combating tax fraud and the prevention of double non-taxation; fiscal measures destined to environment protection. In spite of the Commission's effort, these proposals have not been accepted either by the Inter-Governmental Conference finalised in Nice (2000), where the opposition of Great Britain, Sweden and Ireland could not be overcome, nor in the draft Constitutional Treaty.

ii) making use of the “flexibility clause” introduced by the Amsterdam Treaty – the current „enhanced co-operation” stipulated by Arts.43-45 EU Treaty.

This institutional and decisional innovation allows Member States to agree on rules, beyond those included in the *acquis*, that would be binding only for a sub-set of them within the EU. It is, however, only a possibility of last resort, constrained by strict conditions: the acquiescence by qualified majority voting of the Council, non-affectation of the *acquis* and of the rights of non-participating Member States, compatibility with EU objectives, existence of a minimum number of Member States embracing such an initiative, openness to the participation of any Member State which so desires. This is why, so far at least, this possibility has not been used in any field.

In 2004 a first concrete initiative of this type was recorded, originating with France and Germany, which proposed the establishment of a „single corporate taxation area”, based on a single tax rate and a single tax base, to which the participation of at least Belgium and Spain was also foreseen.⁹ More recently, the reluctance shown by several Member States with respect to the introduction of a common consolidated corporate tax base has led Commissioner Kovacs to evoke the possibility of using the enhanced co-operation” in order to break this stalemate.¹⁰

iii) the recourse to so-called „soft law” measures (not compulsory and not formalised as legal acts according to the Treaty); three kinds of tools fall into this category:

- «Codes of Conduct» agreed between Member States at inter-governmental (not Community) level, whose implementation is secured by considerations of prestige and credibility (*peer pressure*);
- «pilot projects», assumed on a voluntary basis by the interested Member States and taxpayers, such as the one concerning the mutual recognition of the home country tax base rules (« Home State Taxation »);
- «recommendations», «interpretative notes» or «guidelines» issued by the Commission and legitimized by Art.211 TEC; they have a non-obligatory character, but may be used as a source of legal reasonings. The ECJ has often shown the willingness to follow them, especially in the case of „recommendations”, thus bestowing on them a certain legal

⁹ Nico Groenendijk: *Enhanced Cooperation in Corporate Taxation: Possibilities and Possible Effects*, EUSA Economics Interest Section Research Seminar, Waterloo, Ontario, April 2006; p.1

¹⁰ Laszlo Kovacs: *The European Commission's business taxation agenda*, Oxford Centre for Business Taxation, 23 March 2006

force.¹¹ They are, however, criticable because they represent a way deliberately used by the Commission to claim competencies in area where the Treaty did not give it such powers.

The recourse to the instrument of „Codes of Conduct”, as expression of informal governance, is likely to have other positive virtues over and above the overcoming of difficulties associated to formal ways of regulating: ensuring a closer participation of the subjects of regulation, which induces both legitimacy and learning effects, averting the shortcomings deriving from the rigid nature of some regulations etc. This notwithstanding, the first code of conduct, relative to harmful tax competition in business taxation, adopted by the Council and the Member States on 1 December 1997, has not been destined to exploit these advantages and did not signal an abrupt transition from legally formalized measures to informal approaches. It had instead been introduced as an element for facilitating transactional trade-offs of the kind explained below (point iv), being part of a larger package of initiatives submitted by the Commission.

iv) recourse to tactical maneuvers; two such approaches can be discerned in the recent practice of the Commission:

- grouping legislative proposals into „packages”, meant to increase the chances of mutually advantageous trade-offs between Member States (e.g., the „packages” of July 1990 and December 1997): against the background of a decision-making process based on unanimity, every Member State has to be able to get something out of the legislative proposals on the table.¹² The 1997 package had an additional innovative element, in the sense that the three distinct proposals have been explicitly linked, from the outset.
- the threat to use other available tools in order to increase the acceptability by Member States of the Commission’s more formal initiatives; over the last decade, there were, thus, two successive „campaigns” (launched in 1996-97 and 2001, respectively) of investigations concerning national fiscal measures liable to infringe State aid rules, which have been widely regarded as an attempt to „persuade” the more reluctant Member States to adhere to the Code of Conduct on Business Taxation (1997) and, later on, to accept the enactment of the Directive concerning the taxation of interest on savings.

v) the case law of the European Court of Justice (ECJ)

This is a source of rules in continuous and accelerating expansion. The number of corporate revenue taxation cases reaching the Court has grown a lot over the last years. Of about 70 decisions issued with respect to national tax regulations, 60 have been the result of adjudicating disputes presented over the last 10 years.¹³ At the same time, the „activism” of the Court, embodied in „creative” interpretations of the primary legislation, has also been on the rise. Because of this, it has become possible to state that, currently,

¹¹ William Bratton, Joseph McCahery: *Tax coordination and tax competition in the European Union: evaluating the Code of Conduct on Business Taxation*, Common Market Law Review 38:2001; p.688

¹² Thus, on the occasion of the ECOFIN meeting of November 2000, Belgium was granted a transitional period for the implementation of the Directive concerning interest taxation, in exchange for its agreement on further progress in implementing the Code of Conduct on Business Taxation, which was calling into question many sensitive aspects of its taxation system.

¹³ Thomas Rixen, Susanne Uhl: *Europeanising Company Taxation - Regaining National Tax Policy Autonomy*, Friedrich Ebert Stiftung, International Policy Analysis, July 2007; p.4

the Court has become „the most important source of pressure over national tax systems within the EU”¹⁴

The growing activism of the Court has come to be matched, as from the end of the last decade, by that of the Commission. If between 1983 and 1998 the latter had initiated just two infringement procedures in the area of direct taxation, „the Commission is now acting systematically against the Member States”, bringing a far larger number of cases before the ECJ.¹⁵

This activism of the ECJ has led many observers to question whether the Court is really confining itself to the role of interpreter of the Treaty or is actually promoting an own agenda, aiming at an implicit fiscal harmonization. The distinction, in this case, may well be futile since, according to a very perceptive observation, „the only corporate taxation system which is fully compatible with the exercise of the single market freedoms is one that is completely harmonised”¹⁶

The regulation „by default”, using the venue of case law, has not only positive features. As emphasized in literature, „there is no precedent in the world’s history of an economic and monetary union where taxation policy has consisted solely in unbridled competition, protected by a Supreme Court and combined with the prohibition of fiscal incentives”¹⁷

The *quality* of the rules distilled in this way cannot be optimal, primarily because the Court can only do „negative harmonisation”, in the sense attributed to this term by Jan Tinbergen. Secondly, the inner consistency of national fiscal systems is affected by discrete decisions, which have no way of taking into consideration their potentially negative reverberations over related aspects. Finally, there is no guarantee against the case where ECJ decisions generate asymmetric effects on the Member States.

The *insecurity* of the *sui generis* regulation performed in this manner is another serious shortcoming. Indeed, since the decisions of the ECJ are certainly relevant only for those cases in which they were issued, a significant uncertainty persists with respect to their impact and significance for situations where circumstances are not identical, even if very similar.

Also, the *legitimacy* of regulation suffers, because aspects so closely associated with national sovereignty as to trigger the jealous keeping of the national veto rights come to be censored by a supranational body, not answerable before the citizens of the Union. This problem is magnified by the fact that, generally speaking, the Court decisions tend to favour the taxpayers¹⁸, while the financial stakes of some of them have reached exorbitant levels. „Armed” with such decisions, multinational companies initiate court actions (before national tribunals) asking for tens of billion euro-worth of damages arising from national fiscal rules, adopted in full conformity with the domestic

¹⁴ Claudio Radaelli, Ulrike Kraemer: *Shifting Modes of Governance: The Case of International Direct Taxation*, International Workshop, International University Bremen, June 2005, p.22

¹⁵ Martha O’Brien: *Implications for Member State Budgets of the ECJ’s rulings on direct taxation*, Working Paper, Conference at the University of Victoria, August 2005; p.6

¹⁶ Edward Troup, www.FT.com, 4 februarie 2003

¹⁷ Frans Vanistendael: *Memorandum on the taxing powers of the European Union*, EC Tax Review 2002-3

¹⁸ Claudio Radaelli, Ulrike Kraemer: *New Modes of Governance*, Project ITI-CT-2004-506392, Lead contractor: University of Exeter, June 2007, p.13

constitutional requirements and covered by the assumption of good faith as concerns the abidance by the obligations falling on Member States, but which come subsequently to be qualified as „restrictions” by the ECJ.

Finally, there is the risk that ECJ decisions generate perverse consequences for the availability of Member States to acquiesce to fiscal harmonisation initiatives. Under the circumstances in which they consider, in particular, that their attempts to counteract fiscal avoidance practices of multinational corporate taxpayers are being frustrated by the positions taken by the ECJ, they have reasons to wish to retain as large a room for maneuver as possible with respect to other elements of the national tax systems.¹⁹

The potential impact of ECJ decisions on the Member States’ budgets has become a major source of preoccupation, because of the large amounts put in question, but also – more significantly – because the risk of retroactive reimbursements, against the background of small individual cases stimulating a large number of taxpayers in similar situations to make, at their turn, reimbursement requests. This phenomenon is already widespread in Great Britain, where litigants may form litigation groups, the first such construction putting together a number of 160 multinational corporations.²⁰ In such a context, the capacity of the Member States’ fiscal authorities to make accurate projections of their budgetary resources is seriously called into question, with all negative consequences which derive, including on the capacity to implement the provisions of the Stability and Growth Pact.

It can be said that the fiscal governance modalities enumerated above are evolving in a *continuum* which blurs the distinction between the formal and informal ones, and that there is as large potential for trade-offs among them.

Relative to the first aspect, one should note that some *soft law* instruments are stronger than others, coming close to the classical modalities of regulation, and that the „Community method” is in an obvious reflux, as formal initiatives have alternated with informal ones over the last decade.

Explicit rules found in the Treaty, such as those pertaining to State aids, whose rigorous and extensive enforcement would have been controversial and conflictual, have sometimes been used in order to increase the availability of governments for instruments based on peer pressure and political (as opposed to legal) commitment. In other cases, the Member States themselves have attempted (so far, without success, as during the British Presidency in the latter half of 2005) to find inter-governmental cooperation modalities, such as the establishment by ECOFIN of a group of reflection meant to analyze the impact of ECJ decisions, or the Commission has attempted to take advantage of the Court’s decisions in order to issue *soft law* instruments, such as communications and recommendations, ostensibly meant to guide Member States towards solutions less likely

¹⁹ Clemens Fuest: *Corporate Tax Coordination in the European Internal Market and the Problem of “Harmful Tax Competition”*, University of Cologne, December 2002; p.15

²⁰ Martha O’Brien: *Implications for Member State Budgets of the ECJ’s rulings on direct taxation*, Working Paper, Conference at the University of Victoria, August 2005; p.9

to be successfully challenged before the Court.²¹ These latter two attempts are, to some extent, canceling each other, with the consequence that – against the background of the systematic bias of the ECJ in favour of the taxpayer – the interest groups are those who stand to gain.²² One should mention, however, that there are ways of limiting the budgetary impact of reimbursing to taxpayers amounts paid over several years, like for instance stipulating that ECJ decisions can be invoked only *ex nunc* for obtaining damages, and there are such precedents in the Community *acquis* (e.g., a Protocol appended to the Maastricht Treaty, limiting the effects of a Court decision in a gender discrimination case linked to private pension plans which would otherwise have had potentially disastrous budgetary consequences for the Member States)²³.

²¹ Such Communications were issued as concerns the fiscal treatment of occupational pensions (2001), of investment funds (2000), dividend taxation (2003) and cross-border compensation of losses (2006).

²² Claudio Radaelli, Ulrike Kraemer: *New Modes of Governance*, Project ITI-CT-2004-506392, Lead contractor: University of Exeter, June 2007, p.7

²³ Martha O'Brien: *Implications for Member State Budgets of the ECJ's rulings on direct taxation*, Working Paper, Conference at the University of Victoria, August 2005; p.23

II. Problems of the national tax systems in the context of European economic integration

II.1. The risk of an erosion of the tax base

The integration of any national economies is bound to negatively affect tax systems, via two channels:

- *the increased mobility of tax bases*, subsequent to the liberalization of economic flows which integration necessarily entails, and magnified by the consequences of technological progress;
- the increased difficulty of determining and collecting taxes from taxpayers and/or transactions located *outside the fiscal jurisdiction* of the national authorities.

Within the EU, the fiscal independence of Member States is additionally constrained by the obligation not to distort competition within the Single Internal Market, as well as by the need to abide by the convergence criteria set at Maastricht and incorporated in the Stability and Growth Pact.

For all these reasons, economic integration (which is a defining phenomenon for the process of „globalization”) has come to be widely perceived (especially at the level of the non-specialized discourse) as limiting the capacity of governments to do what they desire and deem necessary in such key areas as taxation and its more important correlative, public spending.

These fears do not appear justified in view of the fact that the general trend recorded worldwide is towards an increase of collected taxes, both in absolute, as well as in relative, terms. Thus, for instance, in 2003 the EU(-15) member states were recirculating through the budget lever the important percentage of 41,8% of GDP, substantially up from 1970, when fiscal revenues amounted to just 33,5% of GDP.²⁴

Although the taxation level goes hand in hand with that of public expenditure, none of them can be positively associated, from a statistical point of view, with economic globalization/ integration. Thus, some of the highest levels of taxes collected can be found in strongly „globalized” countries, whereas countries ranked among the last in hierarchies based on „globalization indices” (the most notorious being that constructed by the consulting company A.T.Kearney and periodically published by *Foreign Policy* magazine, edited under the aegis of the *Carnegie Endowment for International Peace*) also tend to have some of the lowest levels of budget revenues. More to the point, EU members such as Sweden or Finland, featuring on the first places in any „globalization tops”, have some of the most generous levels of social spending in the world, rendered possible by taxes which, from a comparative perspective, cannot be characterized as being otherwise than high.

²⁴ Sijbren Cnossen: *Tax Policy in the European Union. A Review of Issues and Options*, 2002, p.4;
xxx: *Pour un serpent fiscal européen. De la concurrence à l'harmonisation*, Syndicat National Unifié des Impôts, Éditions Syllepse, Paris, 2005, p.100

II.2. The mobility of tax bases

Since production factors can access higher rents simply by crossing the border, any rational economic operator will do so *if the border is open*. This is why the mobility of tax bases reaches very important dimensions within the EU, where it is at least stimulated, if not generated outright, by processes belonging to the essence of the European integration process, such as: the liberalization of capital movements; the disappearance of customs barriers at intra-Community borders; the introduction of a common currency, with the consequence of canceling one of the most important transaction costs (the currency risk) for transactions taking place among Euroland countries, whose economic weight in the EU is overwhelming, and very significant at global level as well.

The mobility of all tax bases is not identical, however. In principle, the movement of labour is more limited, because of intrinsic barriers, such as language, family, culture or social aspects. This being said, the more skilled part of the workforce is more mobile and its degree of mobility is on the rise. Consumption is usually considered as a fairly stable tax base, though some mobility has come to be noticeable in this field as well, as a consequence of the higher weight of services in consumption in the developed countries, the extension of cross-border shopping and the development of e-commerce.

What ought to be noted as a widely identifiable trend at global level (and, *a fortiori*, within the EU) is that *a growing part of the tax base is more and more elastic to the tax rates*.

The statistical data show that, in the developed countries, corporate income taxes are not the most important source of revenue. Generally speaking, they do not exceed 10% of total budget receipts. The most important taxes in these countries are those levied on consumption (VAT, excises, customs duties), on the personal income of residents and, respectively, on labour (“payroll taxes”).

Level and structure of taxation for several OECD member countries

	<i>Fiscal burden (% of GDP)</i>			<i>Corporate income tax (% of total budget receipts)</i>		<i>Payroll taxes (% of total budget receipts)</i>		<i>VAT, excises/ Sales taxes (% of total budget receipts)</i>	
	<i>1970</i>	<i>1980</i>	<i>2000</i>	<i>1980</i>	<i>1997</i>	<i>1980</i>	<i>1997</i>	<i>1980</i>	<i>1997</i>
EU-15	33,5		42,5	5,3	6,5 (2000)	56,9	52,0 (2000)	38,0	31,1 (2000)
- France	37.4	43.6	50.9	5.1	5.8	55.6	54.6	30.4	27.8
- Germany	37.2	43.9	44.8	5.5	4.0	64.2	65.5	27.1	27.7
- UK	35.6	35.3	40.6	8.3	12.1	46.6	42.0	29.2	35.0
- Italy	27.9	32.4	46.4	7.8	9.5	61.1	58.8	26.5	25.9
U.S.A.	28.9	30.0	34.4	10.8	9.4	65.3	63.2	16.6	16.7

Japan	19.7	25.6	30.8	21.8	15.0	53.4	57.4	16.3	16.5
Canada	31.3	30.3	43.4	11.6	10.3	44.6	51.4	32.6	24.4

Sources: *Making Sense of Globalization. A Guide to the Economic Issues*, CEPR Policy Paper No.8, July 2002; p.84; Sijbren Cnossen: *Tax Policy in the European Union*, 2002; p.6

Corporate income is easier to tax if based on resources, be they natural or human, specific to a certain location. If corporate income proves to be more difficult to tax, it is theoretically possible (and there proposals to this effect in literature) to change the taxation principle and levy the charges based on such elements as the share capital, turnover of number of employees.

There are also views according to which corporate taxation is inefficient. Several recent studies suggest that the corporate income tax is passed on to consumers and/or the workforce. In such cases, it is obvious that the direct taxation of these elements would be more efficient. Also, too high corporate tax rates could engender behaviours that are irrational from an economic standpoint, such as an excessive reinvestment of profits, not warranted by the existing perspectives for the investment return.

The level of taxation applied to the mobile parts of the tax base has important externalities on the less mobile parts of the tax base. Confronted with the need to lower the tax rates on the more mobile bases, the fiscal authorities are left with the sole alternatives of either increasing the fiscal pressure put on the relatively immobile bases or lowering the quality of public services. Against this background, the phenomenon of preferential treatment of mobile tax bases emerges, which is tantamount to fiscal degressivity.

As concerns *direct taxes*, the Nordic Member States (Denmark, Finland and Sweden), as well as, more recently, Austria and Holland have introduced dual tax regimes, featuring flat rates on capital income (interest, dividends, capital gains) and progressive rates on labour income.

Whereas in the early postwar period, capital income (profit) used to be taxed heavier than labour income (wages), as economies grew more open, capital income taxes tended to diminish, while labour-based taxes went up. Thus, in the EU(-15), between 1980-97, the implicit tax (revenues collected / tax base) on the workforce has risen by 7 percentage points (from 35%, to 42%), while that on capital went down from 42% to 37%. The subsequent trend, however, was much less steep, as the implicit tax on labour varied between 36/37% over the whole course of the following decade.²⁵

This trend also engenders a narrowing of the tax bases, which amplifies the vulnerability of public finances to exogenous shocks. Also, the increase of the tax burden on labour has several negative consequences. There is, thus, a movement of the tax burden towards the least skilled employees: more and more Member States have instituted preferential fiscal regimes for highly-skilled personnel (often, consisting of expatriates), usually in the form of flat tax rates. Secondly, the transfer of economic activities into the parallel sector of

²⁵ Michel Vanden Abeele: *Tax competition within Europe*, Annual Conference of the Foundation for Fiscal Studies, Dublin, 1 October 1999; xxx: *Taxation trends in the European Union. Main results. 2007 edition*, Eurostat, p.13

the economy is encouraged. And, finally, by raising the price of labour relative to that of capital, the substitution of labour by capital is also encouraged.

In the case of *indirect taxes*, the tax base is, typically, easier to “control” than is the case of direct taxes, and this is reflected in a certain re-balancing of the two important categories of tax: in the OECD, between 1965-1995, consumption taxes have seen their weight in total budget receipts increasing from 12% to 18%, and payroll charges have recorded a percentage rising from 19% to 27%.

II.3. Difficulties of assessing and collecting taxes outside one’s own jurisdiction

Several recent trends, associated with the phenomenon of „globalization”, have rendered more difficult the task of fiscal authorities. This is mainly the case of: the expansion of electronic commerce; the proliferation of tax havens; and the exponential growth of intra-group transactions (within multinational corporations).

As a reaction to these trends, more states have begun to take fiscal measures the only purpose of which is the “protection” of their tax bases:

- issuing complex norms regarding the income earned abroad;
- protectionist legislation, destined to limit the relocation of (corporate, as well as individual) taxpayers in more attractive fiscal jurisdictions;
- pressures exerted on states with (too) permissive fiscal regimes, and this not only (and not even primarily) in connection with countering money laundering at a global scale;
- limitation of the confidentiality of personal data.

II.4. Taxing income earned in other jurisdictions

Worldwide, there are two principles for the taxation of this income: the residence principle and the income source principle. According to the residence principle (which corresponds to the global system of taxation) all revenues derived by residents, irrespective of where they were generated, are subject to taxation. When the residence principle applies, an investor faces the same marginal rate of tax for the income earned at its place of resident, as well as for that earned abroad. According to the principle of the source of income (which corresponds to the territorial system of taxation), taxes are applied where the revenues are generated. The territorial system is considered superior to the global system primarily because it is easier to administer.

An analogous situation arises when consumption is taxed (hence, in the case of indirect taxes), which can be levied according to the principle of destination (similar to the residence principle in the case of direct taxes) or to the principle of origin (similar to the income source principle of direct taxation).

The economic implications of the two systems are complex. If production efficiency is pursued, the producer prices of both inputs and outputs have to be equalized across countries, which requires the recourse to the residence principle for direct taxes and to the destination principle for indirect taxes. Conversely, if consumer surplus is to be maximized, it is consumer prices that have to be equalized across countries, which requires the recourse to the source of income principle for direct taxes and to the destination principle for indirect ones.

The theoretical issue arising here is which of the two kinds of efficiencies should be given preference. According to the “Productive Efficiency Theorem” of Diamond and Mirrlees (1971), this is the one deserving priority: even if taxes will distort the choices of consumers, it is preferable not to affect the choice of inputs by producers because, due to its repercussions on the final price, a tax on inputs will come to distort the choice of consumers in the same way as a consumption tax would. This theorem was developed for the context of a closed economy. As Keen and Wildasin (1999) have shown subsequently, it is only applicable to an international economy if there can be autonomous transfers among countries. Otherwise, there is an incentive for all countries to apply the principles of the source of income and of the product’s origin, respectively, in order to maximize their budget revenues. For the EU, this raises an interesting perspective, because the Union has endowed itself with a common budget which, theoretically at least, could operate a redistribution among Member States with a view to counterbalance the above-mentioned incentives. In other words, if the Community budget were sufficiently large (which is obviously not the case now, when its revenues barely exceed 1% of the Community GDP), the EU could apply those principles of international taxation which would ensure maximum economic efficiency. It should be noted, in this context, that a proposal is already on the table, for quite a while, for the switch to the destination principle of the most important indirect tax (VAT), even if the justifications offered by the European Commission for this initiative have not put forward (at least, not explicitly) this consideration.

The problem gets more complicated when equity aspects are brought into the picture, alongside those of efficiency. From an equity perspective, taxation based on the source of income principle is solidly defensible because the host country of an investment supplies public goods, such as infrastructure or the protection of ownership rights, which are essential for the profitable utilization of capital, hence it is entitled to a part of the profits obtained by investors in its own jurisdiction. This problem should be easily solvable if the investor’s home country allows him full fiscal credit for income taxes paid in the country (countries) where his external investments are located.

Moreover, it is also considerations of equity (of an inter-personal nature, this time) which are pleading in favour of the residence principle. The equity requirement is best served by a progressive taxation of all income earned by a taxpayer. In order to do this, it would be necessary to consolidate all this (her) revenues, i.e., something that only taxation based on the residence principle can render possible.

As a result, is it ultimately both the efficiency considerations, and those of equity, which require the transition to a European taxation system based predominantly on the principles of residence and destination.²⁶

An additional argument in favour of this option, which is potentially more attractive to political decision makers than the above-mentioned theoretical aspects, is that taxation based on the source of income principle allows governments to attract foreign capital by reducing the tax rate, betting on a widening of the tax base, but this would come to the

²⁶ Peter Birch Sorensen: *Tax coordination in the European Union: What are the issues?*, Swedish Economic Policy Review, 8:2001; p.155

expense of the tax bases of the home countries (where the capital originates from). In an analogous manner, where the origin principle applies to indirect taxes the authorities may be tempted to attract consumer purchases on their own territory, by lowering consumption taxes, again at the expense of other countries' tax bases.

Currently, however, the vast majority of EU Member States applies the principle of the source of income to the taxation of revenues, to a large extent because of the perception of an unsatisfactory exchange of information between the fiscal authorities of the Member States, as well as because of the desire of the small EU members to be able to attract mobile tax bases from other member countries.

III. “Fiscal competition” : fields of action and effects

The concept of « fiscal competition » has first been introduced by Charles Tiebout (1956) and assumes the existence of a market for public goods, just as is the case for private goods. As a result, the taxpayers will opt for taking residence in those locations offering the combination of public goods and taxes (that is, the prices of public goods) which they prefer most. At their turn, fiscal authorities will try to attract taxpayers in their own jurisdictions, by offering the bundle of public goods and underlying taxes which they desire, until an optimal dimension of the tax base is reached, i.e., the one that allows the minimization of the cost of public goods supplied.

The analogy with competition among private economic actors can be seen from different different perspectives. On the one hand, it can take the form of a cost reducing “race”, which is tantamount to increasing the efficiency of the spending of public funds and, on the other hand, it can engender an effect of “rent limiting”, by offering an attractive combination of prompt and reliable supply of public goods, at a level not in excess of that required for covering the costs and deriving a reasonable profit.

Fiscal competition is especially relevant for the attraction of:

- foreign direct investments, which are regarded as more and more important for job creation in EU Member States;
- the mobile financial capital (portfolio investments), useful for financing investments, strengthening financial markets and for deriving comparative advantages as concerns the supply of financial services;
- intra-firm financial flows, which can be channeled towards one’s own fiscal jurisdiction by attracting those corporative functions used for the international transfer of profits;
- highly skilled workforce.

According to some opinions, fiscal competition is likely to generate important *positive effects*.

First, it contributes to *reducing the vulnerability of taxpayers to their exploitation by the state*. The perspective underlying this view sees the state as a monopoly, with a natural tendency to increase its costs and extending its activities, thus requiring increased resources, obtainable through higher taxes. Having said this, one should be aware of inherent limitations to the materialization of this effect. Thus, taxpayers simply cannot avoid living in a state, hence they always remain “exploitable”, unlike the consumers on a private market, which can refuse to pay for too expensive goods or services. Secondly, the activity of fiscal authorities allows coercion, and the holders of less mobile resources cannot exercise this kind of censorship on the authorities. Finally, the authorities may form (through fiscal “co-ordination” or “harmonization”) true “cartels”. And fiscal cartels are more pernicious than the commercial ones, because commercial decisions are made every day, while general elections take place at far longer intervals.

The problem with this line of arguments is that it is assuming that the decisions of authorities are systematically damaging for citizens, which is only the case if politicians are serving narrow interests and/or bureaucrats are pursuing selfish objectives, maximizing their rents or powers. Yet, if things were indeed like this, then the preferred

modality for correcting the distortions is acting on them directly, rather than through indirect mechanisms, like fiscal competition, which may well generate their own distortions.

Fiscal competition can also stimulate *a higher budget efficiency*, insofar as it leads to the offering of the best services at the least cost for the taxpayer. Because fiscal competition limits the resources of the budget, expenses have to be better managed, reducing waste. This thesis only holds true if the government were to act as a benevolent maximizer of the citizens' welfare, a hypothesis at odds with the one underlying the first argument. Even then, however, fiscal competition will not necessarily have positive effects, this being the case only if the portion of marginal public expenditure which is pure "waste" exceeds the elasticity of the tax base response to the modification of the tax rate.

Thirdly, fiscal competition may *stimulate economic activity*, by freeing investments of a part of the fiscal burden, which discourages them in many ways: by discouraging savings, hence the reduction of the pool of capital available;²⁷ by reducing the profit available for reinvestment purposes; and by the fact that, if the investment income of the shareholders is highly taxed, companies will have to distribute higher dividends in order to attract capital. A study issued under the aegis of the OECD estimates a positive effect on economic growth of 0,5% as a result of a reduction by 10 percentage points of the marginal rate of taxation.²⁸ This effect does not occur uniformly. If the reduction of very high tax rates entices growth, the same cannot be said about lowering towards zero already modest tax rates.

Finally, fiscal competition is reputed to allow the *obtention of information that "uncovers: the desirable features of a fiscal system*.

Fiscal competition is not always a positive sum game. The circumstances in which its **consequences are negative** are neither few, nor infrequent. Succinctly presented, they are related to:

- a) the production of a suboptimal level of public goods: as fiscal competition intensifies, it becomes more difficult to tax at levels covering the marginal cost of supplying public goods;

It is however true that this hypothesis is contradicted by a study by Tanzi and Schuknecht (2000), according to which there are no indications that countries with a smaller ratio of budget revenues to GDP "record weaker social indicators" than the countries with larger budgets relative to GDP: "most of what governments wish to achieve can be done with levels of expenditure equivalent to 25-35% of GDP".²⁹ Moreover, statistical data lend no support to the assertion of a reduction, liable to limit the ability to supply public goods, of budgetary receipts within the EU, even for the kinds of taxes which are influenced by fiscal competition most: the corporate income taxes. Finally, it is not at all obvious that a possible reduction of budget revenues should automatically lead to an under-supply of

²⁷ Richard Teather: *The Benefits of Tax Competition*, The Institute of Economic Affairs, 2005; p.46

²⁸ Daniel J. Mitchell: *The Economics of Tax Competition: Harmonization vs. Liberalization*, Heritage Foundation, 2004

²⁹ Stefano Micossi, Paolo Parascandolo: *Efficient taxation of multinational enterprises in the European Union*, BEEP Briefing no.5, April 2003

public goods. It is more likely that, in such a situation, governments would react by compressing budgetary transfers.

- b) a general erosion of budget revenues, leading, *inter alia*, to the hampering of the efforts towards reducing budget deficits, a particularly delicate issue in the UE, against the background of the limits set by the Stability and Growth Pact.

This effect is supposed to arise as a result of several causes:

- reduction of the receipts from the taxes on mobile tax bases, further to the reduction of the tax rates;
- the flow of mobile production factors from high-tax countries to low-tax ones, resulting in a narrowing of the tax bases in those countries which apply higher rates of taxation;
- the relocation of mobile production factors may negatively impact on the remuneration of the immobile factors, leading to an additional erosion of the tax bases.³⁰

As it will be shown below, this phenomenon has seldom manifested itself until now, with the exception of a handful of small countries which engaged an aggressive fiscal competition, with a view to attract investments of large dimensions relative to their own economic dimension. Moreover, even if confirmed in practice, the reduction of budget revenues would only be a negative byproduct of fiscal competition if the dimension of public budgets was optimal before their possible reduction. According to a study, were governments to operate with a maximum of efficiency, fiscal competition would not cut taxes on capital by more than 3%. Hence, as taxes on capital amount in the EU to about 20% of GDP, the probable revenue reduction due to fiscal competition would not exceed 0,5% of GDP. In other words, even if governments were perfectly efficient, fiscal competition would not manage to reduce budget receipts by over 0,5% of GDP. If, however, the government's inefficiency leads to a situation whereby the level of budget revenues is over 0,5% of GDP above the optimal level, fiscal competition will exert beneficial effects!³¹

- c) transferring the fiscal burden onto less mobile tax bases, with negative social effects.

The budget revenue losses associated to the reduction of the fiscal burden on mobile production factors could be, theoretically, compensated by increases of indirect taxes, but these are already at high levels, *inter alia*, due to the several decades of harmonization efforts already carried out at EU levels. This constraint imposes a different setting for direct taxes, in the sense that less mobile bases come to be taxed slightly more than the mobile ones. As shown in a 1996 Commission report, the rates of taxation for capital and the self-employed have gone down by a tenth, while the rates of taxation for salaried work have risen by one fifth.³² On the other hand, budget receipts from personal income

³⁰ Katrin Rabitsch: *Eastern European Integration and Tax Competition*, Wirtschafts Universität Wien, Discussion Paper nr.26, September 2007; p.11

³¹ Richard Teather: *The Benefits of Tax Competition*, The Institute of Economic Affairs, 2005; p.61

³² William Bratton, Joseph McCahery: *Tax coordination and tax competition in the European Union: evaluating the Code of Conduct on Business Taxation*, Common Market Law Review 38:2001; p.684

taxes have remained virtually static as proportion of GDP since over 20 years: they used to represent 11% of GDP in 1980 and 10,8% in 2002.³³

Inequitable consequences also arise because of the effect exerted on personal income taxation by the reduction of corporate tax rates. This occurs because, if the corporate tax is lower than the personal one, there is an incentive for individuals to register themselves under a corporate form in order to take advantages of lower tax rates. In an attempt to avert this perverse effect, many countries aim at aligning the marginal personal income tax rate to that of the corporate income tax, resulting in the reduction of the progressivity of personal taxes and, hence, of the redistributive capacity of the entire fiscal system.³⁴

Also, as the structure of the public goods supplied changes in the direction of those mostly appreciated by the more mobile taxpayers, social fractures may emerge as a result of the segregation of citizens, or perverse situations may develop, such as the “exploiting” generous social services in a country, without contributing through taxes to their support (the so-called “socio-fiscal nomadism”, of the taxpayers who change residence over the course of their lifetime in accordance with the costs and benefits offered by each national system in different stages of life.

Because fear of capital flows driven by fiscally more attractive destinations seems to have been at the origin of the reticence shown by many European countries to the idea of rebalancing their taxes from labor contributions to capital levies, the containment of fiscal competition may have as a collateral effect the operation of this readjustment, with the consequence of stimulating employment. This effect does not appear to be overly significant, however: the simulation of a 10 percentage points increase of the effective tax rate on capital income in EU-15 and of a reduction of labor taxes so as to keep the public revenues constant shows that the resulting drop in the unemployment rate is a mere 0,6 percentage points.³⁵

In this respect, one may object by stating that the authorities ought to answer to fiscal competition by reducing taxes, not by transferring them onto other tax bases. In fact, this idea presupposes that governments avoid visibly taxing the mass of electors, rather than doing it indirectly (through corporate income taxes) and/or taxing wealth *per se*.³⁶ And, if it is true that fiscal competition hampers redistribution, this is a desirable thing after all, because redistribution has reached already a high level.

d) influencing the decisions concerning the location of investments (distorting resource allocation: these are diverted from the most efficient uses);

A strong and suggestive analogy for this situation is the theft of jewellery, in view of melting them and re-using the precious metals out of which they had been made.

³³ Alfred Boss: *Tax Competition and Tax Revenues*, Intereconomics, January/February 2006; p.47

³⁴ Thomas Rixen, Susanne Uhl: *Europeanising Company Taxation - Regaining National Tax Policy Autonomy*, Friedrich Ebert Stiftung, International Policy Analysis, July 2007; p.9

³⁵ Peter Birch Sorensen: *Tax coordination in the European Union: What are the issues?*, Swedish Economic Policy Review, 8:2001; p.184

³⁶ Richard Teather: *Harmful Tax Competition?*, IEA, Economic Affairs, 22:4, December 2002

This effect of fiscal competition has sometimes been contested on grounds that the choice of the location for an investment is dependent to a larger extent on other factors than the fiscal regime (e.g., proximity to consumers; cheap and adequately skilled labour force; infrastructure; favourable regulatory framework etc). However, when no substantial differences exist between host countries from the point of view of other elements, the fiscal regime comes to play an important part, something highlighted by several studies which found a statistically significant link between the taxation level and foreign direct investments. Recent estimates (2000 and 2003) for the UE have reached remarkably similar results as concerns the effect of tax rates on foreign investments: the reduction by one percentage point of the tax rate in the host country triggers an increase of investments into that country of 4.3% or 3.7%, respectively.³⁷ The tax system also influences investment decisions indirectly, through the impact exercised by other of its parameters on the investment climate: ambiguities of fiscal regulations, multiplicity of tax rates, frequent and unexpected changes of rules etc.

Recent studies have also highlighted another important characteristic of the connexion between the tax regime and foreign direct investments. It has thus been shown that taxation in the host country has a limited impact on investment decisions linked to “horizontal” investments (those aiming at accessing the host country’s domestic market), because in this case the opportunity cost is that of direct exports and no locational alternatives exist. When, however, the investment is of the “vertical” type, being just a link of an international (global) production chain, there are many location options and the final product competes with those of other producers. In this case, the minimization of production costs is more important, so that the level of taxes in the different possible locations plays a more important part.³⁸

Finally, another important characteristic of the relation between foreign direct investments and the variation of tax rates is its non-linearity. Concretely, investments seem to react only to large reductions of the tax rates, which can be explained in two ways. Even if the EU is a well integrated economic area, there are still significant transaction costs associated to the cross-border capital flows (especially of the direct investment type), so that an “arbitration tunnel” appears, in the sense that companies will relocate their activities only if the changes of tax rates are sufficiently large as to leave this tunnel. Secondly, small tax reductions may prove insufficient to compensate the avoidance of taxes effected thanks to fiscal planning methods already tested in fiscal jurisdictions whose rules have become very familiar to corporate taxpayers.³⁹

There are views according to which there is no valid reason to treat the fiscal regime differently from the other defining elements for the attractiveness of a certain potential investment location. Since taxes represent the source for financing the public goods supplied to citizens, goods which can be regarded as an indirect form of remuneration, an

³⁷ apud Wolfgang Eggert, Andreas Haufler: *Company tax coordination cum tax rate competition in the European Union*, University of Munich, Discussion Paper 2006-11, March 2006, p.6; și Sijbren Cnossen: *Tax policy in the European Union. A review of issues and options*, 2002; p.62

³⁸ Amina Lahrèche-Révil: *Who’s afraid of tax competition? Harmless tax competition from the New European Member States*, CEPIL, Working Paper no.2006-11, June 2006; p.12

³⁹ Amina Lahrèche-Révil: *Who’s afraid of tax competition? Harmless tax competition from the New European Member States*, CEPIL, Working Paper no.2006-11, June 2006; p.33

investment decision informed by them is equivalent to a decision made in accordance with the labour costs in one country or another.⁴⁰

- e) Inducing strategic interactions between fiscal authorities of the “prisoner’s dilemma” type, resulting in the setting of lower tax rate levels (*race to the bottom*).

The existence of this phenomenon is empirically documented. A study dealing with the EU concludes that a rise by 10 percentage points of the tax rates in neighbouring countries leads to an increase by 8 percentage points in the tax rate of a European country.⁴¹ The manifestation of this phenomenon is greatly facilitated by the emergence, in the contemporary world, of the possibility to dissociate the advantages (infrastructure, education) from the inconvenients (the contribution to public revenues) offered by a fiscal jurisdiction, a situation that can be designated as *free riding*.

It is practically impossible to determine which of the presumed effects of fiscal competition are more likely to manifest themselves, because this depends on a large variety of factors which the literature has gradually identified and highlighted:

- the availability of alternative mechanisms that could substitute taxation as investment attraction tool;
- the asymmetries among countries from the point of view of their dimensions and resource endowments;
- the concentration of production in certain geographic areas (the „agglomeration” featuring in the „core-periphery” model);
- the existence of economies of scale in the supply of public goods and services;
- the offering by the public sector of inputs which reduce private production costs;
- the degree of mobility of production factors;
- the existence (or not) of a home market bias;
- the possibility of cross-border compensation of fiscal losses;

There are several considerations, based on the particular features of the EU, which are minimizing, in its specific case, the risk of negative consequences such as the under-provision of public goods or the “race to the bottom”:⁴²

- the existence of a “core-periphery” pattern within the EU, confirmed by the high importance of structural funds within the Community budget, allows the countries

⁴⁰ Richard Teather: *The Benefits of Tax Competition*, The Institute of Economic Affairs, London, 2005; p.87

⁴¹ Ruud de Mooij: *A Minimum Corporate Tax Rate in the EU Combines the Best of Two Worlds*, Intereconomics, July/August 2004

⁴² Gaëtan Nicodème: *Corporate tax competition and coordination in the European Union? What do we know? Where do we stand?*, European Commission, DG ECFIN Economic Paper no.250, June 2006; p.11

favoured from this point of view to continue to apply higher tax rates without incurring significant risks of losing investments;

- the large Member States, which tend to have higher tax rates, can afford to take advantage of economies of scale in the supply of public goods, which mitigates the risk of their possible under-provision;
- in the same direction points also the existence of a still important home market bias shown by investments.

It is however likely that, at the level of the European Union, the growing preoccupation of Member States for the issues of fiscal competition is not indicative so much of the internalization of the essentially theoretical considerations mentioned above, but rather of the perception of a clearer definition of the “winners” and “losers”. To the former category belong, with little doubt, countries such as Ireland, Estonia, UK and Austria, whereas France, Italy and, to a lesser extent, Germany see themselves as losing out.⁴³

The empirical verification of the existence of fiscal competition is difficult, but in literature several methods have already been tried:

- a) identifying the phenomenon in an indirect way, by analyzing the response of investments to fiscal incentives;
- b) estimating the correlation between the evolution of tax rates applied in different jurisdiction;
- c) analyzing the evolution of tax rates.

⁴³ Ulrike Kraemer, Claudio Radaelli: *The Coordination of Direct Tax Policy in the European Union: Actors and Modes of Governance*, p.8

IV. Trends of direct taxation of corporations in the EU

The evolution of corporate income tax rates offers a good possibility to check whether some of the above-mentioned effects of fiscal competition do manifest themselves in the real life. In these matters, several notions are being used:

i) **the nominal (legal) rate;**

This does not provide information on the fiscal burden actually supported by a company because it cannot take into account the various ways in which the tax base can be determined. However, nominal rates seem to exert an important psychological effect because they are perceived by international investors as signals characterizing the general fiscal environment of a country.⁴⁴

ii) **the effective rate ;**

The economic effects of taxation do not depend only on the nominal rates, but also of all other elements determining the fiscal burden exerted on a company, i.e, the various provisions concerning the definition of the tax base: deductibility of expenses, fiscal credits, the fiscal treatment of non-distributed profits etc. It is perfectly possible that a high nominal rate translates itself in a low effective rate if the real value of income, consumption or wealth is higher than the value subjected to taxation.

The most important effects of taxation on investment decisions are determined by the *effective marginal tax rate (EMTR)*, which represents the rate of tax on a marginal investment whose return is equal to the interest rate earned on savings, after taking into account the fiscal allowances for depreciation, the inflation rate and the imputation systems.

On the other hand, the effects of taxation on public revenues and their redistributive functions are captured by the *effective average tax rate (EATR)*, defined as the ratio of the aggregate tax levied on a certain activity and the total level of the (economically real) revenue produced by the said activity (or, in the case of indirect taxes, of consumption).

The investment decisions are influenced by both effective tax rates mentioned above, but in different ways. While effective average rates affect the decision concerning the chosen location of an investment, the size of that investment is affected to a greater extent by the effective marginal rate.⁴⁵

Because fiscal regulations may differ from one sector of activity to another, their effects vary according to the types of assets utilized and the financing sources. Also, the existence of non-linear tax systems implies the variation of tax rates in accordance with the profit rates obtained. As a result, in theory there is an infinity of effective tax rates.⁴⁶

iii) **the implicit (apparent) tax rate :**

⁴⁴ Margit Schratzenschaller: *Company Tax Co-ordination in an Enlarged EU*, Austrian Institute of Economic Research (WIFO), May 2005; p.12

⁴⁵ Michael P. Devereux: *Taxes in the EU New Member States and the Location of Capital and Profit*, Oxford University Centre for Business Taxation, WP 07/03, January 2006; p.5

⁴⁶ Rachel Griffith, Alexander Klemm: *What has been the Tax Competition Experience of the Last 20 Years?*, The Institute for Fiscal Studies, WP 04/05, February 2004; p.12

This indicator is determined either at the macroeconomic level (as a ratio of taxes collected to GDP) or at a microeconomic level (as a ratio of the taxes paid to gross profits). The indicator is confronted with serious problems which affect its relevance. On the one hand, if determined at the macroeconomic level, it is strongly influenced by the level and dynamic of GDP, as well by the structure of the enterprise sector (namely, the weight of companies in this sector), hence the limitations of its capacity to facilitate international and inter-temporal comparisons. On the other hand, at the microeconomic level, its dimension depends on that of gross profits, which are difficult to compare across fiscal jurisdictions because of different accounting standards (particularly as concerns reserves, off-balance elements etc).⁴⁷

Having said this, the implicit tax rate is the only indicator which can capture the effects of a parameter of the fiscal system, other than the tax rate and the tax base: the way taxes are administered. Indeed, aspects such as the honesty of taxpayers, the intensity of fiscal controls or the periods for the actual payment of tax obligations may differ a lot, over time and from a fiscal jurisdiction to another.

Depending on the complexity of the operations subject to taxation, the effective tax rate may be closer or lesser correlated with the nominal rate. As a general rule, the difference between the two is greater in the case of direct investments than in that of portfolio investments. This explains why some countries have both low nominal tax rates (so as to induce the recording of profits in their own jurisdictions) and high effective tax rates (in order to have as large a tax base as possible). However, the differences among EU Member States from the standpoint of effective rates are primarily due to the differences among their nominal rates and only to a lesser extent to differences as concerns the elements defining the tax base.

Over the last 25 years, there were important reductions of **nominal tax rates** on corporate income in the EU, and this trend seems to have accelerated in the last years. Thus, in 2007, no less than five Member States implemented further reductions of their tax rates: Greece, Holland, Spain, Bulgaria and Slovakia.⁴⁸ Between 1982-2001, the average nominal tax rate has gone down significantly, from 48% to only 33%. Generally speaking, the reductions carried out by the small countries were larger than those implemented by the large countries of the Union. The nominal corporate income tax rates have started to decrease significantly over the last years also in the newly-acceded members of the EU. The average tax rate in the 12 New Member States was of 21.5% in 2003, declining to 17.8% in 2006. In the old Member States, the average tax rate went down from 30.1% in 2003 to 27.7% in 2006, this latter level representing less than two thirds of the level in place at the beginning of the 1980s.

Although the temptation exists to attribute this reduction of nominal tax rates, which is common to other extra-European developed countries as well, to fiscal competition, one

⁴⁷ Dirk Göppfarth: *The Effect of Tax Harmonisation on Effective Tax Rates in the European Union*, June 2001; p.2

⁴⁸ Thomas Rixen, Susanne Uhl: *Europeanising Company Taxation - Regaining National Tax Policy Autonomy*, Friedrich Ebert Stiftung, International Policy Analysis, July 2007; p.7

should not disregard the fact that other determinants may have played (at least as important) a part. This is the case, first, of ideological preferences, the importance of which can be highlighted by the almost systematic coincidence of the important episodes of capital tax rates reductions with the tenure in government of parties belonging to the right of the political spectrum. The same „key” may explain the very significant reductions of corporate income tax rates operated in the East European countries, reductions which went in tandem with an economic transition process entailing a diminished state intervention and a reduction of the size of the public sector of the economy.⁴⁹

Secondly, one should consider that the reaction of a state to the tax reductions operated by other countries may be indicative not only of actual tax competition, but of a mimetic behaviour, determined by the preferences of one’s own citizens, who compare the tax rates in their jurisdictions with those applied in other states.⁵⁰ Finally, correlated evolutions as concerns the rates and rules of taxation applied in different countries may also reflect the existence of common intellectual trends, usually triggered by “discoveries” of particular solutions to difficult taxation problems (the introduction of VAT or the proliferation of certain kinds of fiscal incentives originally used only by some countries are good such examples).⁵¹

Over the last decades of the past century, a reduction of the dispersion of nominal tax rates applied by the member countries of EU-15 has also taken place: standard deviation declined from 3.4 to 2.0 between 1990-97. Dispersion has been again on the rise, in the 2000s. Moreover, as the New Member States tend to have profit tax rates significantly lower than those of the old Member States, dispersion within EU-27 is still greater. Moreover, the trend that has manifested itself over the last decade is of widening discrepancies between the tax rates applied by the old and new member states, respectively, even against the background of falling rates in both groups of countries. It is also notable that, should one take into account also the local taxes levied on companies (which are significant in countries such as Germany, Italy, Luxembourg and Portugal), the dispersion of nominal tax rates grows even further.

Legal corporate income tax rates (excluding local taxes) -% -

	1980	1990	1995	1998	2001	2004	2007
Austria	55	39	34	34	34	34	25
Belgium	48	41	39	39	39	34	34
Denmark	40	40	34	34	30	30	28
Finland	59	41	25	28	29	29	26
France	50	37	36,7	41,6	36,4	35,4	34,4
Germany	56	50/36	45/30	45/25	25	25,0	25,0

⁴⁹ Amina Lahrèche-Révil: *Who’s afraid of tax competition? Harmless tax competition from the New European Member States*, CEPII, Working Paper no.2006-11, June 2006; p.11

⁵⁰ Gaëtan Nicodème: *Corporate tax competition and coordination in the European Union? What do we know? Where do we stand?*, European Commission, DG ECFIN Economic Paper no.250, June 2006; p16

⁵¹ Rachel Griffith, Alexander Klemm: *What has been the Tax Competition Experience of the Last 20 Years?*, The Institute for Fiscal Studies, WP 04/05, February 2004; p.26

Greece	43	46	40	40	37,5	35	25
Ireland	45	43	40	32	20	12,5	12,5
Italy	36	36	36	37	36	34	34
Luxembourg	40	33	33	30	30	30,4	29,6
UK	52	34	33	31	30	30	30
Holland	48	35	35	35	35	34,5	25,5
Portugal	42/47	36,5	39,6	337,4	35,2	27,5	26,5
Spain	35	35	35	35	35	35	32,5
Sweden	52	40	28	28	28	28	28
Average UE-15 (non-weighted)	45	40,4	38,0	34,9	32	31,6	26,9
Bulgaria			40	37	28	23,5	10
Cyprus		42,5	25	25	28	15	10
Czechia			41	35	31	28	24
Estonia			26*	26*	26*	26*	22*
Latvia			25	25	25	15	15
Lithuania		35	29	29	24	15	18
Malta		32,5	35		35	35	35
Poland		40	40	36	28	19	19
Romania		38	38	38	25	25	16
Slovakia			40	40	29	19	19
Slovenia			25	25	25	25	23
Hungary		50	19,6	19,6	19,6	17,6	18,6
Average New Member States			30,6		24,8	21,5	16,8

* no taxation of reinvested profits

Sources: - Michele Debonneuil, Michel Fontagne: *Fiscalite et Marche Unique*, Rapport du Conseil d'Analyse Economique no.40, Paris, 2003;

- Margit Schratzenstaller: *Company Tax Co-ordination in an Enlarged EU*, Austrian Institute of Economic Research, May 2005; p.13

- Wolfgang Eggert, Andreas Haufler: *Company tax coordination cum tax rate competition in the European Union*, University of Munich, Discussion Paper 2006-11, March 2006; p.4

- Gaëtan Nicodème: *Corporate tax competition and coordination in the European Union? What do we know? Where do we stand?*, European Commission, DG ECFIN Economic Paper no.250, June 2006; p.15

- Katrin Rabitsch: *Eastern European Integration and Tax Competition*, Wirtschafts Universität Wien, Discussion Paper nr.26, September 2007; p.18

On the other hand, the *effective average tax rate* in various member countries of the EU was less mobile: it has registered a certain reduction over the 1980s, but has stabilized starting with the second half of the 1990s. The dispersion of the effective average tax rates was very significant at the beginning of the interval, narrowing significantly subsequently. In 2001, it was only slightly more pronounced than the dispersion of nominal tax rates, suggesting a high correlation between the two types of rates, which the Pearson coefficient of 0.92 confirms also empirically.⁵² In fact, according to the European Commission, about three quarters of the differences among Member States from the standpoint of effective average tax rates are owed to the differences between their nominal tax rates.

The accession of the New Member States does not alter the picture as much as it does with respect to the nominal rates, because these countries do not display very low effective average rates. It is true, however, that the estimates made for the new members do not take into account the various fiscal incentive schemes applied selectively in these countries. Such is the case of measures as: the 10-year tax break for newly-established companies in Czech Rep. and Slovakia; the fiscal credit of 35-50% of the investment's value granted in Hungary for the first 5 years of activity; the tax reductions or exemptions on the income of companies established in the "special economic zones" of Latvia and Lithuania; the accelerated depreciation allowed in Poland for certain categories of newly-acquired assets.⁵³ Had the effects of these incentives been taken into the analysis, the effective average tax rate would be almost halved in some cases (Latvia, Lithuania, Poland, Slovakia)! Because most of these schemes are incompatible with the State aids *acquis*, they have been dismantled on the accession of these countries to the European Union.⁵⁴

Effective average tax rates (%)

	1982	2001	2004	2005
Austria	50,0	27,9	31,4	23,1
Belgium	39,0	34,5	29,7	29,7
Denmark		27,3	27,0	25,2
Finland	53,0	26,6	27,3	24,6
France	41,0	34,7	33,1	34,8
Germany	56,0	34,9	36,1	
Greece	39,0	28,0	27,0	36,0
Ireland	6,0	10,5	14,4	14,7
Italy	30,0	27,6	32,8	32,0

⁵² Sijbren Cnossen: *Tax policy in the European Union. A review of issues and options*, 2002; p.60

⁵³ xxx: *Company Taxation in the New EU Member States. Survey of the Tax Regimes and Effective Tax Burdens for Multinational Investors*, Ernst&Young and ZEW, 2005; p.32

⁵⁴ Michael P. Devereux: *Taxes in the EU New Member States and the Location of Capital and Profit*, Oxford University Centre for Business Taxation, WP 07/03, January 2006; p.9

Luxembourg		32,2	26,7	26,7
UK	36,0	28,3	28,9	28,9
Netherlands	43,0	31,0	31,2	28,5
Portugal	52,0	30,7	28,0	
Spain	29,0	31,0	32,0	36,1
Sweden	54,0	22,9	23,4	24,8
UE average	40,6	28,5	28,5	
Cyprus			16,7	
Czechia			24,6	22,9
Estonia			31,9	
Latvia			23,4	
Lithuania			15,4	
Malta			34,7	
Poland			29,8	
Slovakia			27,4	16,7
Slovenia			33,4	
Hungary			24,9	17,9
NMS average			26,2	

Sources: Margit Schratzenschaller: *Company Tax Co-ordination in an Enlarged EU*, Austrian Institute of Economic Research (WIFO), May 2005; p.17-18; Wolfgang Eggert, Andreas Haufler: *Company tax coordination cum tax rate competition in the European Union*, University of Munich, Discussion Paper 2006-11, March 2006; p.4;

According to various studies, the *effective marginal tax rates* have been much more stable over time than the effective average tax rates, which is explainable in view of the process of widening tax bases in parallel with the reduction of tax rates. If the same trend has not been replicated by the effective average tax rates, which – as seen in the above table – have declined considerably, the explanation has to be found in the increased profitability of investments. Since the more profitable capital tends to be also the more mobile capital, the above-mentioned evolution may also be read as indication of intensified competition for attracting mobile capital, particularly that of multinational corporations.⁵⁵

Effective marginal tax rates on corporate income, 2000

Austria	46,3%	Italy	44,5%
Belgium	17,2%	Luxembourg	51,7%
Denmark	66,3%	UK	48,7%
Finland	25,0%	Netherlands	69,3%

⁵⁵ Rachel Griffith, Alexander Klemm: *What has been the Tax Competition Experience of the Last 20 Years?*, The Institute for Fiscal Studies, WP 04/05, February 2004; p.28

France	36,5%	Portugal	28,4%
Germany	55,9%	Spain	57,3%
Greece	37,2%	Sweden	29,7%
Ireland	47,1%		

Source: Dirk Gopffarth: *The Effect of Tax Harmonisation on Effective Tax Rates in the European Union*, June 2001; p.5

The most frequently used ***implicit tax rate*** is the ratio of revenues derived from corporate income taxes to GDP. This fiscal burden indicator has been remarkably constant over a period nevertheless characterized by important reductions of the tax rates. It is true that, over time, some fluctuations appear, but they reflect evolutions deriving from the phases of the economic cycle. Another conclusion is that, generally speaking, the countries with small-sized economies have increased their revenues from corporate income taxes, including in relative terms, more than the large countries have managed. Finally, there is no indication of the existence of a trend towards convergent fiscal burdens imposed by this type of tax in the EU. The most significant modifications of the level of the indicator considered have taken place in the countries boasting the smallest fiscal burdens (and these variations have occurred both ways), which means that the preferences of countries more inclined towards a stronger redistribution through the budget lever have not been frustrated.

There are two important reasons why the reductions of tax rates have not engendered losses of budget revenues. To some extent, there was the effect of larger tax bases as a result of stimulating the economic activity through reduced fiscal pressure, effect captured by the famous “Laffer curve”. The relative stability of corporate income tax revenues, despite very significant tax rate reductions, is also due to the fact that, in parallel, many countries have introduced measures extending the legal tax bases. In the case of the EU, this seems to be also a consequence of the initiatives taken at Community level for combating harmful tax competition.⁵⁶ This suggests the existence of a strong interest for attracting highly profitable investments, as tend to be those affected by the multinational corporations. In order to reach this goal, tax rates have been reduced, and in order to limit the costs in terms of lost budget receipts, many fiscal deductions have been cancelled. Because the importance of fiscal deductions diminishes as the size of profits increases, such a combination of measures favours multinational corporations.⁵⁷

The widening of tax bases by reducing the opportunities for tax deductions may have inequitable consequences against the background of the internationalization of production and the free cross-border movement of capital. The companies with an essentially domestic activity, generally SMEs, are subject to a higher fiscal burden, while multinationals have access to numerous tax arbitrage instruments which allows them to restructure their national tax bases (on paper, not through physical movements of assets),

⁵⁶ xxx: *Taxation trends in the European Union. Main results*, 2007 edition, p.15

⁵⁷ Rachel Griffith, Alexander Klemm: *What has been the Tax Competition Experience of the Last 20 Years?*, The Institute for Fiscal Studies, WP 04/05, February 2004; p.14

so as to maximize the size of the bases located in the jurisdictions with the lowest tax rates.⁵⁸

On the other hand, the revenues from corporate income taxes do not depend only on the legal fiscal parameters (tax rates and bases), but also on the intrinsic evolution of the variable subject to taxation. The profitability of companies goes on a par with the economic cycle and may explain the variation of the indicator under consideration. However, a recent study was concluding that the effect of economic cycle factors on the budget receipts from corporate income taxes in the EU has been relatively unimportant over the period 1990-2003.⁵⁹

There are, finally, also more “technical” explanations for the variations displayed by the indicator under consideration, such being the case of the changes in the “corporatization ratio” of the economy. Thus, an increase of revenues may simply reflect a larger proportion of the enterprise sector, insofar as reductions of the corporate income taxes have stimulated the organization as corporations of economic activities previously carried out under other forms.

The analysis of the existing data should take into account the fact that this indicator is an *ex post* one, hence its level in a particular year may be conditioned by past events, the residual effects of which are still being felt. Such is, for instance, the case of grandfather provisions (allowing, for instance, an investment to benefit of the fiscal regime in force as of the moment when it was effected, even if this was amended subsequently) or that of the possibility to carry forward, into subsequent year, fiscal losses.

Receipts from corporate income taxes (% of GDP)

	1980	1990	1995	2000	2003	2005
Austria	1,4	1,4	1,5	2,0	2,0	5,4
Belgium	2,2	2,4	2,8	3,6	3,4	4,0
Denmark	1,4	1,5	2,0	2,4	2,8	3,6
Finland	1,2	2,0	2,3	6,0	3,5	3,4
France	2,1	2,3	2,1	3,1	2,6	2,8
Germany	2,0	1,7	1,1	1,8	1,3	1,8
Greece	0,9	1,6	2,0	4,6		
Ireland	1,4	1,7	2,8	3,8	3,9	3,4
Italy	2,4	3,9	3,6	2,9	2,8	2,8
Luxembourg	6,6	6,5	7,5	7,2	7,9	5,5
UK	2,9	3,6	2,8	3,6	2,8	3,4
Netherlands	2,9	3,2	3,1	4,2	3,0	3,9

⁵⁸ Thomas Rixen, Susanne Uhl: *Europeanising Company Taxation - Regaining National Tax Policy Autonomy*, Friedrich Ebert Stiftung, International Policy Analysis, July 2007; p.8

⁵⁹ Alfred Boss: *Tax Competition and Tax Revenues*, Intereconomics, January/February 2006; p.45

Portugal		2,3	2,5	4,1		
Spain	1,2	2,9	1,8	3,0	3,1	3,9
Sweden	1,2	1,7	2,8	4,0	2,0	3,7
EU-15 average	2,1	2,6	2,7	3,8		
Czechia			4,9	3,8	4,8	4,6
Poland			2,8	2,5		
Slovakia				2,8		2,4
Hungary			1,9	2,2		2,1

Source: Alfred Boss: *Tax Competition and Tax Revenues*, Intereconomics, January/February 2006; p.45

- Frank Zipfel: *One Europe, one tax? Plans for a Common Consolidated Corporate Tax Base*, Deutsche Bank Research, EU Monitor 49, 25 September 2007; p.4

Another indicator relevant for analyzing the trends of corporate income taxes is the *weight of receipts derived from this type of taxes in the aggregate budget revenues*. The general trend of this indicator was declining as from 1965, but on a very gentle “slope” starting with the end-1980s. This suggests that, although Member States were able to keep constant the corporate income tax revenues as a proportion to GDP, they did not manage to make them go up to the same extent as other types of taxes did. In the 1990s, the trend was of a slight increase, followed by another mild descending trend over the course of the current decade. In the EU-15, the level reached by this indicator was of 2.7% in 1995, growing to a “peak” of 3.7% in 2000, before descending again, to 3.1% in 2003.⁶⁰ As concerns the New Member States, the variations had opposite signs: a decline in the latter half of the 1990s, followed by increases in the 2000s to date. Generally speaking, the New Member States are more dependent, when feeding their budgets with revenues, on receipts from this type of taxes than are the EU-15 countries.

There are wide discrepancies among the EU Member States as concerns the contribution of corporate income tax receipts to budget revenues. In 2002, these taxes contributed by only 1.5% to Germany’s federal budget, but with 20.5% to the Irish budget. It is only normal that such differences get reflected in the divergent priorities perceived by the Member States in connection with the opportuneness of harmonising this category of tax at the level of the Community. Paradoxically, however, at least in the extreme cases mentioned above the preference for harmonization is not the one that was to be expected: Germany is at the forefront of Member States supporting initiatives aiming at harmonising the tax rates, while Ireland counts among the most vocal opponents to such proposals.

Receipts from corporate income taxes (% of budget revenues)

	2002	2005
Austria	6,9	5,4
Belgium	6,7	8,9
Denmark	5,8	7,3

⁶⁰ Michael P. Devereux: *Taxes in the EU New Member States and the Location of Capital and Profit*, Oxford University Centre for Business Taxation, WP 07/03, January 2006; p.11

Finland	9,3	7,6
France	5,9	6,3
Germany	1,5	5,2
Greece	10,4	
Ireland	13,0	11,3
Italy	6,3	6,9
Luxembourg	20,5	14,6
UK	7,6	9,3
Netherlands	9,4	9,8
Portugal	10,3	
Spain	9,5	10,8
Sweden	5,1	7,3
Cyprus	15,4	
Czechia	12,4	12,0
Estonia	3,8	
Latvia	6,9	
Lithuania	2,1	
Malta	13,1	
Poland	4,9	
Slovakia	8,3	8,3
Slovenia	3,4	
Hungary	6,1	5,8

Sources: Wolfgang Eggert, Andreas Haufler: *Company tax coordination cum tax rate competition in the European Union*, Munich Economics, Discussion Paper 2006-11, March 2006; Frank Zipfel: *One Europe, one tax? Plans for a Common Consolidated Corporate Tax Base*, Deutsche Bank Research, EU Monitor 49, 25 September 2007

Summing up, the hypothesis of a tax competition generating a downwards alignment of the level of taxation is only in part validated empirically, that is, for nominal rates only, and practically not at all for the effective rates. Also, its impact on budget revenues can not be discerned at all.

Having said this, there are views according to which the robustness of budgetary receipts derived from corporate income taxes cannot be expected to last indefinitely. This is because the room left for further tax rate cuts is still vast, while the reserves for additional extensions of the tax bases have largely been exhausted and the profitability of companies cannot go on improving forever.

V. Fiscal harmonisation

To the extent that national tax systems and/or the interaction among them have „negative externalities”, some form of co-ordination among them is unavoidable. According to David Wildasin, tax competition itself is a form, albeit implicit, of co-ordination.⁶¹ Being the market-based form of co-ordination, it has the same limitations as market mechanisms have. Relevant for the case of the European Union are those market failure situations caused by externalities, which require regulatory interventions in order to be internalised. And, as shown in literature, the deepening of European economic integration generates increased fiscal externalities because of the intensification of the cross-border movement of products and production factors.⁶²

Because, under such circumstances, a spontaneous co-ordination can never be optimal, the need arises for more elaborated ways, which can be grouped into two categories:

- the «co-ordination by delegation», consisting of putting in place new structures, endowed with taxing prerogatives, or at least competences to regulate the modalities of taxation, over the entire spectre of countries whose taxation policies are to be co-ordinated. The EU fits the description of such a structure. Even if still at an embryonary stage in many taxation matters, it already exercises fully the above-mentioned function with respect to at least one taxing instrument: the customs duties;
- the «co-ordination through explicit agreement», manifested in joint actions agreed among governments.

The functioning of different national fiscal systems is at the origin of numerous problems:

- the distortioning of resource allocation, with negative consequences for capitalizing on the advantages of a truly single internal market, but also from the standpoint of the international distribution of tax revenues, which may put some Member States at a disadvantage relative to others;
- the fragilisation of budget revenues, through revenue losses associated to tax competition;
- the limitation of fiscal sovereignty,
- the trend towards inequity of fiscal systems, as a result of a privileged treatment of mobile tax bases;
- the risk of double taxation;
- the “de-responsibilisation” of political decision-makers: if “over-taxation” is regarded as a “regulatory failure”, then the *first best* solution consists of correcting the way this regulation is done, not “by default”, through fiscal competition.

⁶¹ David E. Wildasin: *Tax Coordination: The Importance of Institutions*, Martin School of Public Policy, University of Kentucky, march 2002, p.4

⁶² William Bratton, Joseph McCahery: *Tax coordination and tax competition in the European Union: evaluating the Code of Conduct on Business Taxation*, Common Market Law Review 38:2001; p.696

It is, therefore, necessary to find solutions, which can be generically subsumed to the concept of “tax (fiscal) harmonisation”. As long as a uniform terminology has not (yet?) been crystallized, fiscal harmonisation is a general denomination designating a *continuum* of situations, going from the “fiscal unification (or equalisation)” of tax rates and bases, as well as of the procedures for tax collection all the way to the mere “fiscal co-ordination”, which entails the concerted co-existence of the fiscal regimes of different states in those cases where there are grounds for conflict or a joint action is required, so that the fiscal systems pursue the same goals and the national fiscal authorities co-operate in order to avoid the occurrence of “negative externalities”. According to some opinions, none of these extremes is appropriate for the economic integration stage reached in the EU. “Fiscal unification” has neither legal basis (given not only the strictly circumscribed provisions of the EC Treaty in fiscal matters, but also the principle of subsidiarity), nor economic rationality (absent the unification of economic policies at the level of the Community). On the other hand, the simple “fiscal co-ordination” corresponds to a level of economic and political integration far less advanced than the one reached so far in the Ue and is incapable to ensure the desideratum of fiscal neutrality.⁶³

“Fiscal harmonisation”, in the most widely accepted meaning of this term, is located somewhere in between the two extremes mentioned above and would presuppose the putting in agreement of national fiscal systems, giving way to a coherent and orderly “whole”, whose constitutive elements are not identical however. From a strictly theoretical point of view, the appropriate “dose” of fiscal harmonisation is the one which *eliminates the disparities among national fiscal systems to the point where these no longer distort the allocation of resources between states, without however canceling the incentives engendered by tax competition*. The fulfillment of this goal in practice is rather utopical.

There is no unanimity of views as concerns the desirability of fiscal harmonisation. The main objections pertain to:

- the elimination of tax competition, with the consequence of missing its positive effects;
- the possibility that differences among tax rates be fully justified by other considerations: e.g., low tax rates may reflect the intention to compensate locational disadvantages, while high rates reflect the possibility to exploit locational rates;
- the competition between national regulatory systems cannot be reduced to the fiscal system: “it is not obvious why fiscal policies require national harmonization when important differences exist from the standpoint of many other attributes of governments”;
- the efficiency of fiscal systems cannot be gauged in abstract, but in connection with material and cultural elements: it requires that a government strive to offer the bundle of public goods corresponding to the preferences of its citizens and is financed through the system of taxes considered the most equitable by taxpayers;
- the violation of “fiscal sovereignty”; however, as was shown in literature, fiscal sovereignty cannot be understood as the unlimited freedom of states to choose their

⁶³ Jean-Philippe Chetcuti: *The Process of Corporate Tax Harmonisation in the EC*, 2001, p.2-4,5/8

own own types of tax rates and bases: this option is inherently constrained – by market forces, as well as by international obligations.⁶⁴ Under such circumstances, it appears more natural that „sovereignty” be taken as referring to the administration by each state of its own fiscal instruments, in which case harmonisation is an adjuvant rather than an impediment.

As was shown above, tax competition may also be regarded as a passive form of fiscal co-ordination. In these circumstances, fiscal harmonisation in the strict sense of the word necessarily entails an active posture, that is, the adoption of concrete measures. These may concern all components of a fiscal system: the type of taxes levied; the tax bases; the tax rates; and the modalities of tax administration.

All these aspects have been dealt with, in a stricter or more flexible manner, by Community regulations pertaining to indirect taxes.

However, as concerns direct taxation, the issue of tax types and tax rates has so far been the object of non-adopted proposals, while with respect to tax bases and the administration of taxes the progresses achieved were limited and piecemeal.

The preferences for the different concrete modalities of direct tax harmonisation within the EC (EU) have had a capricious evolution over time. To a large extent, this was the result of perception changes at the level of at least some Member States (primarily, the large ones), which have come to gradually alter their absolute preference for retaining the highest possible degree of sovereignty in tax matters with considerations pertaining to the desirability of co-ordinating some fiscal aspects with a view to avoiding revenue losses triggered by tax competition, as well as the stricter censorship exerted by the ECJ against the attempts to counter “fiscal avoidance” practices by taxpayers. It is interesting to note that, whereas at the level of Member States the availability for “Community” solutions has increased with the perspectives of budget revenue erosion, the Commission’s proposals had as main objective the better functioning of the internal market. Even at the level of the Commission, however, the concrete initiatives have varied in time, in part as a reaction to the evolution of theory in this field, but to a significant extent also as a result of the personal preferences of the “Commissioners” in charge of managing this area.

The main signposts of this development are summarily identified below :

- a Fiscal and Financial Committee set up by the European Commission in 1960, under the chairmanship of Professor Fritz Neumark has delivered, in July 1962, a report predicated on the notion that the disappearance of intra-Community borders requires the elimination of “fiscal frontiers” as well.⁶⁵ The report concluded that the “normalization” of competition conditions within the Community did not require exerting any action on tax rates. Instead, the need was emphasized for a uniformisation of the corporate income tax base (recommending, to this end, the recourse of a common imputation system, with two different rates, according to the destination of profits) and for improving the co-operation between national fiscal authorities, *inter alia* by the conclusion of a multilateral

⁶⁴ Henk Vording, Koen Caminada: *Tax co-ordination: crossing the Rubicon?*, Kluwer, Deventer, 2001; p.2

⁶⁵ Claudio Radaelli, Ulrike Kraemer: *Shifting Modes of Governance: The Case of International Direct Taxation*, International Workshop, International University Bremen, June 2005, p.11

treaty for the avoidance of double taxation, meant to replace the multitude of bilateral treaties negotiated in keeping with the requirements of Art.293 of the EC Treaty.⁶⁶

- by two memoranda, adopted in 1967 and 1969, the Commission has expressed the intention that measures be taken in connection of all components of the tax system:
 - types of taxes, asking for the abolition of withholding taxes for gains deriving from the holding of bonds;
 - the tax base, recommending the institution of a uniform tax base for corporate incomes;
 - tax rates, the approximation (hence, not unification) of which was deemed desirable;
 - the administrative procedures, contemplating the uniformisation of tax inspection and tax collection methods.
- another committee, chaired by Professor Van den Tempel (1970) recommended the application of the “classical” (non-imputation) system, entailing double taxation, that is, of both the corporate income, as well as of the personal income of shareholders, including the dividends earned.

Further to these reports, a favourable perception emerged towards a more advanced fiscal harmonisation among the Member States, as indicated by a Council Resolution (21 March 1972) requesting the Commission to come up with fiscal harmonisation proposal and committing itself to take them in consideration within a deadline of six months. On this basis, the Commission proceeded in 1975 with the submission of a first package of initiatives relative to the corporate income taxation which provided, among others, for the alignment of tax rates within a 45-55% range, the recourse to a partial imputation system in order to avert the double taxation of dividends distributed to shareholders, as well as a single rate of 25% withholding tax for dividends. The proposal was blocked at the level of the Member States, but got criticised, in 1979, by the European Parliament as well. This blockage persisted for a decade and a half until, following the release of the White Paper of Lord Cockfield in 1985, the Commission withdrew – in 1990 – its former proposals, opting instead for discrete initiatives, considered essential for the completion of the single internal market.

- The Expert Committee chaired by Onno Ruding proposed (in 1992) a two-staged harmonization: for the beginning, until 1994, any double taxation of cross-border income flows would have had to be abolished, which would have entailed the elimination of the withholding taxes on interest, dividends and royalties earned, as well as the extension to all corporations of the benefits of the Parent-Subsidiary Directive; also, a minimum 30% tax rate on corporate income would have had to be introduced. In a second stage, meant to last until the introduction of the common currency, the unification of some taxation principles was foreseen (in particular, the determination of transfer prices and the introduction of the possibility of cross-border compensation of fiscal losses recorded in other jurisdictions by the subsidiaries of parent companies), and a maximum ceiling of the corporate income tax rate set at 40% was to be introduced.

⁶⁶ It should also be mentioned the view, which tends to resurface, according to which tax harmonization will also require corresponding accompanying measures in the area of the Community budget.

Summarising, one can note that the first harmonisation initiatives were very radical, based on a “top-down” logic and aimed at the egalisation of tax rates and bases. After a period of relative calm, succeeding to the rejection by the Member States of the original approach, a policy of incremental changes was pursued by the European Commission starting with the 1990s and which was founded on two guiding principles the crystallisation of which occurred at around that time: the completion of the common market by eliminating the residual barriers; and subsidiarity. There are currently on the table several ambitious initiatives, originating with the Commission, but also with some member states, but their perspectives of success are uncertain. The extreme diversity of the recommendations coming from the various expert committees over time is, at its turn, a telling indication of the complexity of the issues at hands and of their contradictory implications, which prevent the formulation, be it only at a theoretical level and considerations of political feasibility apart, of widely shared solutions.

One should also mention that the stronger resistance shown by Member States towards the harmonisation initiatives of direct taxes, relative to those concerning indirect taxes, is not solely the result of the different degree of stringency attached to the two kinds of harmonisation in the EC Treaty, but also a consequence of the fact that, once indirect taxes were harmonized, the freedom of movement of national authorities in tax matters dwindled considerably, thus increasing the costs in terms of loss of fiscal sovereignty of additional relinquishing of national prerogatives.

The degree of harmonisation reached so far differs depending on the type of tax concerned and the parameters of the said taxes.

From the standpoint of the type of tax concerned, the stringency of the harmonisation is regarded in different manners, as is shown below.

- a) The highest degree of harmonisation is required in the field of indirect taxes, because differences among these result in different prices at the level of the consumer, hence they segment national markets, that is, a result incompatible with the goal of the single internal market.
- b) Direct taxes, generally speaking, require a limited harmonization, aiming at the avoidance of discrimination, of double taxation or of unintended non-taxation.
- c) There is, however, a sub-category of direct taxes, namely those levied on mobile tax bases, with respect to which it is considered that a closer co-ordination is necessary, with a view to counteract the distortions induced to resource allocation within the single internal market.
- d) The taxation of personal incomes does not call for any kind of harmonisation, except the enactment of rules meant to avert possible restrictive effects on the free movement of persons, to avoid unintended double non-taxation or to mitigate unwanted effects (e.g., double taxation) of measures taken at national level in order to counter “fiscal avoidance”.

It should be noted that this hierarchy does not match the precepts proposed by the *doctrine of “fiscal federalism”* which entail, on the contrary, that tax rates on the most mobile bases be set at the higher decision levels, while those on immobile bases – at

lower levels. Maybe the most important principle which informs the above ranking of priorities is that of *subsidiarity*. Its implications relevant for the fiscal field are:

- the fact that the externalities of fiscal measures taken at national level for the fiscal systems of other members have to be taken into account, whereas these externalities are more likely to manifest themselves whenever there may be diverging “claims” on the same tax base;
- the fact that Member States should keep the possibility of applying those taxes and those tax rates which correspond to the preferences of their electorates;
- the fact that Member States should be able to administer their fiscal systems in as independent a manner as possible, without having to systematically interact with other fiscal authorities (exchange of information, cross-border fiscal audits etc).⁶⁷

From the standpoint of the tax parameters, harmonisation may refer to four aspects: type of tax (e.g., the generalization of the application of VAT in the EU and the prohibition of “cascading” taxes, like turnover taxes), tax rates, tax bases and the tax administration modalities. In general, it is considered that harmonization measures of tax bases enjoy a clear priority over measures related to tax rates. And, in fact, as concerns tax rates, some harmonization measures have been taken so far only with respect to indirect taxes, and no *acquis* whatsoever exists so far in connection with direct tax rates. The reason for this reticence is that a rate harmonization is regarded as inappropriate as long as Member States have particular features (demographic situations, social programmes, different sources of competitive advantage) so that they should be entitled to use the fiscal levers in different modalities and dosages in order to reach their specific economic and social goals.⁶⁸ Having said this, one should not overlook the fact that tax rates and tax bases are, to some extent, inter-changeable, so that the same objections may be raised towards the harmonisation of tax bases.

It should nonetheless be stressed that the non-uniformity of progresses realized on the two paths (type of tax and tax parameters) do not simply reflect considerations of relative opportuneness, but also the degree of availability shown by Member States, given the existing rules concerning decision-making and the division of competences. In principle, the availability for fiscal harmonisation is greater for countries with large tax bases and for which the financial sector of the economy is not overly important. Hence, Germany and France have come out strongly in favour of harmonisation, whereas Luxembourg and Ireland have always objected to such initiatives. The peculiarities of some member countries like Holland (which has a relatively narrow tax base) and Great Britain (which has an important financial sector) have made them to hold nuanced views, acquiescing partially to some initiatives, but also showing clear reticences towards some proposals.

⁶⁷ Sijbren Cnossen: *Tax Policy in the European Union. A Review of Issues and Options*, 2002; p.11

⁶⁸ Charlie McCreivy: *Tax harmonisation – No thanks*, European Business Initiative on Taxation, Brussels, 10 November 2005

VI. Harmonisation measures of direct corporate income taxes in the EU

VI.1. With respect to the administration of taxes

The first Directive related to direct taxes in the EU was that concerning the mutual assistance between national fiscal authorities (Directive 77/799/EC), which aimed at setting the stage for the exchange of information meant to counter cross-border fiscal evasion and fiscal avoidance practices, which frustrate the proper functioning of the single internal market, distorting capital flows, as well the competition conditions.

This Directive was amended and updated in 2003 in order to reflect the new conditions induced by access to modern technology and by the increased cross-border activities in the EU. The accent falls on the co-ordination, between the fiscal authorities of Member States, of the investigation of cross-border fiscal fraud and on the possibility of the fiscal authorities of Member States to conduct several kinds of procedures on behalf of the administrations from other Member States.

Also, at the Community level decisions were taken which, although they do not deal with fiscal harmonisation *stricto sensu*, have nonetheless created conditions for co-operation in the fiscal area. Thus, through *Decision 223* of 3 December 2002 of the European Parliament and of the Council, member states are encouraged to step up their co-operation and are invited to adopt a Community programme to this end, *Fiscalis 2003 – 2007*, which stimulates the exchange of information in the fiscal area. On the occasion of the ECOFIN meeting of November 2007, the Fiscalis Programme 2013 has been adopted, which pursues the path opened by its predecessor, Fiscalis 2007. The new programme, running over the period 2008-2013, offers member states enhanced means to combat fiscal fraud, as well to reduce the costs of fiscal compliance, particularly as concerns VAT and excises.

VI.2. With respect to the tax rates

The differences between the nominal rates of corporate income taxes in the various countries of the EU are sizeable and have grown larger following the enlargements of the years 2000. As a general rule, it is to note that the „large” countries (e.g., Germany and France) tend to apply higher tax rates than the small countries (e.g., Finland and Ireland).

The first proposals concerning the harmonisation of tax rates have been formulated in the context of the reports submitted by the „Neumark” and „Van den Tempel” Committees (of 1963 and 1971, respectively). On this basis, the European Commission initiated in 1975 a proposal of Directive providing for the setting of tax rates within a range of 45-55%. In 1979, this project became a „lame duck”, following the refusal of the European Parliament’s refusal to endorse it on grounds that the harmonisation of tax rates, not accompanied by similar measures with respect to tax bases, would only result in a widening of the sizes of the fiscal burdens felt by corporations, with all negative consequences deriving from this (and which the harmonization of rates was precisely supposed to curb).

A second initiative is that featuring in the report of the Ruding Committee (1992), to the effect of setting the corporate income tax rates within an interval of 30-40%. The Commission's position on this proposal was reserved, against the background of a changed approach, privileging the tackling of "discrete obstacles" rather than comprehensive harmonization initiatives. In a Communication of 24 June 1992, the Commission only mentioned that the proposal deserves a careful examination, while expressing doubts about the justification of setting maximal rates, as well as about the level (considered too high) of the suggested minimal rate. Eventually, the Commission refrained from taking any initiative in this vein.

The subject of rate harmonisation was reactivated in the recent years, as a result of position statements made by governmental authorities from some member countries. Thus, in 1998, the German Finance Minister Oskar Lafontaine asserted that "it is not acceptable that countries benefiting from Community funds engage in fiscal dumping". Lafontaine was referring to Ireland, but the same idea was to be reiterated by the French Finance Minister Nicolas Sarkozy in September 2004, this time with reference to the new member states, Estonia in particular (which does not tax reinvested profits at all).

Subsequently, the German Chancellor Gerhard Schroeder put forward the proposal for creating a "fiscal corridor", entailing the setting of minimum and maximum level of tax rates, an idea relayed in 2004, in an attenuated form, by the Dutch Finance Minister, Gerrit Zalm, who suggested the establishment of a minimum tax rate of at least 20%.

It is to note the decline, over time, of the minimum tax rate levels proposed (from 45%, to 30% and, finally, to only 20%), which shows how dynamic was the evolution of the corporate tax systems in the EU.

Because it implies tax rate hikes for some countries and tax rate reductions for other countries, the harmonisation is likely to have positive effects for some Member States, but negative consequences for others. This situation highlights the fundamental dilemma of any fiscal harmonization policy: the efficiency variations engendered by harmonization are the more significant the larger the differences between the original tax rates, yet the more significant these differences are, the more likely it is that the fiscal harmonisation process creates winners and losers. Under such circumstances, the political acceptability of harmonisation is minimal, unless a mechanism is in place that would allow the compensation by the winners of the losers. If, theoretically, such a vehicle does exist (the Community budget), the paradoxical situation highlighted by studies is that precisely those countries that stand to gain in terms of welfare and GDP growth are those recording budget revenue losses and vice versa.⁶⁹ This triggers another dilemma: in terms of what can winners, and losers respectively, be identified? If the losers are deemed to be those members suffering budget revenue losses because of harmonization, it would follow that the countries recording losses of GDP growth pace should compensate those recording losses! If, however, the winners are identified as being those countries obtaining a higher GDP in the process, a paradoxical situation would follow whereby countries recording budget revenue losses should compensate those with higher budget receipts. Both options are hardly acceptable from a political standpoint.

⁶⁹ Jens Brochner, Jesper Jensen, Patrik Svensson, Peter Birch Sorensen: *The Dilemmas of Tax Coordination in the Enlarged European Union*, IFIR Working Paper no.2006-11, October 2006; p.3

Several simulations undertaken of the results of corporate tax rate harmonisation yield interesting results.

A study based on the scenario of a complete harmonisation of tax rates and bases to the average of EU-25 reached the conclusion that the GDP gain obtained for the Union as a whole is of 0.8% if harmonisation is carried out at the unweighted average level and, respectively, of 0.4% if the average is weighted according to the national GDP levels. In this latter case, the level of receipts from the corporate income tax remains practically unchanged, but it would go down by 0.2% if harmonization is carried out to the level of the unweighted average. In practically all EU-25 countries, an increase of budget receipts is “paid for” by a GDP loss, while GDP gains have as counterpart the reduction of budget revenues. The only exceptions from this trend are those of Latvia, Lithuania and Hungary, but in these cases the variations estimated are almost negligible: GDP gains of 0.1-0.4% and budget revenues either constant or increasing by 0.3-0.4%.

If the above-mentioned scenario is altered and the harmonisation is limited to the tax base alone, GDP gains become more modest (between 0.2-0.35%, depending on whether a weighted or unweighted average is applied), and budget revenues stay practically unchanged (drops of less than 0.1%) at the aggregate level of EU-25. The budget revenue losses result from the fact that the harmonization of the base entails the narrowing of the tax bases of the large countries, which cannot be compensated by the widened tax bases of the small countries.

According to another study, predicated on the notion of setting a harmonized rate on capital income (including both the corporate income tax, as well as personal taxes) of 30.2% (corresponding to the average, weighted by population, of such taxes applied in EU-15), the gains owed to the improvement of capital allocation at the intra-European level would amount to 0.4% of GDP. The result reflects the fact that the reallocation would take place towards the countries which, previously, had higher tax rates, and these tend to be the large states, where the tax base can widen more as a result of the reduction of taxes. Moreover, this estimate might underestimate the actual effects, because the likely alternative of harmonization is not the *status quo*, but a continuation of tax competition, resulting in even lower tax rates.⁷⁰ On the other hand, however, the states which would need to cut their capital taxation rates as a result of harmonisation might be compelled to compensate this by higher taxes on labour income, potentially triggering higher unemployment. At the opposite end, the countries with the lowest taxation levels prior to harmonisation (Greece, Ireland, Portugal and the UK) would need to carry out very steep upwards adjustments of tax rates, likely to generate large capital outflows, as well as important long-term changes of their economic growth pace.

The above-mentioned studies have the tendency to underestimate the adjustments of GDP and budget revenues set in motion by a harmonisation of the corporate income tax because they are based on statical estimates of the resulting allocative effects. They do not take into consideration either the reduction of the compliance costs supported by the taxpayers, which harmonisation cannot fail to achieve, or the fact that, absent

⁷⁰ Peter Birch Sorensen: *Tax coordination in the European Union: What are the issues?*, Swedish Economic Policy Review, 8:2001; p.182

harmonization, tax competition has a natural tendency to intensify, with all negative consequences that derive in terms of constraining the capacity to supply public goods, as well as in equity terms (the switch of the fiscal burden from capital towards labour).

Moreover, although apparently modest, the estimated static gains of fiscal harmonisation are perfectly comparable to those expected from other important common policies of the EU: the estimated GDP growth expected as a result of the implementation of the Services Directive amounted to at most 0.7%, the one induced by the recent enlargement of the EU was gauged at only 0.5%, while that engendered by the much more vast project of completing the single internal market did not exceed 1.8%!⁷¹

As a matter of principle, the harmonisation of tax rates among countries boasting significant differences from the standpoint of their economic dimensions and their comparative advantages as FDI locations raises significant problems. The result engendered on the “good side” of the “Laffer curve”, in terms of an enlarged tax base as tax rates go down, is more significant in the small economies, whose tax bases are small relative to the rest of the world and where, as a consequence, the revenue losses engendered by lower rates are easily (over-)compensated by larger tax bases arising as a result of reallocations of bases from other countries.⁷² The reality of this effect is evidenced by the stability of budget receipts from corporate income taxes, against the background of a stronger correlation between the dimension of the economies and the tax rates in EU(-15) countries. If, in 1980, this correlation was practically inexistent, in 2005 the Pearson coefficient had reached the respectable level of 0.55 (and even 0.76, if the particular case of Luxembourg is set aside).⁷³

Further, in general, the large countries are likely to dispose of more specific locational advantages, which an investment intends to take advantage of, thus displaying the features of a relatively immobile tax base, prone to be taxed at high levels. Conversely, for small countries, low tax rates may be applied precisely in order to compensate the absence of locational advantages.⁷⁴ The same conclusion derives from taking in consideration the principles of the “new economic geography”, which highlight the importance of agglomeration effects and the “core-periphery” pattern so generated. Applied to the case of the enlarged EU, where the old members may be considered as representing the “core”, while the new members constitute the “periphery”, these principles may justify keeping in place a certain differentiation of tax rates as long as the recently-acceded countries have not closed the gap, that is, as not in a position to offer investors “agglomeration rates” of similar size to those that can be extracted in the “core” countries. Moreover, agglomeration effects limit the international mobility of capital, meaning that the effectiveness of tax competition is *ipso facto* limited at its turn.

⁷¹ Gaëtan Nicodème: *corporate tax competition and coordination in the European Union: What do we know? Where do we stand?*, European Commission DG ECFIN, Economic Paper 250, June 2006; p.32

⁷² Amina Lahrèche-Révil: *Who's afraid of tax competition? Harmless tax competition from the New European Member States*, CEPII, Working Paper no.2006-11, June 2006; p.10

⁷³ Steffen Ganghof, Philipp Genschel: *Taxation and Democracy in the EU*, Max Planck Institute for the Study of Societies Cologne, Working Paper 07/02, 2007; p.11

⁷⁴ Stephen Bond, Lucy Chennells, Michael P. Devereux: *Corporate Tax Harmonisation in Europe: A Guide to the Debate*, The Institute for Fiscal Studies, London, 2000; p.33-4

Other significant differences among EU member states pertain to the degree of compliance by taxpayers and to the effectiveness of fiscal administrations. Wherever these are high, the countries concerned can afford to have recourse to lower taxes. Forcing them, against this background, to increase their taxation levels to the one needed by countries confronted with sizeable taxpayer compliance problems and deprived of efficient tax administrations is tantamount to a discrimination⁷⁵, engendering “adverse selection” effects.

Another problem rendering more problematic the harmonization of tax rates within a grouping including both large and small countries pertains to the asymmetrical effects that the tax rate changes have on these two categories of countries. For small countries, the risk of capital outflows as a reaction to increased taxes is greater than for large countries. On the other hand, reductions of the tax rates tend to generate higher capital inflows, in relative terms, than in large countries, because of the higher elasticity displayed by the tax bases of the small countries. Moreover, the harmonisation of rates within such groupings is not very pressing from the standpoint of the need to counteract the effects of tax competition, because the tax cuts operated by the small countries tend to have only limited effects on the large countries, thus rendering less necessary and probable rate reductions in the latter countries in order to keep pace with the fiscal relaxation undertaken by the small countries.⁷⁶

On the other hand, there are limits to how much the new EU member countries can reduce their tax rates. To the extent that this would start engendering budget revenue reductions, thus requiring corresponding adjustments of public expenditures, the ability of these countries to supply the public goods needed by the investors (primarily, infrastructure elements) would suffer, and the favourable fiscal regime might turn to be insufficient for supplanting the absence of other locational advantages.

A result analogous to the unification of tax rates might be obtained by switching to the taxation based on the residence principle, provided there is a reliable exchange of information between fiscal authorities. The exchange of information is, however, affected by difficulties of administrative, legal and even political nature, including the tradition of banking secrecy in many countries. Furthermore, the investment of a corporation is subjected not only to the corporate income tax, but also to the taxes levied on the personal income of its shareholders. A tax system genuinely predicated on the residence principle supposes that investors will bear the same aggregate fiscal burden, resulting from both the taxation of corporate income and of the personal income, irrespective of whether they invest in their own country or in another Member State. Meeting this requirement may face practical obstacles hardly surmountable, as can be illustrated by the hypothetical example of a private investor owning shares in a domestic company which, at its turn, owns shares in a foreign company. Finally, introducing this principle in the EU on a multilateral basis is politically unfeasible in the absence of a compensation mechanism. This is because the application of a purely residence-based tax system presupposes that the fiscal authorities of a country will grant tax credits for the taxes paid in another

⁷⁵ James Barr, Mathew Elliott: *Moving on Up - EU tax harmonisation plans*, The European Foundation, October 1998; p.6

⁷⁶ Margit Schratzenschaller: *Company Tax Co-ordination in an Enlarged EU*, Austrian Institute of Economic Research (WIFO), May 2005; p.7

country. Consequently, the net capital exporting countries would end up with a negative balance of fiscal credits.⁷⁷

VI.3. With respect to the tax base

Although the harmonization of tax bases without the simultaneous harmonization of tax rates has the same unwanted effects as the reverse combination of measures, the European Commission has deemed important and promising initiatives concerning the tax base. The expected advantages of measures concerning this parameter pertain to:

- the reduction of the costs of complying with different national fiscal rules;
- the possibility of cross-border compensation of profits and losses deriving from the activities carried out by a group of companies at the level of the EU ;
- avoiding most possible situations of double taxation;
- the elimination of the fiscal costs of intra-EU corporate restructuring actions (mergers and acquisitions);
- the elimination of the problems engendered by the measures destined to curb “transfer prices”.

Transfer prices aim at establishing the tax base in the jurisdictions with the lowest tax rates, including by carrying out transactions deprived of economic rationality. Fiscal authorities have the latitude of invalidating the fiscal implications of such transactions, thus “reconstituting” the tax base, by having recourse to decisions entailing no guarantees against possible excesses. The harmonisation of tax bases would render impossible the “fiscal optimization” via transfer prices and, hence, useless the “reconstitution” of tax bases by discretionary decisions.

Another advantage of the measures concerning the tax base is that they leave to each Member State the freedom to apply the desired tax rate, thus maintaining a discretion margin in fiscal matters.

A Communication of the Commission of October 2001 explored four possible options.⁷⁸

A. The mutual recognition of the fiscal rules in force in the home state (“Home State Taxation” - HST): the tax base would be determined on the basis of the rules of the fiscal jurisdiction where the Headquarters of a company are located. There is no pan-EU consolidation of the tax base, hence separate tax bases will remain in each Member State in which taxable activities are carried out, but they all are going to be determined according to the same rules. The profits determined in this manner are to be attributed among the Member States on whose territory the companies of the group operate according to “a simple formula”, and each state will apply to the tax base that will revert to it the tax rate applicable at the national level.

⁷⁷ Dirk Gopffarth: *The Effect of Tax Harmonisation on Effective Tax Rates in the European Union*, June 2001; p.16

⁷⁸ European Commission: *Tax Policy in the European Union – Priorities for the years ahead*, Communication to the Council, the European Parliament and the Economic and Social Committee, Brussels, 23 May 2001

This solution is tantamount to the application, in the fiscal area, of the mutual recognition principle. It determines favourable effects especially by reducing the costs of the simultaneous compliance of a taxpayer with several different sets of rules. In the particular case of HST, there is a certain tension between the compliance costs and tax administration costs. If this system allows a taxpayer to operate according to the rules of a single tax system, the fiscal authorities will need to take into account several sets of rules for determining the tax base, as it is theoretically possible that corporate taxpayers taxable on the territory of a Member State determine their tax bases according to 27 different sets of rules. Since any fiscal jurisdiction will be required to apply to some taxpayers the rules of other countries, there are views according to which this method can only work in practice if the tax rules and practices of the different member countries are sufficiently close (which is even less the case in the aftermath of the recent extension of the EU).

Another potential advantage of HST is that it discourages the use of tax incentives contrary to the State aid rules or with to the Code of Conduct on Business Taxation : these incentives will become automatically applicable to all locations where a transnational corporation operates, which will be able to take advantage of them without transferring a single activity on the territory of the home state.⁷⁹ HST is less effective in solving other problems such as, primarily, the cross-border compensation of profits and losses.

From the point of view of its feasibility, given that it does not require an agreement concerning the definition of the tax base (this being determined, in each case, by pre-existing national rules), the HST method allows to avoid significant difficulties (which are not spared to the next method explored).

The Commission considered that this option has the brightest perspective of being applied, but that it is not suitable to the situation of multinational corporations, but only to that of SMEs, which stand to gain most because the clearest advantage of HST, the minimization of compliance costs, it is relatively more important for small and middle-sized companies. Indeed, compliance costs are strongly degressive: compared to an average compliance cost of 2-4% of taxes paid, the compliance costs of SMEs may reach over 30%.⁸⁰ On the other hand, only about 3% of European SMEs operate, through taxable subsidiaries, in more than a single Member State, which suggests a limited potential for application of this method.

Applying the HST method indistinctly, to all companies, risks creating perverse situations. What is its greatest advantage from the standpoint of its acceptability by the authorities, namely their freedom to determine the tax rates and the definition of the tax bases, may also prove to be its main weakness, because this system is practically “inviting” tax competition for attracting the headquarters of companies, particularly of the large ones. Moreover, the competition among multinational corporations based on the territory of a Member State may be distorted by the fact that they are going to be taxed according to different tax bases, according to the rules of each company’s home country.

⁷⁹ Dirk Gopffarth: *The Effect of Tax Harmonisation on Effective Tax Rates in the European Union*, June 2001; p.12

⁸⁰ xxx: *Economic effects of tax cooperation in an enlarged European Union*, Copenhagen Economics, Contract no. TAXUD/2003/DE/307, October 2004; p.39

The beginning of competition among tax bases may put very heavy pressures on the budget receipts deriving from profit taxation, which remained relatively constant over the last two decades, marked by significant reductions of the tax rates, precisely as a result of measures taken to expand the tax bases.

The HST system makes it possible that the narrowing on the tax base in a country affects the budget revenues of other countries, to which parts of the tax base determined according to the taxpayers' home state rules will be attributed. The loss of fiscal sovereignty is likely to be more serious for small countries, which host many subsidiaries of multinational corporations and have few companies incorporated on their territories which carry out extensive activities abroad: their national rules for determining the tax base will thus have a very limited applicability, and a large part of the revenues reverting to them will have been determined on the basis of tax bases regulated by other countries' rules.

All these considerations explain why, in December 2005, the Commission proposed that this system be applied as a pilot project, temporarily (for 5 years as from 1 January 2007) and on a voluntary basis (only by those Member States and those small and medium corporate taxpayers interested). The proposed formula for allocating the tax base among the fiscal jurisdictions entitled is a simple one, consisting of two factors with equal weights: total payroll and turnover.

B. **The Common Consolidated Corporate Tax Base - CCCTB**: this a new, distinct system for determining the tax base, whereby the taxable income of companies will be determined in a consolidated manner. Simply put, this system consists of four steps:

- i) each member of a group of related companies determines its taxable income separately, but according to the same rules ;
- ii) these individual bases are then aggregated, forming a consolidated tax base;
- iii) this consolidated tax base is then allocated among the Member States according to a pre-determined formula ;
- iv) each state applies its own tax rate to the “portion” of the tax base reverting to it.

The expected advantages of such a method are numerous:

- a significant reduction of compliance costs;
- the disappearance of the problems of double taxation within the EU;
- the elimination of an important obstacle to the free movement of capital and the unbridled exercise of the right of establishment, thanks to the cross-border compensation (within the EU) of fiscal losses by reducing the taxable income of parent companies;
- the disappearance of fiscal avoidance practices based on the use of “transfer prices” because the prices at which intra-firm transactions are carried out can no longer affect the distribution among fiscal jurisdictions of taxable profits;

- the simplification of many corporate restructuring operations which have a cross-border dimension;
- the comparability of effective fiscal burdens in each jurisdictions (when the tax base is the same, nominal rates become perfectly comparable), hence the improvement of the quality of investment decisions and, as a result, of resource allocation at the level of the entire Union.

The consolidation of the bases determined according to the same rules is necessary in order to exploit all these advantages, because some of them would not be achievable if harmonization were to be limited to a common definition of the tax base: the cross-border compensation of losses, the difficulties engendered by the recourse to “transfer prices” and the obstacles to cross-border corporate restructuring.

There are, however, also implications with ambiguous implications of the harmonisation of the tax base, because of its consequences on tax competition. First, the uniformisation of the tax base leaves the rates as sole parameter of fiscal incentives that States may grant in order to attract investments, which raises the spectre of an intensification of competition in this respect and, hence, of an even more abrupt decline of tax rates. Secondly, according to the elements which will be used for allocating among national jurisdictions of the consolidated tax base, the competition among Member States may be transferred at this level. The more mobile the factors used in the allocation formula, the greater the likelihood of fiscal competition among Member States. Both above-mentioned effects are very likely to occur because corporate taxpayers will retain an important margin of maneuver as concerns the possibility to arbitrate among different fiscal jurisdictions. In the third place, because a consolidated tax base for the activities carried out within the UE will co-exist, for numerous multinational corporations, with separate tax bases, located outside the Union, this dualism will engender significant opportunities for tax “optimization”.

The application of the CCCTB is likely to influence corporate restructuring decisions, stimulating mergers of companies located in high-tax jurisdictions with companies from low-tax jurisdictions because, in this case, the merger will reduce the average tax rate levied on the profit of the resulting entity.

Also, the adoption of the CCCTB entails significant practical difficulties: “constructing” a new tax base is a laborious and time-consuming undertaking; the fiscal administrations of Member States will need to administrate two tax systems simultaneously; technical issues (the applicability of double taxation avoidance treaties concluded by Member States with third countries, determining the competent jurisdiction in cases of disputes between national fiscal authorities etc). There is also the risk that the agreement of all Member States for these solutions will require the award of a large number of exemptions or possibilities to opt among several versions, so that the compliance costs with different rules will remain high as a result.⁸¹

⁸¹ xxx: *Harmonisation of the Corporate Tax Base in the European Union*, Lithuanian Free Market Institute, 30.03.2006; p.11

On the occasion of the ECOFIN Council meeting of September 2004, a large majority of Member States agreed that there is a need to advance on the path leading to the edification of a common tax base and decided to set up a Working Group made up of experts representing the Member States and chaired by the Commission, meant to examine in a detailed manner the various solutions possible. It is expected that its activity will lead to the formulation of a legislative proposal at the end of 2008. It is remarkable that, in spite of known reticences by many Member States towards the idea of a common consolidated tax base, no one has declined to be represented at the workings of this Group.

Originally, the Commission tabled on the support of this project by about 20 Member States, but most of them have so far preferred to reserve their options. Clearly in favour of the project have come only Austria, Belgium, France, Germany, Italy, Luxembourg and Hungary, while the UK, Ireland, Slovakia, Slovenia and the Baltic states have explicitly opposed it so far.⁸²

Because the concrete solutions to most of the technical problems are still being debated, it could be useful to examine the options under discussion, their pros and cons, as well as – wherever such indications exist – the most likely final option.

As concerns the **subjects of regulation**, the Commission expressed the preference for the system's application only to entities organized as "European companies" (*Societas Europaea SA*), but there are widespread opinions that the possibilities of any European corporate taxpayers to opt for this modality should not be limited.

At this juncture, also under debate is the way of applying this system, i.e. whether on a voluntary or a compulsory basis. The preferences of the European Commission and of the European Parliament are for an optional system, because the aim of the CCCTB is to improve the functioning of the single internal market, not the particular situations of different Member States. Hence, since not all companies carry out activities in more than one Member State, it would be excessive to ask them to change their tax base. Another consideration noted by the Commission is that the optionality of the mechanism should make it more acceptable to the Member States. In this case, in order to minimize tax optimisation behaviours, it should be that, once a taxpayer opts for the CCCTB, this becomes mandatory for a minimum time period, and the consolidation should be mandatory, according to the model already applied in the USA, to the revenues and expenses of *all* members of a group of companies.⁸³

One should note, however, the existence of serious arguments against optionality. First, it is likely that it will intensify tax competition, especially if no clauses will exist relative to the minimum periods during which the companies which made an option have to abide by it. Then, given the choice, corporate taxpayers should opt for the solution promising a smaller fiscal burden, which means that – if they are correctly anticipating their tax obligations – budget revenues should drop as a result. Indeed, a very recent study was estimating that the introduction of the CCCTB would lead to a 2% rise of the corporate

⁸² Nico Groenendijk: *Enhanced Cooperation in Corporate Taxation: Possibilities and Possible Effects*, EUSA Economics Interest Section Research Seminar, Waterloo, Ontario, April 2006; p.5

⁸³ Jack M Mintz: *Europe Slowly Lurches to a Common Consolidated Corporate Tax Base: Issues at Stake*, Oxford University Centre for Business Taxation, WP 07/14, May 2007; p.5

income tax proceeds if the mechanism will be mandatory, but to a drop of 2,5% of these receipts if application will be voluntary.⁸⁴ Finally, national tax administrations will have to operate with two sets of tax rules simultaneously, which engenders obvious difficulties.

Another aspect pertaining to the entities to which the CCCTB will apply is the way of determining the composition of the group to which the consolidated base will apply. Currently, all Member States which have group taxation regimes require that the members of those groups be related through ownership ties. In this respect, there are two approaches possible:⁸⁵

- the “legal” modality, according to which are included in a group all entities related through shareholdings exceeding a certain ceiling (within the EU, no jurisdiction recognizes the inclusion in a group if the ownership ceiling does not exceed 50%);
- the “unitary” modality, according to which only entities mutually integrated economically among themselves are included in a group.

The former modality has the important advantage of its simplicity and ease of implementation, but the latter prevents fiscal arbitraging attempts, by which some investments would be carried out solely in order to “buy” allocation factors in low-tax jurisdictions, so as to reduce the fiscal burden for the entire group.⁸⁶

As regards the geographic coverage of CCCTB, it is obvious that the system can only apply to companies incorporated in the EU. The existence of complex, interlocking ownership ties with extra-Community companies requires the clarification of the status of all companies involved. There are some particularly sensitive combinations, the treatment of which has to be differentiated:

- several Community companies controlled by an extra-EU company: it would be desirable that the system applies to them as well, because otherwise the application of the CCCTB might be avoided by EU companies simply by moving outside the Community space the entity controlling them;
- a Community parent company having a subsidiary in a third country which controls, at its turn, a Community company: Community-based entities ought to be subject to CCCTB if the ownership ceilings are large enough to satisfy the legal definition of ownership, but the consolidation of the tax base by excluding the intermediary entity risks creating serious technical difficulties.

The definition of a common tax base raises some extremely complicated problems. On the one hand, absent a simultaneous reduction of the dispersion of tax rates, the unification of the tax base by harmonizing the pre-existing ones (entailing its widening in

⁸⁴ Michael Devereux, Simon Loretz: *The Effects of EU Formula Apportionment on Corporate Tax Revenues*, Oxford University Business Centre, WP 07/06, October 2007; p.2

⁸⁵ Joann Martens Weiner: *Formula apportionment in the EU: a Dream Come True or the EU's Worst Nightmare?*, CESifo Working Paper 667, February 2002

⁸⁶ Christoph Spengel, Carsten Wendt: *A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: Some Issues and Options*, Oxford University Centre for Business Taxation, WP 07/17, 2007; p.21

some jurisdictions and its narrowing in others) engenders an increase of the differences between the effective tax rates, thus stimulating tax competition and distorting resource allocation because of amplified fiscal considerations orienting investment decisions. This effect is triggered by the fact that, within the EU, the countries with the largest tax bases tend to be those with relatively low tax rates and vice versa.

There are currently significant differences between the national regulations for the definition of the tax base in very important respects: fiscal deductibility of interest, the regime of depreciation allowances, the possibilities of loss carry forward, the types of fiscal incentives available etc.

Very often, these differences act as obstacles to the efforts of transnational groups to organize their activities in the forms that they deem to be the most advantageous. In yet other cases, the discrepancies between national rules may be exploited in favour of the taxpayers. Thus, the existence of different approaches concerning the allocation of asset ownership among fiscal jurisdictions may allow a multinational corporation to obtain recognition for fiscal depreciation in two different jurisdictions for the same asset (situation known as *double-dipping*).

Another technical, yet very important, aspect which has to be sorted out in order to apply any harmonisation method based on consolidated tax bases is the *consolidation of the tax bases of company groups*. Accounting rules for consolidation currently in place within the EU are not adapted to fiscal requirements:

- they include the balance sheets of extra-Community entities which belong to the group;
- periodical revaluation of assets, meant to reflect “market values”, are inducing a cyclical volatility and, hence, the instability of budget revenues which would be collected on such a basis;
- unrealised profits are also included, which would lead to the taxation of virtual amounts.

The definition of a common tax base might use the International Financing Reporting Standards (IFRS). On top of their large international recognition, these have the advantage of an easy adaptation of taxpayers to their requirements given that – as from 1 January 2005 – a Community Regulation is in force which requires all listed companies to draw their balance sheets in accordance with the IFRS requirements. There is also a detailed CEPS study which concludes that, notwithstanding some problems, IFRS are largely compatible with the principles of fiscal accounting.⁸⁷ According to another recent study, there are several aspects with respect to which IFRS might offer solutions that could be taken over in the rules for drawing up a consolidated tax base: depreciation, provisions, cost accounting⁸⁸ Finally, yet another study concludes, on the basis of the analysis of the situation in only 12 Member States, that the adoption of IFRS as a basis for fiscal reporting by corporations would lead to the enlargement of the tax bases in all countries considered with the exception of Ireland. Hence, the conclusion that adopting

⁸⁷ Malcolm Gammie, Silvia Giannini ş.a.: *Achieving a Common Consolidated Corporate Tax Base in the EU*, CEPS Task Force Report no.58, December 2005

⁸⁸ Andreas Oestreicher, Christoph Spengel: *Tax Harmonisation in Europe. The Determination of Corporate Taxable Income in the EU Member States*, ZEW Discussion Paper No.07-035, June 2007; p.34

CCCTB in such a form might be accompanied by a certain reduction of tax rates, which would increase the attractiveness of the whole EU as an investment location.⁸⁹

The European Commission is, however, reserved as concerns the possibility to adapt IFRS to the needs of devising a common tax base, mainly because the definition of the consolidated group and the consolidation method are different from the current practices of Member States and not very compatible with the needs of taxation. This is why, from its point of view, IFRS only constitute a useful and neutral point of departure for defining a common base, able to orient discussions and term definitions, but which should not be assigned a larger part. It is preferable to agree on an *ex novo* tax base, founded from the outset on fiscal accounting principles and able to minimize compliance costs and increase transparency.

The extent to which IFRS will be accepted as a starting point for determining the common base will undoubtedly depend also on the preferences of the Member States. The results of a debate organized by the Federation of European Expert Accountants offers interesting indications from this standpoint. In an attempt to determine how dependent on accounting rules are the fiscal rules, it was concluded that in Austria, Finland, Germany, Greece and Italy the two are “closely linked”, whereas in Denmark, Ireland, Netherlands and the UK there is only a “certain connexion”⁹⁰

The most important stake of CCCTB is, however, the **allocation formula, among Member States entitled, of the consolidated income determined on the basis of the common tax base eventually devised**. Ideally, the rules for apportioning the tax base should satisfy the following requirements :

- to be transparent and easy to implement ;
- not to entail excessive compliance and administration costs, which presupposes the use of macroeconomic factors or of microeconomic variables that are already used in the companies’ reporting;
- to be as neutral as possible for investment decision purposes, against the background of the tendency of allocation formulae to convert the tax on corporate income in a tax on the factors used in the formula, but also from the standpoint of the relative intensity of production factors and of corporative financing forms (e.g., not to favour credit financing over initial share offerings);
- to offer legal certainty, in the sense that rules must be sufficiently precise and non-ambiguous as to make the taxpayer fully aware of its fiscal obligations in any circumstances;
- to limit the opportunities for „fiscal arbitrage” of taxpayers, which requires that allocation factors be relatively difficult to move from one location to another, and to be easily measurable;
- to be equitable.

⁸⁹ Otto Jacobs, Christoph Spengel, Thorsten Stetter, Carsten Wendt: *EU Company Taxation in Case of a Common Tax Base*, ZEW Discussion Paper No.05-37, 2007; 21

⁹⁰ Antonio Russo: *Formulary Apportionment for Europe: An Analysis and A Proposal*, INTERTAX, 33:1, 2005; p.12

This latter consideration is the most complex and multiform. From its perspective, it might be held that a larger portion of the tax base should revert to the jurisdictions where the activity of the taxpayer is more profitable (or where the business owns more revenue generating factors) or that there should be a “reward” for the states whose public services are benefiting the companies and whose contribution might be approximated by such factors as the physical capital or the number of employees (who, for instance, use public transportation, benefit from social insurance etc).⁹¹

Equity considerations may be pushed further, but in this case the risk arises of excessive complexity. For instance, one should distinguish between “active” income, which has to be *distributed* among the locations where it was generated, and the “passive” income, which needs only to be *allocated* to a certain location (e.g., the income from intellectual property rights can be attributed to the location of the headquarters of the company holding the patent etc). In the same logic comes the application of the principle of the “*economic nexus*”: “There is no justification for divining between states A and B the revenue obtained by a corporation from a discrete activity carried out in the state A solely because the same corporation undertakes another activity, not linked to the former, in the state B.”⁹²

No single allocation factor can possibly satisfy simultaneously all above-mentioned requirements, among which there are obvious trade-offs. For instance, the more one tries to satisfy the equity principle, the more neglected is the efficiency principle. This unavoidable divergence is only one of the reasons why agreeing on the allocation rules will prove extremely difficult. At least as important a reason is the fact that, in this respect, Member States are engaged in a zero-sum game: any additional revenue accruing to some necessarily comes at the expense of the others.

So far, the European Commission has refrained from making public its preferences for the configuration of the apportioning system of the consolidated tax base, as it limited itself to generic mentions: “the formula will be based on economic factors the choice and weighting of which are currently the object of the Commission’s research”⁹³

There are two possible ways of approaching the rules of distributing the tax base. There is, first, the ***microeconomic approach***, based on factors specific to individual taxpayers, such as:

- ownership (capital), be it expressed as stock (gross value, not including depreciation), or as flow (depreciation plus the interest on loans for covering the replacement value); this element is considered as appropriate primarily because profit, that is, the variable subject to taxation, is a return to capital;

⁹¹ Ana Agundez-Garcia: *The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options*, DG TAXUD, Taxation Papers, Working Paper no.9, October 2006; p.37

⁹² Walter Hellerstein, Charles E. McLure: *The European Commission’s Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States*, European Conference on Company Taxation, Rome, 6 December 2003; p.3

⁹³ *An Internal Market without company tax obstacles; achievements, ongoing initiatives and remaining challenges*, Communication from the Commission, Brussels, 24 November 2003; p.21

- employees (payroll) or sales (turnover); both have the advantage of administrative convenience (being easy to measure and apply), but also the disadvantage of irrelevance for the substance of the operation.

In principle, these criteria are presumptive indicators of the economic activity carried out in each fiscal jurisdiction, thus playing the part of proxies for the advantages deriving from each location. Generically speaking, microeconomic indicators have the advantage of allowing a good correlation between the actual economic activity carried out in a certain Member State and the portion of the tax base allocated to that country. Relative to the current situation, whereby states have access to tax bases more according to the legal form of taxpayers than according to their economic substance, this is an undisputable progress.

The recourse to microeconomic criteria has, however, also several shortcomings. The effort of data collection and processing is far larger than in the case of the macroeconomic approach. Moreover, any key of allocation chosen cannot fail to affect somehow the incentives perceived by the taxpayer and, as a result, there is the risk of manipulation by the authorities. Concretely, these may reduce non-harmonised taxes in order to maximize the level of the relevant indicator in their own jurisdiction: for instance, if the number of employees is used as a criterion, employment may be stimulated by reducing social contributions. This situation not only perpetuates fiscal competition, but may direct it towards obviously welfare-reducing outcomes. For instance, as long as the activity of a group is profitable overall, states may attempt to attract activities – even if unprofitable on their own territory – solely in order to increase their portion of the consolidated tax base.⁹⁴ Tax competition is also intensified by the fact that, as demonstrated in literature, by attracting investments in the fiscal jurisdiction of a country one gets access to taxing the average profit of that investor, whereas under separate accounting one can only tax the marginal profit of the investor (i.e., the one corresponding to the said investment).⁹⁵

To these generic shortcomings one should add the problems specific to the choice of each individual factor.

a) Capital. This is a factor whose inclusion has a very serious justification, because profits are, at the end of the day, the return of invested capital. Measuring this indicator is, however, prone to difficulties. First, there are valuation problems, especially for intangible assets (like intellectual property rights), for which no relevant market prices usually exist. Market valuation problems are, though, present in any case, but one can have recourse to the book value, as a normalizing and easy-to-determine factor, in spite of its conceptual inferiority. Secondly, the question arises of whether one should have recourse to stock measurements (as in the USA, for instance) or to measures of flows. Flow measurements (new investments and the depreciation of existing capital) would tend to allocate a larger tax base to the jurisdictions where there is capital subject to

⁹⁴ Gaëtan Nicodème: *corporate tax competition and coordination in the European Union: What do we know? Where do we stand?*, European Commission DG ECFIN, Economic Paper 250, June 2006; p.29

⁹⁵ Ana Agundez-Garcia: *The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options*, DG TAXUD, Taxation Papers, Working Paper no.9, October 2006; p.62

depreciation. Stock measurements (at gross value, without depreciation) are hence considered to be a better choice.

Another problem pertains to the very significant mobility of this factor and to the fact that companies have full control over its location, which makes easily possible their shifting towards low-tax rate jurisdictions and, at the same time, increases the temptation for some states to attract a larger portion of the consolidated base in their own jurisdiction, by having recourse to lower tax rates. This problem gets magnified in the case of assets leased intra-group, where access to a better fiscal treatment is possible without affecting their optimal location, simply by registering them in low-tax jurisdictions and leasing them to group members located in other jurisdictions.

For all the above reasons, it would be advisable to have recourse to a limitative definition of the factor capital, by excluding intangible assets (because difficult to value), stocks (because excessively mobile) and leased assets.

b) Labour. This factor may be taken into account in two ways: as number of employees or as payroll. The implications of each of these choices are very different.

The number of employees may have a limited relevance, as it has no systematic correlation to value added. Also, there can be measurement problems linked to temporary employees and to activities performed by independent contractors, but on indefinite durations. On the other hand, however, this version of the indicator considered (labour) averts the distortions induced by the differences between wage levels in different Member States, which are not fully determined by productivity differences.

Payroll is, *a priori*, better correlated with value added in each location, but it exhibits at its turn measurement problems determined by different modalities of employee remuneration in different Member States (for instance, profit participation, stock options or employer contribution to various employee compensation schemes). From a conceptual standpoint, the main problem of this indicator stems from the implicit redistribution that it operates from countries with low wage levels and towards countries with high wage levels, especially against the background of increased wage gaps within the EU further to the recent enlargements. Since these differences do not reflect solely productivity gaps, such a redistribution might be considered inequitable and could require a correction by adjusting wage levels for the purpose of including them in the formula. It is true that existing precedents (USA and Canada) do not suggest such a solution, but wage differentials are smaller in these federations than within EU-27.

An important advantage of choosing labour as an apportioning indicator is the fact that its relative immobility renders far more difficult the fiscal arbitrage by companies subject to taxation according to the CCCTB method.

c) Turnover. As for the other factors mentioned, we can distinguish in this case as well between measurements problems and conceptual problems. From the latter standpoint, the question arises whether demand (which this indicator approximates) may be regarded as a revenue generating factor. Secondly, there is the need to opt between considering sales at destination or at origin, respectively. Since the influence of the place of origin is taken into account by the other microeconomic factors, the latter option might be preferred, subject nonetheless to the caveat that, in this way, consumption and imports

would be stimulated, while imports would be discouraged. The choice of sales at origin would enhance even more the incentives for locating investments in the jurisdictions boasting the lowest tax rates. From the standpoint of political feasibility, the solution seems to lean towards choosing the sales at destination, which would balance the apportioning of fiscal revenues among net producing and net consuming countries, respectively. Moreover, sales at destination are less mobile and controllable by the taxpayers.

It is, also, highly desirable to exclude intra-group sales from this indicator, because the enormous potential that it engenders for having recourse to “transfer prices”.

As concerns the possibility of accurate measurement of the indicator, one should mention the problems engendered by the correct identification of the place of sale for some services, intangible property and electronic commerce, as well as by the way the sale of an intermediary product should be taken into account: should one choose the place of its actual sale or, rather, the place of sale of the final product in which it was incorporated?

The concrete choice among all these microeconomic factors is likely to trigger important divergences between the Member States, because the use of factors based on origin (labour and capital) will yield greater budget revenues for the countries with excess production relative to consumption, while the choice of sales (measures at the place of destination) favours the countries with large consumption markets. In principle, from the standpoint of equity considerations, origin-based factors should be privileged, because in accordance with the origin principle of international taxation (applied by the majority of Member States), the source of revenue is considered to be the place where the production factors generating the company’s revenues operate.⁹⁶ Moreover, since the tax base attributed to a fiscal jurisdiction is taxed at the rate of that jurisdiction, CCCTB is already conceptually aligned to principle of the source of revenue.

In a very recent position statement, Eurochambres has strongly advocated an allocation exclusively based on microeconomic indicators.⁹⁷ This position is very telling, because the distribution of budget revenues in accordance with the chosen formula concerns, first and foremost, the states involved. The net preference of Eurochambres has thus to be linked to the fact that the opportunities for fiscal arbitrage which (to various degrees, depending on the chosen factors) the microeconomic approach engenders, and which can trigger competitive behaviours by Member States, raising the spectre of further reductions of the fiscal burden on the revenue of corporations, are completely absent in the case of the macroeconomic approach.

The alternative is represented by the **macroeconomic approach**, based on indicators determined at the level of Member States (e.g., GDP). The European Commission seems to lean towards this approach, and the preferred indicator in this case would be the VAT receipts.

⁹⁶ Christoph Spengel, Carsten Wendt: *A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: Some Issues and Options*, Oxford University Centre for Business Taxation, WP 07/17, 2007; p.12

⁹⁷ xxx: *Company Taxation – complement the freedoms of the Single Market to foster the growth of European businesses*, Eurochambres, Position Paper 207, October 2007; p.4

An advantage of this approach is that it completely eliminates the incentives perceived by companies to relocate their activities in such a manner as to minimize the taxes paid, hence an important source of investment decisions distortions. Also, fiscal supervision by the authorities is greatly facilitated, been exercised on the basis of publicly available statistical data, and the compliance costs for taxpayers are absent.

The big problem with this approach is that the connection between the economic activity undertaken by a taxpayer in a certain fiscal jurisdiction and the amount of the tax paid by the taxpayer which reaches the said jurisdiction is very weak, if non existent, which makes this solution very impractical from the standpoint of equity considerations and, ultimately, also politically. Secondly, this approach does not only eliminate tax competition, but may also encourage tax rate hikes, because they can no longer negatively affect economic activity in the fiscal jurisdiction which has recourse to such measures (even if it affects it at the level of the whole Union). Finally, the utilisation of these factors raises dramatically the exigencies linked to the accuracy of the statistics employed.

It must also be decided if the allocation according to macroeconomic factors will be operated towards all Member States or solely towards those where the group subject to the consolidated taxation undertakes economic activities. In the former case it would mean that all company groups to which the CCCTB applies are subject to the same average tax rate irrespective of where they operate, which is equivalent to a complete harmonisation of tax systems, even if a *sui generis* one.⁹⁸ In the latter case, however, complex problems would emerge concerning the determination of what is sufficient for a company to be considered as “operating” in a certain fiscal jurisdiction and, moreover, the opportunities for fiscal arbitrage by companies would increase exponentially.⁹⁹

The choice of VAT as an allocation factor is a particular version of the macroeconomic approach. Pleading in its favour is the advantage of a very easy administration, because the largest part of the required information exists already: EU budget rules require that a part of VAT receipts be surrendered to the common budget, hence there are comparable reportings for this indicator across the whole Union. Also, it would not require the recourse to specific formulae according to the sector of activity, because it applies in the same manner to all sectors. If however, for the sake of simplicity, one will choose the current legal regime of VAT, problems may arise in connection with the way of treating the sectors which are VAT-exempt or to which such a tax does not apply (the most important case being that of financial services). The choice of VAT as allocation factor also eliminates the incentives for minimising the fiscal burden by altering the way subsidiaries are being financed (leading to a shift from lending to equity financing). Finally, because value added is the result of the action of both capital and labour, VAT has the great advantage of combining within a single indicator the two microeconomic factors which are essential for carrying out economic activities, weighted implicitly,

⁹⁸ Ana Agundez-Garcia: *The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: A Review of Issues and Options*, DG TAXUD, Taxation Papers, Working Paper no.9, October 2006; p.40

⁹⁹ Ana Agundez-Garcia: *The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options*, DG TAXUD, Taxation Papers, Working Paper no.9, October 2006; p.42

through the specific contribution that each of them brings to the generation of new value (labour – two thirds and capital – one third).

Systems for the apportionment of tax bases exist and operate since almost a century in the USA (among its states), Canada (among provinces) and Switzerland (among cantons), but this precedent does not only augur well for their introduction in the EU: the existing systems tend to show a relatively high degree of approximation (being often based on rough estimates). This engenders a certain inequity, which can be accepted as long as the tax rates of each state of the USA (Canadian province or Swiss canton) are relatively low; the variation of tax rate from one state to another is limited; and there is a federal budget, larger than local budgets, which can mediate important revenue redistributions within the said federations. None of these circumstances exists in the case of the EU, which raises considerably the stake of the chosen redistribution rules and diminishes the availability of Member States to accept them.

The precedents existing in extra-Community countries are, nonetheless, a source of inspiration for the formula to be chosen and for gauging the pros and cons of the inclusion of various factors under its realm.

The allocation key used in the United States comprises three factors, equally weighted (according to the so-called “Massachusetts formula”): sales, payroll and capital. The individual states have the latitude of altering the weights of these factors (which they often do by increasing the weight of sales)¹⁰⁰ and even the definition of the tax bases. In some sectors of activity (transports, radio and TV broadcasting, financial services, professional sports and others) different formulae apply.

In Canada, there is a generic formula uniformly applied by all provinces, in which are included, with equal weights, payroll and sales (at destination). Distinct formulae are applied to financial and transportation services, with further adjustments according to the types of such services. In Switzerland, too, allocation formulae differ from one sector to another. In manufacturing, the allocation factors applied are property value and payroll.

The devising of specific formulae for some sectors is to be expected in the EU as well, but so far the only sector singled out expressly by the Working Group for a particular treatment is that of financial services.¹⁰¹ Constructing distinct formulae for particular sectors may be justified in order to avoid major distortions if the existing factors are irrelevant for the said sector(s). On the other hand, applying special formulae increases the complexity of the exercise, as it may require the splitting of an already consolidated tax base, this time according to the types of activities undertaken, rather than depending on the legal personality of the group members.

In the light of these experiences, it seems unavoidable that the chosen formula will contain several factors (without excluding a combination of micro and macro indicators) and will have different versions for some sectors of activity. A more comprehensive coverage of factors in the formula has the advantage of accommodating the interests of

¹⁰⁰ Antonio Russo: *Formulary Apportionment for Europe: An Analysis and A Proposal*, INTERTAX, 33:1, 2005; p.3

¹⁰¹ Jack M Mintz: *Europe Slowly Lurches to a Common Consolidated Corporate Tax Base: Issues at Stake*, Oxford University Centre for Business Taxation, WP 07/14, May 2007; p.6

more countries and of satisfying, even if only in part, several of the requirements mentioned above.

This being said, any allocation formula has an inherent shortcoming, in the sense that it may make an unprofitable investment advantageous for a company, if this gives it the possibility that a part of its tax base be taxed in a low-tax state. It is true, however, that these losses of economic efficiency are generated by those allocation factors which satisfy equity considerations to a greater degree, so that a trade-off between the two may be considered acceptable.

Another issue that needs to be sorted out pertains to the **way of reflecting in the consolidated tax base the extra-Community activities of taxpayers**. In this respect, the experience of other countries are not relevant, because the USA, as well as Canada, deal with international taxing issues by treaties concluded at the federal level and directly applicable to all the members of the federations. In the EU, however, the starting point is different, because each Member State has its own set of bilateral treaties dealing with taxation issues, and the way of taxing the revenues derived by their own nationals in other jurisdictions, as well as those accruing to foreigners in their own jurisdictions differs as well from one Member State to another. The optimal solution in these circumstances would be to surrender to the Community level the prerogative of concluding international taxation treaties, but this seems to be too ambitious a hypothesis. Alternative solutions may, of course, be imagined, but they can be only suboptimal. It is, thus, possible to apply the common tax base only to revenues obtained within the EU, but in this case a clear delineation of revenues and expenditures must be done according to whether they pertain to activities undertaken on the Community and extra-Community territories, respectively, and the right to tax the revenue obtained in third countries must be left with the Member State where the group member obtaining this revenue is incorporated. Any solution alternative to the multilateralisation of the international treaties remains very vulnerable to the tax avoidance practices of the taxpayers. These could reorganise their activities in such a manner as to render the revenues originating from extra-Community investments taxable in the Member State with the most advantageous rules.

- C. **European Corporate Income Tax (EUCIT)**: theoretically, there are several ways in which such a tax could start operating: as a replacement of the corporate income taxes levied in each Member State; as a tax levied only on the revenue of corporations operating in more than a single Member State; or as a tax additional to those levied by Member States on the profits of the companies located in their own jurisdictions.

Each of these versions has its own specific implications.

- **an European tax replacing national taxes** would obviously eliminate any kind of tax competition among Member States, while also limiting to a large extent the tax avoidance possibilities arising from the manipulation by the multinational corporations of the tax bases located in various countries. As concerns the destination of the proceeds of such a tax, there is either the possibility of it being transferred to the Community budget or that of its distribution among the Member States. From a political point of view, the former option seems completely unfeasible, as it would imply a true “leap forward” on the path of fiscal federalism, which few Member States, if any, are prepared to consider. The other

possibility requires the determination of a distribution modality, among the Member States, of the revenues collected, which is a very complex process.

- levying the „European tax” solely on the revenues of multinationals might engender some reductions of the compliance costs, but would induce very serious complications pertaining to the concrete identification of the taxpayers concerned. On the other hand, leaving at the latitude of taxpayers the choice between the two types of taxes is likely to engender competitive behaviours by the Member States, which might be tempted to adjust their corporate income tax regimes in such a way as to render them more attractive than the EUCIT.

- the additional levying of a European tax should apply to tax bases defined as closely as possible in the same way as those of each Member State where the company concerned is paying its taxes. In itself, this can only be – for the problems engendered by the existence of a large number of different national tax systems (high compliance costs, tax competition, large possibilities of tax avoidance/evasion) – a partial solution and, even then, only in particular circumstances: for instance, if the highest part of the corporate income tax would be levied at this level and the national tax rates would not vary too much. It thus appears that this version is more significant from a budgetary standpoint, in the sense that it might allow an important increase of the resources of the Community budget, making it apt to support more and more elaborate common policies.

In the 2001 Commission Communication, only the first option was taken into account, and the option was suggested that the revenues collected be transferred to the EU budget.

On the other hand, it would become necessary to set up a new, pan-European, fiscal administration, over and above the national ones, and all agreements with fiscal components concluded by the Member States with third countries would need to be renegotiated by the Union in its entirety. The alternative of mandating the national fiscal administrations to collect this tax has shortcomings, because their incentives for an effective collection would be very limited. The consequences of the lack of incentives are well documented in the case of Germany, for instance, where the *Länder* manage taxes destined in their largest part to the federal budget, which, according to some studies, leads to a loss of revenues of some 15%.¹⁰²

From all options explored by the Commission, EUCIT had, obviously, the least chances of being adopted, its mentioning being more of a theoretical exercise, for the sake of exhaustivity. Recently, however, the Commission has re-launched the debate on a “European tax”, this time in the framework of an exercise dedicated to the restructuring of the Community budget from the standpoint of its revenue sources, an exercise mandated by the Inter-Institutional Agreement which enshrined the adoption of the multiannual financial perspectives for the period 2007-2013. The on-going reflection has this time as object the option of the co-existence of a European tax with the national ones.

¹⁰² Clemens Fuest: *Corporate Tax Coordination in the European Internal Market and the Problem of “Harmful Tax Competition”*, University of Cologne, December 2002; p.11

D. **The “traditional approach”**¹⁰³: the harmonisation of taxation rules by establishing a single system for determining the tax base, applicable on a compulsory basis in all fiscal jurisdictions and replacing the national systems.

Relative to the option B. above, this has the advantage of not being vulnerable to the tax avoidance manoeuvres of taxpayers. The mandatory character makes it unlikely to meet the acceptance of the Member States.

The developments in the area of company law, linked to the institution of the mandatory drawing up of annual balance sheets of listed companies according to international accounting standards (*ex-IAS*, now *IFRS – International Financial Reporting Standards*), constitute a facilitating factor for a possible implementation of this radical way of harmonising the corporate income tax base.

The implications of the various methods of tax base harmonisation examined by the European Commission can be explored based on the degree to which they can satisfy a number of important requirements, that is:

- *neutrality*, which presupposes the non-distortion of the international allocation of resources as a result of the tax system applied;
- *the existence of externalities*, namely the averting of tax competition (and, consequently, the weakening of incentives for tax rate cuts);
- *simplicity*, leading to the minimisation of the administrative formalities and of compliance costs;
- *diversity*, which should lead to the application of those tax systems corresponding best to the preferences of citizens from each jurisdiction.

A synopsis of the extent to which the options reviewed by the European Commission meet the above-mentioned requirements is presented in the table below.

Criteria ⇒ Proposal ↓	<i>Neutrality</i>	<i>Externalities</i>	<i>Simplicity</i>	<i>Diversity</i>
HST	+	+	+/-*	0
CCCTB	+	+	+/-*	-
EUCIT	+	+	+	-
Complete harmonization of the tax base	+	+	0	-

* *The reduction of the variability of tax rules is a plus, but the application of tax base apportioning systems generates difficulties.*

¹⁰³ By analogy with the methods of eliminating the obstacles to the free movement of goods deriving from standards and technical norms.

The first two options are considered the most feasible because they do not replace the national systems (which have often been configured in such a way as to support particular interests), but can operate in parallel. Even relative to the first two options, however, the Member States have expressed their skepticism, if not their outright rejection. Among the arguments used by the Commission in order to overcome these reservations, prominently featuring is the one that harmonization measures reduce the risk that various national fiscal rules of the Member States be declared restrictions incompatible with the Treaty by the ECJ.

VI.4. Specific measures relative to the tax base, meant to correct some of the most obvious shortcomings

Only a small number of Directives aiming at this goal could be adopted so far, and at large intervals, after being blocked for a long time (thus, the Directives adopted in 1990 had been submitted by the Commission about 20 years before) and after many other proposals had to be withdrawn.

A. Directive 69/335 (the “*Capital Duty Directive*”) provides for the abolition of any charges levied on any mergers or business transfer operations.

B. Directive 90/434 (the “*Mergers Directive*”) is meant to facilitate mergers and other types of reorganisation (break-ups, share swaps, asset transfers¹⁰⁴), by allowing the postponement of the payment of taxes until the subsequent occurrence of a taxable event. Thus, the capital gain arising from the transfer of an asset is not taxed as of the moment when this corporate restructuring operation takes place, but only when it is sold subsequently. The Directive aims to avoid the emergence of a tax obligation solely as a result of cross-border corporate restructuring operations. Another provision of the Directive aims at ensuring that the fiscal advantages of a merger, such as the possibilities of cross-border compensation of losses and the corresponding reduction of the tax base of the resulting entity, will not be frustrated by discriminatory measures applied by the national fiscal authorities.

Although undoubtedly useful this Directive nonetheless has serious limitations. It does not cover all types of companies, all kinds of taxes (for instance, transfer charges applied by some Member States), nor all restructuring modalities possible: for instance, partial divisions (whereby some activities are split up and reorganised independently, but the original entity continues to exist) are not mentioned, and the conversion of branches into affiliates may endanger the compensation of losses accumulated prior to the conversion. Also, the provisions of the Directive are not applicable for those companies not subject to corporate income tax.

Significant divergences have arisen as concerns the way the Directive was transposed in the various national legislations. Some Member States have attached additional conditions in order to grant the benefit of the application of the Directive, such as the mandatory holding of the shares acquired or swapped for a period of several years and, worse still, have significantly restricted the possibility of transferring the losses of an acquired entity towards the acquiring entity.

¹⁰⁴ That is, operations which are resorted to when a cross-border merger is not possible.

In February 2005, ECOFIN approved an amendment mitigating some of these problems, by extending the range of companies to which the provisions of the Directive apply and reducing to 10% (as opposed to 25%, previously) the threshold of shareholding which gives access to the provisions of the Directive.

C. Directive 90/435 (the “*Parent-Subsidiary Directive*”) has several goals:

- non-discrimination from a fiscal standpoint of transactions among companies incorporated in different Member States relative to the transactions occurring among corporate nationals of the same state;
- avoiding the double taxation of dividends distributed between parent companies and their subsidiaries from other Member States;
- simplification of the rules and administrative formalities and, consequently, the alleviation of the cash flows problems so generated for companies.

The Directive abolishes the withholding taxes on dividends distributed by subsidiaries to their parent companies incorporated in other Member States, and the state of residence of the parent company must explicitly opt for one of the two systems of taxation, namely the *territorial* one, based on the exemption from taxation of income obtained abroad (hence, of the profits recorded by their subsidiaries located on the territories of other Member States and subject to taxation in the host country) or the *global* one, based on fiscal credits for taxes paid abroad by the respective subsidiaries.

This Directive also has limitations which prevent it from solving in an optimal manner the numerous problems which rendered it necessary in the first place:

- it only applies to corporations organised in particular forms, explicitly mentioned in the text of the Directive;
- both the company distributing the dividends and the one receiving them have to have their fiscal residences in different EU member countries;
- only direct shareholdings are covered, which reduces the attractiveness of fiscal credits relative to the exemption, because it is not possible to obtain credit for the tax paid by a “daughter-company” abroad, corresponding to dividends it received from its own subsidiaries;
- it was only applicable for individual shareholdings of over 25% of the share capital of the entity distributing the dividends; several Member States have decided to unilaterally reduce this threshold, which was eventually set, following the revision of the Directive’s original version, to 15% in 2007, going down to 10% in 2009;
- some Member States asked for and managed to secure transition periods for the full application of the Directive’s provisions; this was initially the case of Spain and Portugal, but subsequently five of the Member States which acceded in 2004 obtained the same treatment, which required another formal amendment of the Directive.

D. Directive 2003/49 (the “*Interest-Royalty Directive*”), entered recently into force (1 January 2004), eliminates withholding taxes on interest and royalties paid between related companies located in different Member States. Several possible shortcomings are thus averted: the risk of double taxation of interest and royalty; the administrative formalities, time- and resource-consuming, required for the avoidance of double taxation; cash flow problems engendered by the time elapsed between the payment of taxes and their subsequent regularisation so as to avoid double taxation.

The Directive also includes provisions meant to avoid the abusing of its stipulations, with a view to escape normal tax obligations:

- the company paying interest and royalties must have a “continuous and effective connection” to the economy of the country where it is incorporated;
- the company paying interest and dividends has to pay corporate income tax at a rate not inferior to the one generally applicable (hence, should not benefit from a privileged fiscal treatment);
- the amounts paid as interest or royalty should not exceed a reasonable level, comparable to the one payable in a transaction between unrelated parties.

E. Cross-border compensation of losses

An important obstacle to the free movement within the internal market stems from the fact that most Member States, while accepting the reduction of the taxable income of a parent company with the fiscal losses of its subsidiaries residing in the same jurisdiction, do not allow the same treatment if these subsidiaries are residing on the territory of other Member States. There are currently also numerous Member States which do not accept any fiscal compensation among the members of the same group of companies, irrespective of their place of residence: Belgium, Czechia, Estonia, Greece, Latvia, Slovakia and Hungary. Other countries allow this to occur by different modalities, in different proportions (varying between 50-100%), while others deny this possibility for losses recorded in other jurisdictions, which clearly amounts to a limitation of the right of establishment. Moreover, as literature has shown, the possibility of cross-border loss compensation is liable to weaken tax competition between different jurisdictions.¹⁰⁵

It was not yet possible to adopt a Directive meant to allow the cross-border compensation of profits and losses registered by the member companies of the same group. The Commission has identified this problem long ago and has initiated in 1991 a Directive proposal meant to correct it but, confronted with the Council’s reticence, was forced to withdraw it in 2001. As of today, national fiscal rules restrict the possibility of such a compensation. Under the best circumstances, it is only applicable:

- a) to the losses of foreign subsidiaries lacking legal personality, which may diminish the taxable income in the home country of the parent company;
- b) to the losses of affiliates incorporated abroad, but only for those losses stemming from the activity of the subsidiaries of these affiliates which are located on the territory of the home country of the parent company.

¹⁰⁵ Gaëtan Nicodème: *corporate tax competition and coordination in the European Union: What do we know? Where do we stand?*, European Commission DG ECFIN, Economic Paper 250, June 2006; p.24

There are, also, differences as concerns the minimum shareholding thresholds allowing compensation: 51% in Germany, 75% in Austria, Ireland and UK, 90% in Sweden, Finland, Portugal and Spain, 95% in France, 99% in Luxembourg and Netherlands, 100% in Denmark.

This issue has recently been brought back to immediate attention following a decision by the ECJ (the Case Marks & Spencer, December 2005) declaring incompatible with the Treaty the denial of the British company's possibility to compensate the losses recorded by group members located in other Member States (Belgium, France and Germany) by a corresponding diminution of its profits reported in the UK, *although the said subsidiaries had exhausted all possibilities accessible within their jurisdictions of residence for deducting or carrying forward the said losses.*

In 2006, the Commission issued a Communication presenting various options for the institution of a mechanism for the cross-border compensation of fiscal losses. Eurochambres, in a very recent position statement, expressed its preference for the scheme entailing a "temporary loss transfer", whereby the losses recorded by a subsidiary located in another Member State, which had been deducted from the financial results of the parent company, may be retrieved fiscally once the said subsidiary returns to profitability.¹⁰⁶

VI.5. Measures meant to counteract, at origin, *harmful tax competition*

The distinction between two types of tax competition, one acceptable, and the other justifying its countervailability, may look specious, but it can claim justifications not easy to ignore.

A first category of explanations is based on the existence of negative externalities. The citizens of democratic societies should enjoy the right to choose by themselves the size of the public sector that they prefer (hence, the part of GDP "recirculated" through the public budget), "but this does not mean that countries have the right to offer advantages to foreign investors to the detriment of the capacity of other countries to supply those services that their citizens wish"¹⁰⁷ An even more compelling case of negative externality is that of the tax evasion rendered possible by some instruments through which harmful tax competition comes about, such as the *offshore* tax havens, "endowed" with strong guarantees of banking secrecy.

Another category of justifications is linked to national equity considerations. Privileged investors tend to reside in countries offering a high level of public services, but refrain from equitably contributing to their financing by paying taxes in full. Their "defection" may need to be compensated by tax increases falling on the less mobile taxpayers, thus leading to a severely inequitable situation.

Finally, one should mention the justifications based on international equity considerations. From this perspective, tax competition may be likened to a sort of

¹⁰⁶ xxx: *Company Taxation – complement the freedoms of the Single Market to foster the growth of European businesses*, Eurochambres, Position Paper 207, October 2007; p.6

¹⁰⁷ Reuven S.Avi-Yonah: *Globalization and tax competition: implications for developing countries*, CEPAL Review 74, August 2001; p.65

“poaching”, whenever a country, making use of some particular kinds of fiscal incentives, triggers the transfer of foreign tax bases under its own jurisdiction.

There are, on the other hand, several generic objections to the principle of countering any form of tax competition, which should not be neglected. This is the case of:

- deference for national sovereignty: a country ought to enjoy the right to configure its tax system any way it likes;
- restricting tax competition can only lead to other forms of competition for attracting investments, potentially even more harmful (one can recall, in this vein, the controversies triggered by the so-called “social dumping” or “ecological dumping” practices, reproached to countries suspected of attracting foreign investments thanks to their lack of decent norms of social protection and/or environment protection);
- offering attractive tax regimes may be the only way for neutralising exogeneous disadvantages, such as the peripheral position of a country, in the sense given to this term by the “new economic geography”.

There is no scientific consensus on the theoretical definition of harmful tax competition, and the borderline between the two categories of tax competition is traced differently, according to the preferences of economists and political science scholars. The supporters of public choice theory are very little inclined to admit the existence of harmful tax competition cases.

The possible definitions cover a large range of concrete situations:

- tax competition becomes harmful if it undermines the capacity of a state to finance its essential public services;
- harmful competition is deemed to exist between two countries when an economic operator, distributing its tax bases between those two countries, may reduce its aggregate tax obligations below the level that would have prevailed if its entire tax base would be placed under the same fiscal jurisdiction;¹⁰⁸
- tax competition is harmful if the state engaging in such practices “deprives its competitor countries of tax bases without making an equivalent sacrifice”¹⁰⁹ (in terms of tax revenue losses).

The issue of harmful tax competition has firmly entered the Community agenda in the second half of the 1990s, mainly as a result of the time’s “fashion”. On the one hand, the liberalization of international capital movements and the explosion of foreign direct investments carried out by multinational corporations ever more apt to arbitrage among alternative locations have generated wide and imaginative attempts by host countries at attracting foreign investors, including through fiscal incentives. On the other hand, the moral connotation suggested by the term “harmful” has attracted the attention of the civil society, triggering the activism of many NGOs (e.g., Tax Justice Network) concerned by such issues as “tax havens” or “corporate social responsibility”, which contributed a lot to the enhanced sensitivity of public opinion. Moreover, there is the view, critically

¹⁰⁸ Bernard Grand: *L'évolution des systèmes de taxation dans l'Union Européenne*, Revue Française de Finances Publiques, no.68, décembre 1999; p.12

¹⁰⁹ Wolfgang Schon: *idem*, p.96

predicated on the notion that the European Commission relentlessly follows an agenda of ever expanding prerogatives for the Community, that this increased visibility of the issue provided the Commission with a platform for launching new harmonisation initiatives which, thanks to the recourse to the tactics of putting together “legislative packages”, could go beyond measures strictly linked to the countering of “harmful” tax competition.

Specialised writings on this matter have provided a series of criteria for distinguishing harmful tax competition from other forms of fiscal competition. They are all converging towards the idea that a harmful competition exists whenever a significant influence on the localisation of a business is exerted by means of a tax level significantly different from the one generally applicable in a country.

The concrete criteria, taken over by the Community *acquis* (in the wide sense of this word), are:

- i) granting a favourable fiscal treatment only to non-residents or in connection with transactions carried out by non-residents and/or the “ring fencing” of these fiscal advantages so as not to interfere with the domestic market and lead to the erosion of one’s own tax base.

In less rigorous terms, we may imagine a national economy carefully „ring-fenced”, so as not to miss a tax base, at the same time as one simultaneously engages in a sort of “fiscal dumping” so as to attract other tax bases.

- ii) granting tax incentives even in the absence of a real economic activity and of a substantial economic presence on the territory of the state dispensing them;
- iii) the existence of practices encouraging non-compliance with the fiscal legislation of other countries, such as:
 - rules for the determination of taxable profit of multinational groups departing from generally accepted principles (in the sense of their lack of exigence);
 - the absence of an effective exchange of information with the fiscal authorities of the investor’s home country and/or granting the investor special confidentiality terms.
- iv) fiscal advantages granted on a discretionary basis, such as administrative fiscal decisions lacking legal basis¹¹⁰ or tax rates/bases decided further to negotiations with the investor.

The aim of these measures is not identical, which complicates the choice of the method for gauging them and, eventually, countering them. If some such measures are destined to attract foreign direct investments, hence to favour employment and spill-over effects on the territory of the host country, others aim simply at attracting financial activities, solely in order to derive budget revenues (even if modest, they represent a plus, as they would not have existed in the absence of the incentives), and yet others may have no other

¹¹⁰ The practice of « private informal decisions », traditionally used in Belgium and Holland in order to render more “flexible” the implementation of domestic rules regarding transfer prices.

rationale than to curb the double taxation elements which would otherwise emerge as a result of the interaction between national fiscal systems.¹¹¹

The primary legislation of the EU does not provide a solid basis for incriminating harmful tax competition. On the one hand, as shown at the beginning of this paper, the ECJ has consistently refrained from accepting that the loss of budget revenues may justify exemptions from the rules and, on the other hand, the national treatment rule is not bypassed if foreign nationals enjoy a *more* (as opposed to a *less*) favourable treatment than the locals.

Opinions were expressed to the effect that Article 96 TEC might provide the legal coverage for combatting harmful tax competition : “Where the Commission finds that a difference between the provisions laid down by law, regulation or administrative action in Member States is distorting the conditions of competition in the common market and that the resultant distortion needs to be eliminated [...] the Council shall, on a proposal by the Commission, acting by a qualified majority, issue the necessary directives.” So far, this path has not been explored concretely.

Finally, some of the fiscal measures generating harmful tax competition are, without doubt, incompatible with the Community State aid rules (Art.87 TEC). The risk of having them investigated from this perspective is probably the main reason why Member States have finally acquiesced to instill, even if in a non-conventional and diluted manner, a certain discipline into this area.

Under these circumstances, a political document was adopted by the Council and the Member States on 1 December 1997: “the Code of Conduct for Business Taxation”. This was enshrining several commitments of the signatories:

- “standstill” (non-introduction of new harmful measures);
- “rollback”: the elimination of harmful measures or their adjustment so as to eliminate their harmful aspects;
- permanent reciprocal information on measures adopted or in the process of being adopted;
- establishment of a Working Group mandated to assess, from the standpoint of their impact, the fiscal measures concerning corporate incomes utilized by the the Member States.

The Code is an example of *soft law*, which has important particularities relative to a typical Community regulations. Its provisions cannot be enforced, in case of non-compliance of a Member State, by having recourse to the ECJ hence it can be considered as voluntary. The explicit political commitment of the parties compensates only in part for the absence of a legal obligation. Secondly, the Code is not a Community instrument in the narrow sense of the word. Its negotiation took place in an inter-governmental framework, and the activity of the Working Group, although it involved the European

¹¹¹ Stephen Bond, Lucy Chennells, Michael P. Devereux: *Corporate Tax Harmonisation in Europe: A Guide to the Debate*, The Institute for Fiscal Studies, London, 2000; p.38

Commission as well, had essentially the same nature. To the same direction points the decisionmaking modality inside the Working Group: by consensus.¹¹²

In March 1998 the above-mentioned Working Group for the implementation of the Code was set up. Made up of high-level officials from the Member States (State Secretaries or the highest-ranked civil servants of the Finance Ministries), this came to be known as the “Primarolo Group”, after the name of the British representative who chaired it. The Group has debated on 271 fiscal measures, reaching agreement for designating 66 of them as harmful. Over a third of these (26) was referring strictly to aspects of the tax systems of territories dependent of or associated to the UK or Netherlands. The remaining 40 measures, those really relevant for the stance of Member States in the area of harmful tax competition, are very unequally distributed among countries. The majority of these measures were applied by just four Member States (Belgium, Ireland, Luxembourg and the Netherlands), while the large Member States did not apply, in aggregate, more than 6 such measures. A possible explanation for this situation is that smaller countries have more reasons to grant selective fiscal incentives, but this is not validated by the observation that in all Nordic countries (Denmark, Finland and Sweden) combined only one such measure was identified, which led to the hypothesis that the large Member States “exercised a disproportionate influence in the drawing up of the list”.¹¹³

As concerns the nature of the measures incriminated, most of them (46) have been identified on the basis of criteria ii) and iii) above and were dealing with financial services, offshore companies and intra-group services. It is thus the case of measures typical for the intent to attract tax bases rather than actual economic activities, with spillover effects in the host country. This is compatible with the use of the Code as an instrument for preventing the erosion of the budget revenues of some countries as a result of the measures adopted by other countries, rather than as a means to avoid the distortion of investment decisions.¹¹⁴

The Group submitted the report with its findings in November 1999, alongside no less than 54 dissenting opinions expressed by the various Member States with regard to the list of the measures deemed as harmful. Because of this, the list was never formally endorsed. However, the ECOFIN Council of 27 November 2000 agreed that all measures identified as harmful be eliminated or adjusted until 31 December 2002, with a grace period for the incentives in place, granted to specific companies, until 31 December 2005.¹¹⁵

Among the most visible progresses engendered by the Code one can mention:

- the abandonment by Ireland of the dual system consisting of a special profit tax rate of 10% applicable to manufacturing and financial services activities and a generic rate of 32%; the system was replaced by a single rate of 12.5%, generally applicable;

¹¹² Philippe Cattoir: *A history of the “Tax Package”. The Principles and Issues Underlying the Community Approach*, Taxation Papers, DG TAXUD, Working Paper no.10, December 2006; p.4

¹¹³ Henk Vording, Koen Caminada: *Tax co-ordination: crossing the Rubicon?*, Kluwer, Deventer, 2001; p.5

¹¹⁴ William Bratton, Joseph McCahery: *Tax coordination and tax competition in the European Union: evaluating the Code of Conduct on Business Taxation*, Common Market Law Review 38:2001; p.686

¹¹⁵ The ECOFIN Council of 19 March 2003 agreed to extend the application of some of the existing tax privileges even beyond end-2005.

- Belgium amended its fiscal regime for “co-ordination centres”, which provided for exemptions from some taxes and a more favourable way of determining the tax base for such entities set up by large transnational corporations; between 1992-96, 379 such centres had been established, of which 288 were still active in 2002;
- the Netherlands has revised its system, in place since over 50 years, of private decisions concerning the allocation of taxable profits;
- Denmark has limited the exemptions granted in connection with the withholding tax on dividends paid to non-residents.

It is not at all obvious that the results achieved are compatible with the original motivation. In particular, since EU member countries are required to apply the same tax rate to activities that are very mobile internationally, as well as to less mobile activities, the competition for attracting mobile tax bases may lead them to reduce the general level of business taxation, as it actually happened in the above-mentioned case of Ireland. Yet, if a reduction of the tax rate on mobile activities might generate increased tax revenues thanks to a widening of the base, applying the same recipe to less mobile bases has, most likely, opposite effects on the budget revenues. Summing up, one can question the economic rationality of the principle of non-differentiation of tax rates in accordance to the types of activities, because an alignment to the (high) rates previously applicable to less mobile bases may trigger the migration of the respective activities (possibly, even outside the EU), while an alignment to the (low) levels previously applicable to the mobile bases results in a loss of budget receipts.¹¹⁶

VI.6. Measures linked to the application of “anti-abuse” instruments in the Member States

For reasons which will be further detailed below, a corporate taxpayer with transnational activities may be subjected to a large variety of fiscal measures which raise its costs, resulting in an effective rate of taxation far in excess of the nominal rate. Apart from the fact that this effect comes to be felt by a taxpayer already afflicted by high transaction costs, because it has to deal with several different sets of rules and fiscal administrations, the great existing potential for vexing measures inherently generates uncertainty. Under these conditions, some potential investors may forego the choice of acting also outside their national frontiers or may be tempted to engage in unproductive investments in fiscal consulting services and offshore activities, up to the level where the marginal cost of these “fiscal planning” activities equals the marginal benefit of the tax savings so obtained.

Double taxation. The fiscal systems have been designed and have evolved within (relatively) closed economies. This is why it becomes possible that one and the same cross-border economic activity be taxed twice, by different states.

¹¹⁶ Stephen Bond, Lucy Chennells, Michael P. Devereux: *Corporate Tax Harmonisation in Europe: A Guide to the Debate*, The Institute for Fiscal Studies, London, 2000; p.27

There are two kinds of double taxation of the corporate income. First, the profits of a company may come to be taxed twice: once, through the corporate income tax and, additionally, through the taxation of the personal revenues of the shareholders, which include dividends paid. In EU-15, except Ireland - where this kind of double taxation is the norm (as in Romania, a singular case from this point of view among all New Member States) -, all countries make use of some mechanism for mitigating this problem, which typically takes one of the following forms:¹¹⁷

- Imputation or fiscal credit systems: what has been paid as corporate income tax will be explicitly taken into account when the personal income tax is assessed and is deducted from the latter; this was the prevalent approach in France, Italy, Portugal, Spain and the UK, but there are important differences from one country to another as concerns the percentage size of the fiscal credit allowed. Among the New Member States, only Malta applies an imputation system.
- Shareholder relief schemes : these entail the reduction (or even exemption) of the tax applied to personal incomes deriving from dividends, without however linking it explicitly to what had been paid as corporate income tax – e.g., lower tax rate (even zero in Greece and the Netherlands as well as, among the New Member States, in Latvia and Slovakia) for revenues derived from dividends; exemption of part of the dividends from taxation etc; apart from the above-mentioned countries, such schemes are employed in Austria, Belgium, Denmark, Germany and Luxembourg, as well as in a majority of New Member States: Cyprus, Czechia, Lithuania, Poland, Slovenia and Hungary.
- Dual taxation : all capital income, irrespective of its source and beneficiary, is taxed, once and for all, at a relatively low rate, while labour income remains subject to progressive taxation; this system is applied in Finland and Sweden.

The problem with all these mechanisms is that their benefits can only be guaranteed to the own fiscal residents, i.e., something which – in particular circumstances – may discriminate against non-resident shareholders, thus impairing the free movement. One of the first direct tax harmonisation initiatives of the Commission, submitted already in 1975, targeted precisely this aspect, but had to be withdrawn in 1990 because of the lack of support from the Member States. On the other hand, the stringency of this problem is dwindling, as several Member States (Germany, Ireland, UK) have given up the tax credit systems.¹¹⁸ According to some opinions, the gradual abandonment of the imputation system is also the result of ECJ rulings which sanctioned the discriminatory treatment of non-resident shareholders, against a background whereby ensuring full equality of treatment in the context of imputation systems is excessively complicated, as it would entail the cross-border payment of tax credits and the granting of exemptions for dividends received from abroad.¹¹⁹

¹¹⁷ Sijbren Cnossen: *Tax policy in the European Union. A review of issues and options*, 2002; p.50-52

¹¹⁸ Stephen Bond, Lucy Chennells, Michael P. Devereux: *Corporate Tax Harmonisation in Europe: A Guide to the Debate*, The Institute for Fiscal Studies, London, 2000; p.13

¹¹⁹ Rachel Griffith, Alexander Klemm: *What has been the Tax Competition Experience of the Last 20 Years?*, The Institute for Fiscal Studies, WP 04/05, February 2004; p.24

Secondly, the profits distributed to foreign shareholders (natural persons or corporations) may come to be taxed both in the country where they have been generated and in the country where the shareholder resides.

The elimination of double taxation within the EC is a goal explicitly stated in the text of the Treaty (Art.293). This goal can only be fulfilled in its entirety if all Member States were to adhere to a single taxation principle. In international fiscal practice, there are two such principles: the one of the residence and that of the revenue source, respectively. According to the residence principle (the “global system”) are subjected to taxation all revenues earned by residents, irrespective of the place where they had been generated. This system ensures the equal tax treatment of residents, irrespective of where they invest, which confers more equity to those fiscal systems, because they derive a better capacity to tax according to the ability to pay of their taxpayers. In keeping with the revenue source principle (the “territorial system”), taxes are levied where incomes are generated. The territorial system is reputed as superior to the global system from the standpoint of its simplicity and administrative convenience. Also, it ensures non-discrimination between residents and non-residents, who are subjected to the same fiscal burden for their investments in a certain fiscal jurisdiction.

The two above-mentioned principles differ from the standpoint of their implications in terms of fiscal neutrality. The revenue source principle ensures the neutrality of capital import, whereas the residence principle does the same for capital export. Consequently, each of these systems generates some sort of distortion. In literature it is widely held that the distortions induced by the residence principle are less serious, because the sensitivity to tax incentives is greater for capital users (the corporations) than for capital providers (the shareholders).¹²⁰

It should be mentioned that the application of both systems is confronted with serious practical difficulties. The revenue source principle requires the breakdown of the tax bases of a group of companies by host countries, which should ideally happen on the basis of rigorous principles, able to avoid self-interested manipulations on the part of corporations. This often results in disputes between fiscal authorities and taxpayers, triggered by the tax base adjustments operated by the former. The residence principle, in order to be applied in a genuine way, would require the award of full taxcredits for the taxes paid at source, in other jurisdictions. This engenders a serious difficulty: the fact that the home (residence) state becomes conditioned, in the implementation of its own fiscal policy, by the level of taxes levied in the host countries. In practice, the home states refrain from granting tax credits for the part of the tax paid at source which exceeds the locally applicable tax rate.

Both above-mentioned systems are used in the EU, but to varying extents from the standpoint of the types of taxes to which they apply. Corporate incomes are more frequently taxed in accordance with the revenue source principle, while personal incomes (including those stemming from dividends, interest and royalties) tend to be taxed according to the residence principle.

¹²⁰ Sijbren Cnossen: *Tax policy in the European Union. A review of issues and options*, 2002; p.15-16

The adoption of a single taxation principle for corporate income within the EU could not take place because of diverging interests: while the capital exporting countries are favoured by the residence principle, the capital importing ones derive advantages from the revenue source principle.

Under such circumstances, there can only be a second best solution, consisting of the conclusion of *treaties for the avoidance of double taxation*. By these treaties, the signatories divide their taxing rights, either by granting tax exemptions in one of the countries, or granting tax credits in a country corresponding to the taxes paid in the other (or by any combination of the above-mentioned methods). In this way it can also be ensured that the decision concerning the location of investments will be as neutral as possible from a fiscal standpoint.

The treaties for the avoidance of double taxation operate with one of the following two important rules:

♦ *The rule of tax credit* (corresponding to the „global system”), which entails the award, by the fiscal authorities of the residence (home) country, of credits for the taxes paid in other jurisdictions. Most often, the countries applying this rule also grant the possibility of postponing the payment of the tax corresponding to the profits obtained abroad (if they are re-invested) until the moment of their repatriation as dividends. The proper implementation of this rule is, however, dependent on the availability of the source-countries of revenues to co-operate with the authorities of the residence country of the investor. Moreover, if tax payments effected in another jurisdiction exceed the level of what would have been owed had the tax been paid in the residence country, the tax credit is limited to this latter (lower) amount. Among EU countries, this rule is applied by the UK, Ireland, Greece and Spain.

♦ *The exemption rule* (corresponding to the territorial system), according to which the revenue from external sources which has already been taxed is no longer included in the tax base for the purpose of taxation by the residence country. The application of this rule has limitations as well: for instance, in order to be eligible for an exemption, the company concerned must control a substantial part of the capital of the company whose capital is taxed at source and/or the tax paid at source must exceed a certain minimum limit. About half of the OECD member countries adhere to this rule, and so is the case for a majority of EU member countries.

On a global scale, the number of treaties for the avoidance of double taxation has recorded a spectacular increase, reaching 2118 in 200, as opposed to just 1150 in 1990 and 700 in 1980. The majority of the treaties concluded in the world (including those among EU Member States) are based on a “model convention” drawn up by the OECD.

TCE Art. 293 requires that Member States enter into bilateral tax treaties for the avoidance of double taxation “so far as is necessary”. The practical fulfillment of this obligation is affected by some weaknesses. The said treaties are inter-governmental instruments, being thus situated outside the jurisdiction of the ECJ. Moreover, there are no bilateral treaties between all EU members, and the existing treaties are sometimes considerably different one from another.

Opinions were expressed according to which these treaties should include most favoured nation (MFN) clauses¹²¹, because the nationals of a signatory state A may come to be treated less favourably by the co-signatory state B than the nationals of state C, which are benefiting of a more advantageous treaty concluded between states B and C. The main objection against including such a rule is that the provisions of such treaties are often the result of very complex trade-offs. The suggestion to include an MFN provision reflects to a large extent the frustrations felt by some Europeans as a result of the fact that double taxation avoidance treaties concluded by some Member States with the United States are more favourable than those concluded with other Member States, which has been qualified as “scandalous” by the former chairperson of the Economic and Monetary Affairs Committee of the European Parliament, Christa Randzio-Plath.¹²² The applicability of this rule is currently the object of a case submitted to the ECJ: a German taxpayer residing in the Netherlands claims the benefits of the provisions of the treaty for double taxation avoidance concluded between the Netherlands and Belgium, which is more advantageous to him than the treaty between the Netherlands and Germany.¹²³

In order to correct these problems, two options are being envisioned: devising a “Community” version of the Model Convention for the avoidance of double taxation, the provisions of which would become mandatory for the bilateral treaties concluded among Member States; or the conclusion of a multilateral treaty for the avoidance of double taxation. None of these options stands good chances of getting implemented in the near future because of the reticence shown by Member States.

One of the most delicate double taxation issues, which the bilateral treaties cannot solve in a satisfactory manner, pertains to the right of fiscal authorities to operate adjustments of the taxable income in order to combat “transfer prices” practices. Such “upwards” adjustments operated by a fiscal authority have to be acknowledged and compensated (by a corresponding “downwards” adjustment) by the other fiscal authority, failing which a double taxation situation occurs.

Fiscal «planning», «avoidance» and «evasion»

The differences among national tax regimes render possible or facilitate practices by which taxpayers may diminish their tax payments. This kind of reaction by taxpayers to a fiscal environment perceived as too burdening may have considerable effects on budget revenues. According to a study based on data collected for OECD countries, over 65% of the additional receipts expected as a result of a unilateral tax increase is likely to be lost due to practices of artificial profit transfer and its reporting in other fiscal jurisdictions.¹²⁴

In this manner, transnational corporations may use public goods supplied by some countries, while avoiding to pay for them by honouring their tax obligations in full. This unambiguously negative effect of such practices is somewhat mitigated by the part they

¹²¹ Pasquale Pistone: *An EU Model Tax Convention*, EC Tax Review 2002-3

¹²² Christa Randzio-Plath: *Company Taxation in an Enlarged Union. Challenges and Options*, European Conference on Company Taxation, Rome, 6 December 2003

¹²³ Albert J. Radler: *Recent Trends in European and International Taxation*, Intertax, Vol.32, No.8/9, 2004

¹²⁴ Michael P. Devereux: *Taxes in the EU New Member States and the Location of Capital and Profit*, Oxford University Centre for Business Taxation, WP 07/03, January 2006; p.6

play in reducing the intensity of tax competition: these practices may attenuate the need to carry out investments in low tax jurisdictions.

♦ *Transfer prices* are artificial prices for intra-firm transactions, meant to minimise tax obligations as a global scale. By manipulating prices, a transfer of profits is operated from high-tax jurisdictions to low-tax ones. Such practices occur when:

- a company from a high-tax jurisdiction purchases from a related company inputs at very high prices in order to reduce its taxable profit;
- affiliates located in high-tax jurisdictions supply goods for foreign-based members of the group at undervalued prices;
- members of the same group enter into transactions devised artificially, solely for fiscal purposes.

The standard method of countering such practices is based on the right of fiscal authorities to revise the financial results declared by corporate taxpayers which are controlling or are under the control of other companies, by applying the so-called *arm's length pricing* (ALP), that is, comparable or estimated prices, based on similar transactions between unrelated companies.

Internationally, the OECD has developed a set of recognised principles, which designate ALP as the “international standard that OECD member countries have agreed to use in order to identify transfer prices applied for fiscal considerations”. The non-adherence of EU Member States to this standard (in the sense of its non-application or less-than-strict application) is deemed by the Code of Conduct as feature of harmful tax competition.

The OECD Guidelines (1995) establish methods for ALP determination, as well as the order of preference in which these have to be used:

- a) the comparison of transactions between related companies with similar transactions occurring between independent companies;
- b) the “cost plus” method;
- c) “resale price less margin”;
- d) “transactional methods”, for the reallocation of profits among group members according to various distribution keys.

The ALP system cannot function properly even if all factual data were known to the authorities, which is in itself a very ambitious hypothesis. This, because of unsolvable conceptual problems: “There is, in theory, no satisfactory answer to the question of where the profits of a pharmaceutical company originate if a drug is invented in France, manufactured in Italy and marketed in Spain”.¹²⁵ The “fair” prices established by the authorities are, ultimately, as artificial as the intra-firm prices that they substitute. Many of the transactions occurring within transnational corporations are so specialized that they lack any market comparator. Moreover, the reason for setting up a group of companies is to reap the benefits of integration, hence the group is supposed to have an aggregate profit larger than the sum of the profits of its component entities, should they operate

¹²⁵ Sijbren Cnossen: *Tax policy in the European Union. A review of issues and options*, 2002; p.77

independently. Since these extra profits exist solely thanks to the existence of the group, hence only at its level, their origins cannot be attributed to particular transactions.¹²⁶

Then, even in the best case scenario, ALP can only solve part of the problem, namely the manipulation of prices within current intra-group transactions, but it cannot prevent the diminution of tax obligations by creating additional intra-firm transactions. Finally, the application of ALP becomes ever more complicated, as transactions entailing intangible elements (intellectual property, brands etc) are quickly expanding.

Under these conditions, ALP determination can only be discretionary, which made it an instrument used by fiscal authorities for ensuring the receipt of a minimum of budget revenues. Thus, in France, Article 57 of the General Tax Code (which provides for such adjustments) has come to represent the most “fiscally productive” provision. Among the EU-15 member countries, Spain makes the most parsimonious use of this system.

Conceptual problems are magnified by practically insurmountable implementation difficulties, as it would be necessary that each intra-firm transaction be valued by taxpayers and controlled by the authorities, which generates substantial costs both for the taxpayer needing to comply with stringent documentation requirements, and for the tax administrations which have to examine the cases. This is a source of great dissatisfaction for European companies, as evidenced by a survey according to which 20% of them rate the transfer pricing problems as the main tax obstacle to which they are confronted.¹²⁷

A study carried out by Ernst & Young on the tax treatment of 638 transnational corporations from 22 European countries revealed that, in 2001, about 47% of the adjustment operated in order to counter transfer prices have resulted in double taxation problems!¹²⁸

Apart from the important risk of double taxation that it entails, the determination of the “fair price” by tax authorities generates other negative consequences for the taxpayers concerned: the significant compliance costs imposed by the often excessive documentation that needs to be supplied by taxpayers (estimated by the European Commission to EUR 4-5.5 million for the large transnational corporations)¹²⁹ and the uncertainty as to the final decision of the tax authorities. The capricious and unpredictable nature of these decisions entices a growing number of companies to enter into so-called “advance pricing agreements” with tax authorities, which are meant to reach agreement on the methodology used for ALP determination. The practice of such agreements has proliferated in the EU over the last years, when it was adopted by France and the UK (1999), Germany (2000), the Netherlands (2001) and Belgium (2002). There is however a certain tension between the intention of some tax authorities to facilitate the ALP determination rules, by having recourse to “informal private decisions”, more

¹²⁶ Christoph Spengel, Carsten Wendt: *A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: Some Issues and Options*, Oxford University Centre for Business Taxation, WP 07/17, 2007; p.15

¹²⁷ Antonio Russo: *Formulary Apportionment for Europe: An Analysis and A Proposal*, INTERTAX, 33:1, 2005; p.2

¹²⁸ Jose M. Calderon: *European Transfer Pricing Trends at the Crossroads: Caught Between Globalization, Tax Competition and EC Law*, Intertax, 33:3, 2005; p.107

¹²⁹ Gaëtan Nicodème: *corporate tax competition and coordination in the European Union: What do we know? Where do we stand?*, European Commission DG ECFIN, Economic Paper 250, June 2006; p.24

flexible than the rules prescribed by the OECD Guidelines, and the provisions of the Code of Conduct for Business Taxation, according to which such practices may amount to harmful tax competition instruments. For this reason, countries like Belgium and the Netherlands had to revert to rules more constraining for taxpayers.¹³⁰

Even if guidelines agreed at the level of the OECD exist, the concrete rules applied by the various countries are sufficiently different, thus triggering either the risk of double taxation or that of under-taxation. In order to avert double taxation, there is, at EU level, the *Arbitration Convention 90/346/EEC*. Originally, this instrument was to take the form of a Directive, but Member States opposed this solution, for reasons pertaining to the avoidance of the censorship of the Commission and the ECJ. The Convention mandatorily subjects to arbitration the interpretative differences occurring between the tax authorities of the Member States if these do not reach agreement within two years from the date when the interested taxpayer has submitted its case, and the recommendation of the arbitration commission becomes binding only if the tax authorities continue to fail reaching agreement for another six months as from the date when the recommendation was issued.

The status of the Convention has fluctuated in time: fulfilling the ratification requirements postponed its entry into force until 1995, for a period of just 5 years. Because its renewal in 2000 was not automatic, despite the signature in 1999 of a Protocol extending its applicability for another 5 years, ratification by the Member States was again required. This delayed the re-entry into force of the Convention until 1 November 2004, when it was put in force with retroactive affect and with provisions attached allowing its automatic renewal at 5-years intervals. The usefulness of the instrument is, however, debatable, as it has produced only a single decision in its first 10 years of existence.

Apart from these ratification problems, the European Commission has identified several shortcomings of the Convention, liable to reduce its effectiveness: the absence of rules concerning the suspension of tax collection in case of dispute between tax authorities; the existence of excessive sanctions applied to taxpayers in some Member States; ambiguity concerning the date triggering the flow of the 2-years interval during which an amicable solution must be sought; and many other interpretation problems.¹³¹

Another means for mitigating the difficulties generated by the application of ALP was the establishment of the European Joint Transfer Price Forum (EJTPF). This October 2001 initiative of the European Commission got materialized in July 2002. The Forum is constituted by one representative of each tax authorities of the Member States and 10 experts designated by the business community. Its role is to study and debate the transfer price issues and to elaborate, on the basis of consensus, pragmatic and “non-legislative” solutions for alleviating the problems deriving from the application of different legislations and administrative methods at the level of EU countries.

¹³⁰ Jose M. Calderon: *European Transfer Pricing Trends at the Crossroads: Caught Between Globalization, Tax Competition and EC Law*, Intertax, 33:3, p.106

¹³¹ Michel Aujean: *The EU Company Tax Initiatives – where we are?*, Dublin, March 2005; p.8

The first tangible result of EJTPF's activity was a *Code of Conduct for the implementation of the Arbitration Convention*, adopted by the ECOFIN Council in December 2004.

More important still is the *Code of Conduct on Transfer Prices*, adopted by the Council and Member States in June 2006. This is applicable not only to intra-Community transactions, but also to transactions between a EU-resident company and a related company incorporated outside the Community. The Code standardises the documentation which needs to be submitted by taxpayers in order to substantiate the intra-group prices practiced. Tax authorities retain the right to request additional documentation, but only with respect to specific discrete issues or during tax controls. It was not possible to include in the Code the requirement that tax authorities accept, when available, the results of price comparability studies carried out in other Community countries. It is, however, requested from the tax authorities not to automatically reject the relevance of these results solely on grounds that they refer to the situation existing on other countries' markets. The beginning of the application of the Code of Conduct also entailed unpleasant surprises, in the sense that Member States which previously did not have or had only few documentation requirements concerning the reality of the declared intra-group prices, such as Spain or Italy, took this opportunity in order to increase their documentation requirements, even if only within the limits set by the Code.¹³²

Until now, the results of the Forum's activities are felt rather in connexion with "collateral barriers" generated by the requirements of the national fiscal authorities, that is, in the attenuation of the costs of complying with the documentation requirements and of the excessive sanctions applied in case of a non-deliberate lack of cooperation on the part of taxpayers. Substantial issues, such as clarifications concerning the methods used for determining the "fair value" or the recourse to "advance pricing agreements", remain, for the time being at least, unsolved.¹³³

Other "fiscal avoidance" practices and methods for countering them.

◆ Companies may alter the proportions of their financing through loans and equity, respectively. By maximizing borrowing in high-tax countries, it becomes possible to maximize the benefits of tax deductions corresponding to interest expenditures (a method known as *thin capitalization*). The scheme consists of setting up, in a high-tax country, of an affiliate with a working capital far inferior to current financing needs. This capital is then supplied by the parent company in the form of interest-bearing loans, which cut the profit of the affiliate, while increasing that of the parent company, which is subjected, in its own fiscal jurisdiction, to a lower tax.

Several EU countries have introduced rules in order to avoid the losses of potential budget revenues because of excessive interest payments: limiting the fiscal deductibility of interest expenditure which exceeds a certain proportion of the share capital; and/or the application of the ALP principle in order to identify a reasonable level of the interest rates.

¹³² Stephan Schnorberger et al: *Transfer Pricing Documentation: The EU Code of Conduct Compared with Member States Rules*, INTERTAX, 34:10, 2006; p.519

¹³³ Jose M. Calderon: *European Transfer Pricing Trends at the Cross Roads: Caught Between Globalization, Tax Competition and EC Law*, INTERTAX, 33:3, 2005; p.105

The existence of such rules is allowed by the EC legislation, but their implementation should not be done in a discriminatory manner. An illustrative case in this respect is «Lankhorst-Hohorst», which was brought before the ECJ: a loan from a Dutch parent company to a subsidiary from Germany was subject to the ALP test, whereas similar transactions occurring between two German corporate entities were not subject to the same treatment. Following the Court's decision, Germany has generalized the application of anti-“thin capitalisation” rules.

“ Companies may have recourse to different structures in order to operate abroad: representative offices, branches, affiliates etc. In low-tax countries, the activity is typically organised as companies with distinct legal personality, at the level of which profits (ultimately belonging to the parent companies) are maximized. To the extent that such foreign entities are deemed to be mere vehicles of the parent companies (**CFCs – Controlled Foreign Corporations**), being deprived of any significant economic activity on the territory of the host country and being under the exclusive control of the parent companies, some tax authorities decline to recognize their distinct legal personality and tax the parent companies as if the profits recorded by the CFCs represent direct incomes of the parent companies. There are two possible theoretical approaches in such cases: the transactional approach, according to which the profits of CFCs are automatically attributed to the parent companies, and the jurisdictional approach, in keeping with which the distinct legal personality of the companies set up in certain jurisdictions (typically, “tax havens”) is denied. As literature has shown, the latter approach, to the extent that it would concern companies incorporated in the Member States, may fall foul to the provisions of the Parent-Subsidiary Directive.¹³⁴

The special fiscal regime applied to CFCs may also be construed as a restriction to the right of establishment, to the extent that a resident is hampered in its decision to set up a subsidiary in another Member State by the fact that the latter's profits will be taxed as if they belong to it directly.

If the CFC practice is common, first and foremost, to tax havens, there are also in the EU countries enticing through fiscal incentives the establishment on their own territories of holding companies or companies exercising management functions for transnational corporations. The beginning was made by the Netherlands (earning it the designation as “Europe's Delaware”), but countries like Belgium, Denmark and Spain have also made use of similar incentives. The advantage of choosing such locations over traditional tax havens are manifold: they are more accessible, revenues are better protected thanks to the double taxation avoidance treaties concluded by these countries and, most of all, the fact that they are less conspicuous locations in the eyes of the tax authorities.¹³⁵

Within the EU, problems associated to this modality of countering “tax avoidance” emerge whenever the national regulations relative to CFCs do not exclude EU host countries, and the tax authorities of the home country and host country, respectively, hold different views on the economic substance of the activity carried by the CFC, which automatically leads to double taxation situations. The recent practice of the ECJ (the case

¹³⁴ Marjaana Helminen: *is There a Future for CFC-regimes in the EU?*, INTERTAX, 33:3, 2005; p.117

¹³⁵ Richard Teather: *The Benefits of Tax Competition*, The Institute of Economic Affairs, London, 2005; p.76-77

Cadbury Schweppes, September 2006) is not to allow the disregard of the legal personality of CFCs in order to increase the taxes levied on the parent companies incomes. It is sufficient that the establishment set up for tax purposes does not be a simple “letter box” (hence, it should have some employees and own assets).¹³⁶

¹³⁶ Thomas Rixen, Susanne Uhl: *Europeanising Company Taxation - Regaining National Tax Policy Autonomy*, Friedrich Ebert Stiftung, International Policy Analysis, July 2007; p..11

VII. Measures for the harmonization of indirect taxes in the EU

VII.1 The *raison d'être* of the community rules for indirect taxes

The EU member states apply indirect taxes more extensively than other countries: the consumption taxes represent more than 30% of the fiscal revenues in the EU, compared with 20% in US and Japan. This general situation coexists with important difference between the Member States: in 2003, Cyprus collected 49,9% of its fiscal revenues from indirect taxes, whereas the level in Belgium was only 28,8%. Most of revenues from indirect taxes (over 60%) are collected from VAT.

An indicator that offers a comprehensive image of the fiscal burden associated with indirect taxes in the EU is the implicit tax rate (ITR) on consumption. Generally speaking, the implicit tax rate measures the real fiscal burden in the case of various incomes or economic activities. The rate is calculated as a ratio between the fiscal income from a particular tax and the corresponding fiscal basis of the respective tax. The main components of the implicit tax rate on consumption are: VAT, excise duties on tobacco and alcohol, excise duties on fuel and energy and a residual calculated on the basis of taxes specific to certain member states. With an average ITRC of 19,6%, Romania stands out as a country with a rather reduced level of the fiscal burden in the period 1995-2005, compared to an arithmetic EU-27 average of 21,3% for the same period.

The important weight of indirect taxes can also be explained by the advantages that they present compared with other sources of fiscal incomes:

- they are relatively neutral regarding the impact on saving/investing decisions
- they are much less vulnerable to the effects of fiscal competition
- they offer a symmetric treatment of the production factors
- they are easier to administrate, incurring substantially lower administration and compliance expenditures per unit of collected income, compared to direct taxes
- fiscal fraud is more difficult in their case.¹³⁷

However, on the other hand indirect taxes have a regressive character which puts them in conflict with the criteria of fiscal and social ethics, plus they have a clear inflationary effect.

Implicit tax rate on consumption in the EU (%)

								Average	Difference
	2000	2001	2002	2003	2004	2005	Rank in EU-27	1995 to 2005	1995 to 2005
BE	21.8	21.0	21.3	21.3	22.0	22.2	11	21.6	1.6
BG	19.7	18.9	19.1	21.1	23.7	24.6	7	21.2	-
CZ	19.4	18.9	19.3	19.6	22.0	22.1	12	20.2	0.1

¹³⁷ Jörn Quitzau: *Competing government funding systems*, Deutsche bank Research, EU Monitor 30, January 2006; p.3

DK	33.4	33.5	33.7	33.3	33.3	33.7	1	32.9	3.2
DE	18.9	18.5	18.5	18.7	18.2	18.1	22	18.5	-0.7
EE	19.7	19.4	20.0	20.4	20.5	23.8	10	20.1	3.2
IE	26.4	24.5	25.5	25.3	26.5	27.2	4	25.6	2.3
EL	19.0	19.5	18.8	17.9	17.6	17.0	23	18.1	-0.5
ES	15.7	15.3	15.5	16.0	16.1	16.3	26	15.5	1.8
FR	20.9	20.3	20.3	20.0	20.2	20.2	16	21.1	-1.3
IT	17.9	17.3	17.1	16.6	16.9	16.9	24	17.3	-0.5
CY	12.2	13.7	14.8	18.3	19.4	19.3	18	14.0	7.2
LV	18.7	17.5	17.4	18.6	18.5	20.4	15	18.9	1.1
LT	17.8	17.4	17.8	17.0	16.0	16.5	25	17.9	-1.1
LU	23.1	22.7	23.0	23.4	24.7	24.3	9	22.6	3.3
HU	27.5	25.7	25.4	26.0	27.7	26.5	5	27.5	-4.4
MT	15.7	16.4	18.1	16.6	17.4	19.2	19	16.0	3.8
NL	23.7	24.4	23.8	24.2	24.9	25.4	6	24.0	2.2
AT	21.3	21.4	21.9	21.5	21.5	21.3	14	21.4	1.0
PL	18.0	17.4	18.0	18.5	18.7	19.8	17	19.3	-1.6
PT	19.2	19.3	19.9	19.8	20.0	-	?	19.6	-
RO	-	14.4	16.4	18.3	16.8	18.5	21	16.9	-
SI	24.1	23.7	24.9	24.9	24.8	24.5	8	24.6	-0.6
SK	21.8	18.8	19.9	19.4	21.5	21.9	13	22.5	-5.2
FI	28.6	27.6	27.7	28.1	27.7	27.6	3	28.2	0.0
SE	26.5	26.9	27.4	27.5	27.6	28.1	2	27.3	0.2
UK	19.4	19.0	18.9	19.2	19.1	18.7	20	19.4	-1.5
EU-27									
Weighted average	20.0	19.6	19.7	19.7	19.8	19.8		19.9	-0.3
Arithmetic average	21.2	20.5	20.9	21.2	21.6	22.1		21.3	0.6

Source: *Taxation Trends in the EU, 2007 - EUROSTAT*

Given the fact that indirect taxes are a direct component of the final price of goods and services, the risk of distorting the intra-community transactions is bigger, which explains the presence in the Treaty of firm and concrete stipulations regarding fiscal harmonization in this field.

The distortions potentially generated by indirect taxes originate mainly from:

- differences between types of taxes (before 1967, the member states used to apply different types of indirect taxes – e.g. VAT);

- differences between the applicable rates;
- differences between fiscal bases (including the extension of exceptions and privileged situations);
- administrative formalities that have to be fulfilled according to the prescriptions of each fiscal jurisdiction.

The level of fiscal harmonization can also be regarded, beyond its legislative dimension, in terms of concrete operational relationship between the taxpayer and the tax administration. There are several specific indicators offering a relevant picture of the differences between national fiscal systems when it comes to the compliance effort.

Such an indicator is the annual number of hours to comply with the tax obligations. The time spent by a firm for fulfilling the formalities deriving from the relations with the fiscal administration, depends on a number of factors: the complexity of the fiscal system and the related bureaucracy, the institutional transparency and the clarity of norms and procedures, the degree of informatization of fiscal procedures etc. The indicator, calculated in a recent study¹³⁸, varies from very low levels in countries like Ireland (76 hours/year) to surprisingly high levels for the Czech Republic (930 hours/year) or Ukraine (2600 hours/year). It's interesting to observe the proportion of indirect taxes within the total number of hours. In certain states, the proportion of the time spent for fulfilling the indirect tax obligations (especially VAT) is higher than the proportion of the respective indirect taxes in the total amount of fiscal obligations, for example in Bulgaria and in Czech Republic. In Bulgaria indirect taxes occupy almost half of the hours to comply with the fiscal system. The above mentioned study identifies also the main time consuming activities: the corroboration of data from the accounting statements and the calculation of the fiscal contribution by introducing the accounting data into the specialized software.

Another relevant indicator for the complexity of fiscal systems and the taxpayers' compliance effort is given by the number of fiscal contributions for the average taxpayer. Unfortunately Romania is ranked among the latest in the world, the Romanian taxpayer having to make no less than 96 payments annually. However, it's important to mention that taxes on labour represent the majority of taxes – 60% although they consume only 110 hours p.a. of the total compliance time.

VII.2. The Value Added Tax (VAT)

Before 1967, the EU member states used to apply different indirect tax systems. Only France applied VAT, whereas all the others used different forms of cascade taxes. One of the drawbacks of these taxes, from the perspective of trade liberalization, was the impossibility to determine the fairness of adjustments at the border (returning of indirect taxes incorporated in the price of the exported product and applying the indirect tax of the destination country): because the fiscal burden of a cascade tax can not be precisely estimated (given that it depends on the number of intermediary stages), therefore the amount to be returned could not be determined. This uncertainty offered a large number of possibilities of protectionist manoeuvres of the fiscal adjustments at the border.

¹³⁸ *Paying Taxes 2008. The Global Picture - PriceWaterhouseCoopers - The World Bank, 2007*

Besides the fact that VAT is neutral from the point of view of vertical integration, thus solving this problem, this tax offers other important advantages:

- it's a tax that stimulates compliance: because the right to deduct has to be justified, each firm has the incentive to obtain from the suppliers the invoices that certify the payment of VAT up to that stage;
- it is a very stable and robust source of fiscal revenue, an advantage that explains the use of VAT as one of the sources of revenues for the community budget;
- VAT is the most "effective" tax from the point of view of the ratio between the collected revenues and the administration expenditures. Every percentage point of VAT increase generates additional revenues equivalent to 0,4% of GDP.¹³⁹

The proposal of adopting VAT by all member states has been formulated by the Neumark Report (1963). On this basis, the Commission drafted two Directives ("the first" and "the second" VAT Directives). The proposals have been adopted by the Council in 1967 and have been enforced starting from 1970. The main elements of the VAT regime established by these Directives can be summarized as follows:

- the separate application at each commercial stage, avoiding the cascade effect (i.e. double/triple/etc. taxation);
- recovery (regularization) of VAT paid in previous stages, which allows precise determination of the VAT burden for the final consumer, irrespective of the payments in the intermediary stages;
- application of the "zero rate" (exemption with the right of refund) in the case of exports, to avoid erosion of competitiveness on the international markets.

The efforts of harmonization of the VAT regime focused on two main aspects:

- uniformization of the tax base (categories of goods and services subjects to taxation) which has been roughly accomplished with the adoption of the 6th VAT Directive (no.77/388/CEE).

- harmonization of tax rates has been considered necessary to counteract distortions induced by the big differences among rates in the intra-community trade. These differences can distort the intra-community trade and can also induce distortions in the functioning of other common EU policies: e.g. in agriculture, high differences between VAT rates made it impossible for the farmers in UK and Denmark (unlike those in others member states) to recover part of the VAT incorporated in the price of the inputs they purchased.¹⁴⁰

In 1987, an analysis of the European commission on the VAT rates in the member states highlighted the existence of some striking discrepancies:

¹³⁹ Genser CESifo jan02, *EU Tax II*, p.2

¹⁴⁰ Jeffrey Harrop: *The Political economy of Integration in the EU*, Edward Elgar, 2000; p.235

- in terms of the number of distinct rates applied EU-wide (from only 2 in Germany to no less than 6 in France);
- regarding the dispersion between the highest and the lowest rates (the ratios ranged from 2:1 in Germany, to 6:1 in France);
- regarding the number of special regimes, stipulating tax exemptions or special mechanisms of deduction or VAT refund);
- regarding the inclusion by different member states of the same goods in different fiscal categories.

Following the suggestions presented in the White Book of Lord Cockfield (1985), the Commission proposed a system based on two tax rates, with levels established within a “band”: the “reduced rate” of 4-9%, respectively the “standard tax” of 16-20%. Finally, the Council agreed only on the adoption of minimum VAT levels, through Directive 92/77/EEC. According to this Directive, the member states were supposed to apply a standard minimum rate of 15%, having the option to apply one or two reduced rates, but not lower than 5%, for certain goods and services of social and cultural interest (a list of 17 goods and services of primary necessity such as food, drugs, books, newspapers and magazines, drinking water, passenger transport). The zero rate has been temporary authorized for some countries but the rates above the standard maximum rate have been eliminated (previously, most of the member states used to apply higher VAT rates for a limited group of products considered luxury, especially automobiles). The *Council Directive 2004/15/EC*, that came into force in February 2004 has brought an amendment, in the sense that it extended the facility for the member states to apply a reduced VAT rate also to certain intensive labor services (in tourism, certain restaurants etc.).

As it was mentioned, the possibility to apply reduced rates has been limited to a relatively restricted list of goods and services but – despite this harmonization – their extensiveness reveals enormous differences among the member states: from only 20% of total consumption spending in Germany to 40% in United Kingdom!¹⁴¹ The essentially social considerations that pleaded for the acceptance of special treatments don’t seem to be confirmed by empirical studies: according to OECD, in 1998 the distribution of the fiscal burden was basically the same irrespective of the application of systems with a zero rate (as in UK), a reduced rate (in the Netherlands) or a unique standard rate (Denmark).¹⁴² On the contrary, the existence of reduced rates interferes seriously with the fiscal effectiveness considerations. Besides the loss of fiscal revenues, they unnecessarily increase the complexity of the system, which complicates the evaluation of the degree of compliance by the fiscal authorities as well as the tax burden for the taxpayer: a study made in UK suggests that the firms producing goods subjected to different VAT rates incur double compliance costs compared to the firms having to apply only one rate.¹⁴³ There are also risks of distortions in the production and consumption structures (e.g. the existence of a reduced rate for catering services but not for restaurants). Last, the differences between the member states as far as the reduced rates are concerned, are very important.

¹⁴¹ Cnossen 2002, p.19

¹⁴² Cnossen 2002, p.25

¹⁴³ Cnossen 2002, p.27

It's interesting to be remarked that the harmonization measures regarding the VAT rates failed to produce an important effect in reducing the disparities between the member states. The differences between the extreme levels of the standard rates in the EU have been diminished with only one percentage point during 1985-2000 (from 11 p.p., to 10 p.p.).

The Evolution of Standard VAT Rates in the EU (%)

	1980	1990	2000	2003	Implicit rate (in % of standard ratio)	Threshold of exemption for the VAT taxpayer (EUR)
AUT	18	20	20	20	61.2	21802
BEL	16	19	21	21	49.0	5578
DEN	22	22	25	25	58.3	2681
FIN	22	22	58.5	8409
FRA	17	18.6	19.6	19.6	53.0	76225/26679
GER	13	14	16	16	59.0	16617
GRE	...	18	18	18	53.0	7337
IRL	25	21	21	21	58.2	50790/25395
ITA	14	19	20	20	42.7	2582
LUX	10	12	15	15	59.2	9916
HOL	18	18.5	17.5	19	60.1	1883
POR	...	17	17	17	61.5	14964
ESP	...	12	16	16	49.7	...
SWE	23.5	25	25	25	40.1	...
UK	15	17.5	17.5	17.5	50.1	82426

Sources: - Panos Kanavos: *Tax Harmonization: The Single Market Challenge*, Dartmouth Publishing, 1997

- Isabelle Joumard: *Tax systems in European Union countries*, OECD, Economics Department Working Paper no.301, 29 June 2001

- Bernd Genser: *Coordinating VATs between EU Member States*, CESifo Working Paper 648, January 2002

- Miroslav N.Jovanovic: *The Economics of European Integration. Limits and Prospects*, Edward Elgar, 2005

VAT Rates in the Member States

	Standard	Reduced	"Super reduced"	TVA Parking
BE	21	6	-	12
BG	20	7	-	-

CZ	19	5	-	-
DK	25	-	-	-
DE	16	7	-	-
EE	18	5	-	-
IE	21	13,5	4,4	13,5
EL	19	9	4,5	-
ES	16	7	4	-
FR	19,6	5,5	2,1	-
IT	20	10	4	-
CY	15	5	-	-
LV	18	5	-	-
LT	18	5/9	-	-
LU	15	6	3	12
HU	25	5/15	-	-
MT	18	5	-	-
NL	19	6	-	-
AT	20	10	-	12
PL	22	7	3	-
PT	21	5/12	-	-
RO	19	9	-	-
SI	20	8,5	-	-
SK	19	-	-	-
FI	22	17	-	-
SE	25	12	-	-
UK	17,5	5	-	-

The aim of a VAT system integrated as much as possible at EU level is to offer the companies a system of indirect taxation implying ever reduced barriers in the intra-community trade. Apart of several exceptions, the businesses consider that a common VAT system at EU level won't create significant¹⁴⁴. However, some aspects remain susceptible to be reformed in view of increasing the degree of harmonization. One of these elements is linked to the norms governing the consolidation of VAT. Although in some member states the entities with organizational links are allowed to operate internal transactions without paying VAT, in other states there are no rules permitting such cases, even less in the situations of cross-border transactions. Therefore, we see an obvious need for the modernization of the EU legislation regarding VAT, in order to adapt it to the international character of an increasingly significant proportion of EU trade. The lagging

¹⁴⁴ *Shifting the balance - the evolution of indirect taxes* - PriceWaterhouseCoopers, 2007

behind of the legislation vis-à-vis the EU economic realities generated uncertainty and implicitly a whole range of cases in the field of VAT, at the level of the ECJ¹⁴⁵ and other courts.¹⁴⁶

Many of these disputes appeared as a result of tensions between the need to eliminate fraud on one hand and the need to insure a reasonable fiscal burden on the other hand. For example, one of the most pervasive frauds at EU level is the so called the “carousel fraud”, that creates increasing concern and numerous debates regarding the means to avoid it. One of the possible solutions taken into account is the application of the reverse charge mechanism, transferring the responsibility of collection to the taxpayer. Though, the risk here is to demand an unjustified effort of fiscal administration from the companies, already carrying a heavy burden in terms of collection and payment of VAT.

The debates at EU level pertain also to the need of introducing extensively a reduced VAT rate. In July 2003 the Commission proposed the rationalization and simplification of reduced rates, through the revision of exemptions, thus insuring their uniform application in all member states. The objective was the avoidance of distortions resulted from the unequal application of reduced VAT rates in some member states, an objective that implies basically a certain degree of fiscal harmonization in the sense mentioned in Article 93 TUE. The maximum rate of 25% still creates strong motivations for fraud and evasion, a situation that could be clearly improved by the introduction of a average rate of 8-12%. The experience of countries like Singapore, New Zealand or European countries such as Slovakia or Poland shows that a reduced rate is both in the advantage of fiscal authorities and taxpayers.

Given the numerous exemptions in terms of reduced VAT rates granted to certain member states, the Council asked the Commission to present a general report of evaluation of the impact of reduced rates on the creation of new jobs, growth and functioning of the internal market. The study was commissioned to an independent institute¹⁴⁷, which presented the final report accepted by the Commission in the Communication of 5 July 2007. On the basis of this study, the Commission considers that there is a real need of simplification and rationalization of the VAT rates structure, particularly in the sense of reduced rates.

A very important parameter of the VAT regime, in terms of its implications, refers to the *place of taxation*.

Initially, given the existence of intra-community border controls, the VAT was applied in the EU on the basis of the **destination principle**, implying the levy of the tax in the consumption stage. Consequently, the income goes to the state where the good is consumed, and the price competitiveness of the exported product is not affected. All these characteristics responded to the need to avoid distortions of intra-community trade. However, the subsequent evolutions have questioned the opportunity of this principle. The first reason is the elimination of intra-community border controls, which played an important role in the administration of VAT at EU level, because they offered the evidence of the taxable good crossing the border and,

¹⁴⁵ See the situation of ECJ decisions in the field of VAT

¹⁴⁶ The fiscal authorities in the majority of the member states are critical in general vis-a-vis this solution

¹⁴⁷ Copenhagen Economics

implicitly, facilitated the verification of the right to refund at the previous stages. Secondly, with the internationalization of production, the destination principle became a hampering factor because many cross-border businesses have to pay VAT in countries where they do not have permanent residence, which is cumbersome and expensive, particularly for SME's. Finally, the increased mobility of goods and services introduces increasing de-synchronizations between the place of purchase and the place of consumption.

These drawbacks could be eliminated by adopting the **origin principle**, which has been proposed repeatedly by the European Commission (1987, 1989, 1996), in different forms, but it has been rejected each time by the member states. This principle implies the treatment of intra-community cross-border transactions in an identical manner with the one for the transactions that occur inside each national fiscal jurisdiction. The definition of origin *per se* is still subject to modification. Initially, it referred to the place of sale. The evolution of businesses determined the European Commission to propose a new definition: the place of residence of the seller. The advantages of this principle are multiple:

- it can be levied without border controls;
- is less vulnerable to fraud, offering higher certainty in the collection of revenues;
- cross-border transactions will be taxed following an invoicing and refund system identical with the national ones;
- companies will have to register only in one place as VAT payers.

The application of this system requires however the solving of some delicate problems, which explains on the other hand the reticence of member states until now:

- a) a higher harmonization of rates and fiscal bases than in the present (because of the bigger potential of distortions of intra-community trade structure);
- b) the national rules of administration (collection and control) of VAT should be unified or, at least, subjected to a profound process of convergence;
- c) the creation of an EU re-distribution system for VAT, because the net exporting countries would be disadvantaged if the revenues would be left to the place of collection and the countries with reduced VAT rates would extract in this case a competitive advantage; furthermore, VAT is a tax on consumption so its result should go normally go to the state where the taxable goods are consumed.

The re-distribution system could consist either of a “micro” compensation based on the evidence of intra-community transactions, or of a “macro” compensation based on statistical data regarding the aggregate consumption and intra-community trade. The first system is more laborious and more difficult to administrate whereas the second risks to de-motivate the national fiscal administrations, because the level of revenues collected would not depend in the same measure on the their own effort.

Currently, the origin principle is only applied to cross-border purchases by individuals (with the exception of new cars).

The decisional deadlock that manifested itself in this field since more than a decade, implied a transitory system which became a *de facto* permanent system, introduced by Directive 91/680/EEC. This is a system of compromise, suboptimal, that became inevitable following the abolition of intra-community border controls (1993). The transitory system prescribes the levy of VAT in the country where the consumption takes place, at the rates applicable in that country. Given the absence of border controls, the functioning of this system requires a whole range of complicated rules for determining the place where the transaction is taxed. Therefore the serious disadvantages:

- The system is excessively complicated, being based on the verification of documents: the VAT for the imported product is not explicitly levied in the moment of the import, but implicitly, as the paying company can not demand the refund of the VAT related to that purchase (the system of “deferred payment”).
- The vulnerability to fraud is increased, because the shift from explicit levy to the implicit one occurs in a very delicate point, the one of the transfer from one fiscal jurisdiction to another. The existence of a large and continuous flow of goods without VAT payments, increases the risk of fraud, whose dimensions are estimated (cautiously) at about 8 bn. EUR/year.¹⁴⁸ The problems of VAT collection under this system can explain why the revenues from VAT don’t increase as predicted by the rates of GDP growth.
- The uncertainty for taxpayers (due to the complexity of rules) and the costs of compliance are much higher (estimated within a sample of Dutch companies at the equivalent of a border tax of 5%).¹⁴⁹
- Given the persistence of important differences between the national rates, there are incentives for consumers / users to make use of price arbitrage and for the national authorities to engage in a strategic competition in terms of VAT rates.
- There are differences of treatment between the national and the cross-border transactions.

In the absence of tangible progress in the line of a comprehensive solution for the problem of the place of taxation, the Commission resorted to (in a similar effort with the one in the field of direct taxation) to initiatives targeted specifically to the correction of specific problems. Thus, the *Council Directive 2003/92/EC*¹⁵⁰ adopted on 7 October 2003 amended *Directive 77/388/EEC* as far as the rules of the place of origin for the supply of gas and electricity were concerned. Consequently, this Directive facilitated the functioning of the single market, targeting the problems of double-taxation, tax evasion and the distortions induced by tax competition, by transferring taxation from the place of

¹⁴⁸ European Commission: *A Strategy to Improve the Operation of the VAT System within the Context of the Internal Market*, Communication to the Council and European Parliament, 7 June 2000; p.5

¹⁴⁹ Isabelle Joumard: *Tax systems in European Union countries*, OECD, Economics Department Working Paper no.301, 29 June 2001

¹⁵⁰ The Directive came into force on 1 January 2005.

supply to the place of the place of consumption. A more recent initiative of the Commission proposes the modification of the rules regarding the place of supply of services. Resorting to tactical formulas already tested in the field of direct taxes, this proposal has been included in the “VAT Package”, together with two measures of simplifying the VAT collection, i.e. the “one stop shop” and the simplified rules for VAT refund to the taxpayers in another member states.

The commissioner for taxation and customs, Laszlo Kovacs, presented in a series of speeches at the beginning of 2007, the priorities of the Commission and the Presidency regarding the reform of indirect taxation at EU level, over the current year. The Commissioner remain though concerned by the position of Germany which conditioned its acceptance of the VAT Package with the requirement of including a *reverse charge mechanism*¹⁵¹, on a national basis, in view of fighting fiscal fraud. The reverse charge mechanism is applied to sales towards legal persons. This allows the seller to skip the collection of VAT from its client. Therefore the seller is not responsible for paying the VAT because this obligation is shifted to the buyer. The later can recover the amount of VAT when the goods or services are consumed for production purposes.

Germany, which held the EU Presidency till 31 July 2007, affirmed its intention of promoting harmonization of VAT at EU level, by the simplification and harmonization of the application of the VAT Directive and through enhanced cooperation among the member states. On the other hand the German Presidency confirmed the preoccupations of commissioner Laszlo Kovacs regarding the delay of the decision on the VAT package, until the clarification of the ways to avoid the risks of fraud induced by simplification of the VAT system.

On the occasion of the recent meeting of 13 November 2007, in the ECOFIN Council there was an exchange of opinions regarding certain issues related to the VAT Package, with the intention to reach a compromise in the sense of adopting the entire Package at the Council meeting of 4 December 2007¹⁵². The elements of the Package that are to be adopted and to come into force on 1 January 2010¹⁵³ are:

- i) a draft Directive regarding the place of supply of services;
- ii) a draft Directive on the procedures for VAT refunds to non-established businesses;
- iii) a draft regulation on improved administrative cooperation as regards VAT and the exchange of information between member states.

The proposal regarding the place of supply of services refers to the change of the place of the taxable operation from the place of origin of the supplier to the place where the

¹⁵¹ On 14 August 2007 The European Commission launched a public consultation on the reverse charge mechanism with the objective of consulting the opinion of businesses regarding the introduction of this mechanism. The results of the opinion poll have been published in the “*Study in respect of introducing an optional reverse charge mechanism in the EU VAT Directive*”, TAXUD/2007/DE/305.

¹⁵² The compromise was reached on 5 December and the VAT Package was adopted with some minor amendments.

¹⁵³ Under the final agreement the new rules will come into force in 2015 rather than 2010.

consumer is established. On this proposal there has been an agreement of principle expressed by the member states already at the ECOFIN Council in June 2007. However, there was some divergence generated by the position of the Luxemburg minister of finance who opposed the modification of the definition of the place of taxation as far as the services of telecommunication, radio and TV were concerned. For these services, three solutions were proposed to the Council:

- a) maintaining the current rule (taxation at the place of origin), combined with the implementation of a mechanism for sharing the VAT levied on services between the country to cover administrative expenses and the country where the service is consumed;¹⁵⁴
- b) application of the new rule (taxation at the place of consumption);
- c) application of the new rule (taxation at the place of consumption) from 1 January 2010 – and for the compensation of the state of origin for the administrative expenses, the retention of a certain share of the payments collected through the “one-stop-shop”.

All the member states with the exception of Luxemburg opted for solution (b), i.e. the taxation at the place of consumption. But Luxemburg expressed the firm option for maintaining the rule of taxation at the place of origin. This position was justified by the fact that the taxation at the place of consumption would have deprived its budget of fiscal revenues up to 1% of GDP.

Regarding the second draft Directive of the VAT Package, it has been decided that for the simplification of the obligations of non-established businesses, they could use the “one-stop-shop” so they could fill a unique set of VAT obligations in the state of origin. The country of origin will have the responsibility to share the information and the revenues from VAT with the concerned member states whose rules are applicable in the case of the respective companies. This responsibility is corroborated with the proposals regarding administrative cooperation in the field of VAT and with the rules regarding the VAT refund to the non-established businesses.

VII.3. The excise duties

The excise duties are consumption taxes levied on certain products which have a low price elasticity of demand and display one of the two following features: they have an important weight in the aggregate market demand and their consumption generates negative externalities (in terms of public health, environment etc.). These features allow the application, without major shortcomings, of very high taxes. Consequently, excise duties represent some very flexible elements of the fiscal system, which can be easily maneuvered when supplementary fiscal revenues are needed.

The necessity of harmonizing excise duties at EU level is even higher than in the case of VAT:

¹⁵⁴ The final agreement stipulates the following sharing of revenues: 30 pct of the VAT levied on services originating in the country to cover administrative expenses, whilst the country where the service is consumed gets 70 pct

- they are applied systematically to fuels, whose major influence on almost all production costs is susceptible to induce intra-community distortions in the situation of very different excise levels in the member states;
- excise duties have a higher potential of fiscal competitiveness by attracting consumers from other member states with lower rates.

However, the first measures towards harmonization of excise duties at EU level, took place rather late, i.e. since 1 January 1993, with the “inauguration” of the Single Market. This delay seems to reflect their relatively limited importance as sources of fiscal revenue (roughly twice less “productive” than VAT) and also the relatively limited range of products on which they are levied, which implies a reduced potential for distortion of intra-community exchanges. On the other hand, the episodes of implicit discrimination of imports from other member states are more frequent in this field, particularly in the case of alcohol, where traditionally excise duties used to be set at lower levels for the indigenous alcoholic beverages that were substitutable with similar imported ones (e.g. in France – cognac with whisky, in UK – beer with wine etc.).

The harmonization of the excise system took place on three pillars:

- a) The *structure*, with the aim of avoiding the discrimination of imports by favoring national production through ways of establishing the tax object:
 - the definition of the products concerned: tobacco, alcoholic beverages, mineral oils and (only since 2003) energy: coal, gas, electricity: the member states have the right to levy excises on other products as well, but under the condition that the respective duty doesn’t imply custom formalities; thus, the use of this type of excise duties is discouraged because the possibility of collecting them in the case of imports is reduced, which means that the indigenous products would bear a higher *de facto* fiscal burden.
 - the definition of tax bases (e.g., MRSP - *maximum retail selling price* – for cigarettes; Plato grades for beer; the hectoliter of pure alcohol for alcoholic beverages (a definition which made impossible the discrimination in favor of indigenous products))
 - exemptions (e.g. plane gasoline, energy products used as raw material)
- b) the tax rates, with the aim of minimizing distortions of the intra-community trade (if the differences between the level of duties surpass the cost of reallocation of resources or transport).¹⁵⁵

Although minimum common rates have been introduced in 1992, the range of variation is still big (e.g. for cigarettes the incidence of excise duties differs with a factor of 4:1 between the countries with the highest respectively the lowest excise), a situation which reflects the cultural idiosyncrasies of the consumption of these products, more accentuated than in other cases.

¹⁵⁵ Miroslav N.Jovanovic: *The Economics of European Integration. Limits and Prospects*, Edward Elgar, 2005; p.186

c) *Administrative arrangements:*

- the taxable event is, in principle, the production/import in the EU of the good excised;
- the tax levy is however suspended till the moment of consumption: therefore special warehouses are established under the administration of authorized agents and the national fiscal authorities;

Thus, one can make sure that the excise duties are paid in (and by) the state where the goods are consumed.

VII.4. Measures for improving the collection indirect taxes

On May, 31st 2006, the European Commission delivered the Statement on the need of developing a coordinated strategy for boosting the fight against tax fraud. The primary goal was that of launching a debate among the stakeholders/involved entities – the Council, the European Parliament and the business environment – on the different aspects that might be considered when drawing up an anti-tax evasion strategy at community level. The Statement presented to discussion a wide series of pragmatic ideas that would contribute to improving the VAT present state of affairs. The need to revise the legal framework in order to offer an effective system of controlling the tax fraud either through the generalization of the reversed charge mechanism or introducing an intra-community taxing system was also emphasised.

The ECOFIN Council of June 7th, 2006 gave a positive answer to the EC Statement and expressed its availability to examine all the options suggested by the Commission. Resting on the technical analysis of the Council as well as on the subsequent efforts of the Commission¹⁵⁶ and the European business environment suggestions, the Council reached important conclusions during the reunion on June 5th 2007, both on the consolidation of the existing VAT system and the necessary reforms in the following period.

The need of modernizing the technical infrastructure and training of specialists capable of using advanced computer tools in the analysis and control activity has stepped in the operational coordination process of European fiscal systems as well as in the existing process of fiscal harmonization. On December 20th 2001, the Council adopted the Directive on VAT invoicing. Council Directive 2001/115/EC¹⁵⁷ (that entered into effect on January 1st 2004) amended the VAT Directive from 1977¹⁵⁸ and simplified the invoicing rules across the entire EU territory, enforcing, among others, the validation of electronic invoicing by the member states. The abovementioned directive creates the legal framework for the electronic transmission and storage of invoices, a process with significant advantages in terms of increased operability and cost cutting, especially in the context of increasing electronic commerce. Implementing the necessary technologies for

¹⁵⁶ The conference “*VAT Fraud Conference*” in March 2007, the expert group “Anti Tax Fraud Strategy (ATFS) expert group” with experts from all member states.

¹⁵⁷ The Directive had to be implemented in the national law 1 January 2004.

¹⁵⁸ Directive 77/388/EEC or the VAT Directive launched the process of harmonization of the VAT base.

electronic invoicing offers advantages to both firms and fiscal authorities that are thus more able to conduct effective supervising and check/control activity.

Because of the fact that indirect tax revenues represent the main share of the budget revenues and a significant share of GDP the fiscal authorities are motivated to augment the control/checking on firms in view of a most effective collection.

Poland, Czech Republic, Bulgaria, Hungary and Romania are among the countries to be noted for the systematic measures implemented for enhancing the checking/control, especially the one on VAT. These efforts may also reflect the fact that indirect taxing is the most prone to fraud and avoidance/evasion?. In this context, the fiscal authorities have intensified their efforts in view of implementing increasingly effective computer systems for tracking and checking the firms' fiscal behaviour.

For example, in January 2006, The Fiscal Authority in Poland acquired 200 licences for a computer program (**ACL**¹⁵⁹) designed for the speedy analysis of large amounts of data used in the fiscal audit process, financial analysis and fraud detection. The European Commission acknowledged the benefits of this program and started an advanced training program on computer fiscal audit based on ACL. More than 150 auditors have been trained by the Finance Ministry in 2006 and then the program continued with other 200 experts in 2007. The program financing has been realised through a twining program financed by the European Commission¹⁶⁰. Similar efforts have been conducted in Romania with European financing and technical assistance for implementing computer systems for monitoring VAT collection (**VIES** - *VAT Information Exchange System*) and excises (**SEED** - *System of Exchange of Excise Data*) starting on January 1st 2007 but their operability is still in an early developing stage.

VII.5. Regional evolutions in the field of VAT and excise duties

In the field of harmonization of indirect taxes, one can notice a certain regional trend in Central and Eastern Europe, where fiscal authorities are engaged in an ample reform process, partially induced by the need of convergence with the internal market and by the systemic evolutions of the respective national economies. Therefore, in all the central and eastern European accession countries, the VAT and excise duties legislation has been reformed or amended. In many of these cases, the pressure in the direction of reforms came from the business environment, strongly interested in the simplification and modernization of legislation, despite a certain resistance on the side of fiscal authorities. Even with the intensification of the reform process imposed by the EU accession, the fiscal authorities display certain inertia in the sense of lack of adaptation to the EU legislative environment. For example one can notice a significant degree of ignorance regarding the decisions of the European Court of Justice¹⁶¹.

¹⁵⁹ Software produced by a Canadian company (www.acl.com)

¹⁶⁰ For a more detailed presentation of the program see "Advanced training for tax auditors in the field of computer audit", CRIS Number: 2006/018-180.01-03.

¹⁶¹ *Shifting the balance - the evolution of indirect taxes* - PriceWaterhouseCoopers, 2007

Indirect taxes as % of GDP

								Average	Difference
	2000	2001	2002	2003	2004	2005	Rank in EU-27	1995 to 2005	1995 to 2005
BG	15.1	14.6	14.6	16.1	18.0	19.0	1	16.2	-
CZ	11.3	11.0	10.8	11.1	12.0	11.9	26	11.5	-0.3
EE	12.4	12.1	12.5	12.4	12.5	13.5	16	13.0	-0.4
LV	12.3	11.8	11.2	12.1	11.9	12.9	22	12.9	-1.2
LT	12.6	12.2	12.4	11.7	11.3	11.5	27	12.5	-0.9
HU	16.1	15.3	14.9	15.6	16.3	15.8	8	16.1	-2.0
PL	12.6	12.5	13.2	13.2	13.1	13.9	13	13.4	-0.3
RO	-	11.4	11.7	12.5	11.8	13.0	21	12.1	-
SI	16.3	16.1	16.4	16.6	16.4	16.4	5	16.3	0.5
SK	12.8	11.5	12.0	11.4	12.5	13.0	20	13.0	-2.1
EU-27									
Weighted average	14.0	13.7	13.7	13.7	13.7	13.8		13.8	0.4
Arithmetic average	14.0	13.6	13.6	13.8	14.1	14.4		13.9	0.5

Source: Taxation Trends in the EU, 2007 - EUROSTAT

Indirect taxes as % of Total tax revenues

								Average	Difference
	2000	2001	2002	2003	2004	2005	Rank in EU-27	1995 to 2005	1995 to 2005
BG	45.4	45.6	46.9	47.7	51.0	52.8	1	48.2	-
CZ	33.5	32.3	31.1	31.0	32.5	32.9	24	32.9	-1.0
EE	39.6	40.2	40.3	39.4	39.8	43.7	8	39.2	7.1
LV	41.8	41.3	39.8	42.5	41.8	43.9	7	42.4	1.4
LT	41.8	42.6	43.8	41.7	39.8	40.0	13	42.4	-3.5
HU	41.8	39.5	38.8	40.6	42.1	41.0	10	41.0	-1.8
PL	37.1	37.2	38.5	39.4	40.1	40.6	11	38.5	2.4
RO	-	41.0	41.4	45.3	43.3	46.3	3	43.4	-
SI	42.2	41.4	41.8	41.9	41.4	40.5	12	41.5	1.1
SK	38.9	36.5	37.6	36.8	41.9	44.3	5	38.9	6.3
EU-27:									
Weighted average	34.4	34.3	34.8	34.8	35.0	35.0		34.4	1.2
Arithmetic average	37.6	37.4	37.7	38.2	38.7	39.1		37.8	1.8

Source: Taxation Trends in the EU, 2007 - EUROSTAT

Regarding the indirect taxes, it has to be mentioned that Romania is on the third place in the EU, after Bulgaria and Cyprus, from the point of view of the percentage of indirect taxes in total fiscal revenues. Indirect taxes stand for 46,3% of the fiscal revenues, whereas the EU average was 39,1% in 2005. Corresponding to this level, the percentage of VAT in total fiscal revenues was the second at EU level, i.e. 29%¹⁶². Also is important to remark the high percentage of indirect taxes compared with the GDP:

Romania – The structure of revenues from indirect taxes as percentage of GDP

	2000	2001	2002	2003	2004	2005
Indirect taxes	-	11,4	11,7	12,5	11,8	13,0
VAT	-	6,3	7,1	7,2	6,7	8,1
Excises and consumption taxes	-	2,3	2,4	3,5	3,6	3,3
Other taxes on goods (including tariffs)	-	2,3	1,6	1,2	1,0	1,0
Other taxes on production	-	0,5	0,7	0,6	0,5	0,5

Source: *Taxation Trends in the EU, 2007 - EUROSTAT*

However this situation is not to worry about, given the fact that at EU level and particularly in the new member states one can notice a significant shift from direct to indirect taxes, with the corresponding impact on their weight in the total fiscal revenues. This phenomenon is not that much the result of certain fiscal policies but the effect of fundamental economic factors reflecting the consolidation of market mechanisms and superior rates of growth at regional level.

¹⁶² *Taxation trends in the EU* –European Commission, 2007

VIII. Harmonisation measures of direct personal income taxes in the EU

There has not been so far any attempt to harmonise personal income taxes in the EC/EU. This reflects the special political sensitivity of the issue more than any convincing theoretical arguments. Indeed, personal income taxes may affect saving and investment decisions at the international level, the movement of persons and, indirectly, the choice of locations from which companies are managed. Even if, over time, the European Commission has stressed that some co-ordination in this area may prove necessary in order to prevent the emergence of barriers to free movement (e.g., double taxation of workers) or in order to fight tax avoidance/ evasion, Member States have only been open, so far, to the latter argument. This is why the only initiative for a Community-wide regulation in this area was confined to the taxation of interest of personal savings.

The relative lack of concern for the harmonisation of personal income taxes also reflects the fact that the mobility of persons in the EU area is still limited, as linguistic and cultural barriers contribute to the preservation of an important segmentation of national markets. Over the long term, however, the trend is towards greater mobility, which will call for more attention towards the tax issues associated to it.

A better co-ordination among Member States as concerns personal income taxes is very desirable, from at least two standpoints. On the one hand, it does not erode, but on the contrary strengthens fiscal sovereignty: a substantial improvement of the exchange of information among national tax administrations provides states with a better control on the income sources of individual taxpayers. On the other hand, the favourable effect of this improved control over the budget receipts from this type of tax gives states a larger room for manoeuvre also in the area of corporate income taxation, facilitating their adherence to harmonisation initiatives in this latter field. Concretely, if a state considers that harmonisation might result in an insufficient taxation of corporate income, it would still be able to increase the personal taxes on dividends and capital gains. In an analogous way, if taxation of corporate income is deemed too burdening by some countries, they could offer tax credits to the shareholders.¹⁶³

The worldwide trend is towards giving up the taxation of interest and capital gains reverting to non-residents, especially in the aftermath of the decision made in 1984 by the United States to stop subjecting the interest owed to non-residents to any withholding tax: a study carry out for 19 developed economies has revealed that the rate of withholding taxes on interest has halved over the course of the 1990s.¹⁶⁴ Attempts by some Member States at introducing such taxes have failed in the past. Thus, in 1989, Germany adopted a 10% withholding tax on interest, only to set in motion an “exodus” of savings amounting to some DEM 20 billion towards Luxembourg, which triggered its cancellation in April 1989. It is, however, true that Germany has re-introduced the measure in 1992.

¹⁶³ xxx: *Economic effects of tax cooperation in an enlarged European Union*, Copenhagen Economics, Contract no. TAXUD/2003/DE/307, October 2004; p.14

¹⁶⁴ Chris Edwards, Veronique de Rugy: *International Tax Competition. A 21st-Century Restraint on Government*, Cato Institute Policy Analysis no.431, April 2002

The desirability to regulate this kind of tax at the Community level was justified by:

- the need to protect the tax bases of Member States against the tax “poaching” exercised by some of their Community partners;
- the existence of wide disparities at Community level both as regards the tax rate, as well as with respect to the sheer recourse to this instrument;
- the fact that withholding taxes have a neutral effect on investors who faithfully declare all their sources of income.

The initiatives for regulating this issue have varied over time and have required a very long period before they finally took shape. This reflects the exigence of the unanimous vote against the background of diverging interests in the EU. On the one hand, Great Britain, Luxembourg and Austria have opposed the regulation of this issue, albeit for different reasons (the UK being concerned with its fiscal sovereignty, while Luxembourg and Austria – by protecting their banking secrecy rules). Whereas the positions of Germany and Belgium have fluctuated with time, France, Italy and Spain have constantly manifested themselves in favour of this initiative.

The first proposal of the Commission dates from 1967 and intended the complete harmonisation of withholding taxes, combined with full deductibility in the country of residence. Reaching agreement proved impossible because of the divergences arising with respect to the level of the tax: France, Belgium and Italy were in favour of a 10% rate, deemed too high by the Netherlands and Luxembourg.

The second episode unfolded against the background of the adoption of the Directive for the Liberalisation of Capital Movements, which triggered an increased mobility of this tax base. The European Commission has put together in February 1989 a draft Directive providing for the setting of a minimum withholding tax of 15%. Over a transition period, this system was to co-exist with a mechanism of mandatory exchange of information between the competent authorities, meant to allow for the taxation of all revenues of a taxpayer. Member States were to opt for one of the two possibilities. The reaction of the member countries were, again, divergent: France and Italy asked for a higher tax level and for the extension of the system over dividend earnings as well, Denmark and the Netherlands expressed their strong preference for an information exchange system, while the UK and Luxembourg, who are hosts to important international banking centres, have categorically opposed the introduction of a minimum tax level.

The initiative was resuscitated in the context of the “package” of December 1997, which got the political agreement of the ECOFIN Council. On this basis, in May 1998, the European Commission drafted a new proposal for a Directive. Unlike the 1989 version, this draft put forward the idea of a co-existence of the two systems, without privileging any of them, but with a proposed level of the withholding tax increased to 20%. Some of the Member States acquiesced to this project only upon the explicit condition that the regulation applies to selected third countries as well, which are potential competitors in the attraction of savings, and which the European Commission was mandated to agree with: Switzerland, Monaco, Liechtenstein, San Marino, Andorra. In June 2000, the Feira ECOFIN Council rejected the co-existence model, opting instead for a single system, based on the exchange of information. The countries with a special interest in the issue of

banking secrecy have only adhered to this political agreement against assurances that they may be granted exemptions. In November 2000, the Finance Ministers have agreed in ECOFIN on the tax rates to be applied, over a transition period, by those Member States that were not to immediately adhere to the mandatory information exchange system.

Following these developments, the Commission reviewed its initial proposal and came up in 2001 with a revised draft Directive. This provided for the obligation to supply information to the tax authorities from the depositor's home country, as well as for the possibility that some countries temporarily waive this obligation and apply a withholding system instead. The new draft obtained the endorsement of the ECOFIN Council in June 2003, and the Directive entered into force on 1 July 2005. Its main stipulations are the following:

- mandatory system of mutual information between tax authorities;
- temporary derogation from this obligation for Austria, Belgium and Luxembourg, until 2015 at least, with the possibility of an extension if the issue of co-operation with third countries competing for the attraction of deposits is not sorted out; until the expiry of the transition period, the three Member States are required instead to apply a withholding tax system, at rates progressive over time: 15% until June 2008, 20% until June 2011 and 35% subsequently. The yield of this tax is to be shared between the taxing country (1/4) and the residence country (3/4) ;
- application limited to the persons residing in one of the Member States; also, dividends and capital gains are not concerned, nor are the placements with mutual funds. In exchange, the definition of the term „interest” is wide one, including the yields of corporate and government bonds.
- conclusion of arrangements meant to protect the competitiveness of financial markets within the EU; in this vein, agreements were concluded with Switzerland, Liechtenstein, Andorra, Monaco, San Marino; also, the UK and Holland have made corresponding arrangements with their dependent territories (e.g., the Isle of Man, Virgin Islands, Aruba) so as to ensure that these will apply to the deposits of non-residents „equivalent measures”.

Further to the enlargement of the EU, to the application of its principles also by the associated or dependent territories of some of the Member States (on the basis of bilateral agreements concluded to this end) and to the agreement to apply equivalent measures with third countries (among which Switzerland and the United States), the principles of the Directive were in force, as of 1 January 2007, in 42 fiscal jurisdictions.¹⁶⁵

Assessments made in literature shortly after the Directive's entry into force have highlighted numerous problems liable to seriously diminish its expected effectiveness:

- a) in spite of the progress made with some third countries, important financial centres are still not covered, towards which the deposits of Community nationals might migrate; for this reason, in October 2006, the Council asked the Commission to

¹⁶⁵ Philippe Cattoir: *A history of the “Tax Package”. The Principles and Issues Underlying the Community Approach*, Taxation Papers, DG TAXUD, Working Paper no.10, December 2006; p.15

initiate exploratory talks with Hong Kong, Singapore and Macao, with a view to find co-operation solutions similar to those also agreed with other third countries.

- b) the provisions of the Directive are unlikely to keep under an effective control the enormous range of financial instruments able to substitute interest-bearing deposits; in this sense, it is worth mentioning that, immediately after Switzerland accepted to co-operate with the EU in this respect, Swiss banks started to aggressively advertise the financial products not affected by the Directive.

Simulations carried out with respect to the results of the implementation of the Directive seem to point to very modest effects at the EU scale: fiscal revenues would increase only negligibly, while GDP stays practically constant. The effects are significantly more pronounced on the three countries with derogation which, upon the switch to the exchange of information, stand to lose receipts equivalent to 0.2-0.4% of their total fiscal revenues. Not even in their case, however, would GDP be affected in a significant manner (reductions of less than 0.1%).¹⁶⁶

¹⁶⁶ xxx: *Economic effects of tax cooperation in an enlarged European Union*, Copenhagen Economics, Contract no. TAXUD/2003/DE/307, October 2004; p.28

IX. Considerations about the stakes for Romania

IX.1. With respect to the decisionmaking process in tax matters, as indicated above, progress of Community regulations concerning direct taxation is severely constrained by the unanimity rule requirement. On the other hand, there are different instruments (as well as attempts to make use of them) which aim at neutralizing at least in part the impact of the unanimity requirement on the development of the relevant Community *acquis*.

An important option for Romania, in this context, is whether to support the initiatives towards limiting the coverage of the unanimity rule in tax matters or to prefer the *status quo*. There are convincing arguments in favour of the former alternative. First, from the point of view of the voting power in the Council, Romania is the seventh country in the EU, hence it can exert a stronger influence than many other Member States in the case of a switch to qualified majority voting. On the other hand, the unanimity rule does not seem to be very useful for (hence, *a fortiori*, it is not indispensable to) Romania. This rule is valuable for the states whose specific situations are extreme or close to the extreme in the relevant field. But, despite the signals that would seem to arise from the fact that Romania has currently one of the lowest corporate income tax rates among all Member States, the country's interests in tax matters are far closer to the middle ground: Romania shares with the states supporting fiscal harmonisation in the EU the characteristics of a relatively large country, with a relatively under-developed financial sector, hence likely to be rather the „victim” of fiscal competition than the „predator”; on the other hand, Romania shares with many of the states opposing the narrowing of fiscal disparities in the EU a rather small preference for publicly supplied goods and a limited availability to pay the kind of taxes required by this supply. Under such circumstances, it is difficult to see what does Romania stand to lose from the abandonment of unanimity, since it is difficult to imagine a case of some importance in tax matters where Romania could be the only diverging voice (i.e., the only situation where the existence of a veto right is crucial). Given Romania's position, close to the middle ground, as well as its voting power (and, implicitly, its blocking power), it is to be expected that most often it should be able to find a blocking minority in order to avoid the introduction of rules that do not fit its desires.

Facilitating decision-making through mechanisms specific for the „Community method” is preferable to the *status quo* also because, paradoxically, the latter is ... dynamic. The alternative methods for advancing on the path of a certain fiscal harmonisation, apart from the fact that they engender an *acquis* of low quality (which should not be unimportant from the standpoint of any Member State), tend to be disadvantageous to Romania.

The *ad hoc* construction of *acquis* realized by the ECJ, besides the generic problems that it entails and which have been described above, risk creating additional difficulties for Romania. As already mentioned, the Court's decisions tend to be „creative” and biased in favour of the taxpayers. The latter, typically multinational corporations, have to a larger extent the expertise and the resources needed for an adjudication in their favour of a dispute with the Romanian fiscal authorities. Even without assuming a bias of the ECJ, the mere fact that, in those cases that a piecemeal secondary legislation cannot clarify,

there is a risk of expending the administration's resources for defending Romania's interests is in itself disadvantageous.

The assumption by the Commission, through *soft law* instruments, of the position of guide in various matters not explicitly addressed because of lacunary secondary legislation, is also inferior – from Romania's point of view – to solutions explicitly adopted through the „Community method”. This is not only because, at least from the point of view of voting power, its influence in the Council (and, if need be, in the Parliament) is significant, but also because the options of the European Commission are not always symmetrical as concerns the implications for the Member States and precedents show that those Member States whose citizens are better represented in the Commission's staff (and, *a fortiori*, in management positions) have less unpleasant surprises. Yet, Romanian citizens are currently far under-represented in the services of the Commission and the perspectives for correcting this imbalance are very distant.

Another interesting issue is the extent to which Romania should be willing to assume additional obligations in the context of a possible recourse to the „enhanced co-operation” mechanism, meant to agree, among a sub-group of Member States, more comprehensive rules in the area of direct taxes. Obviously, any concrete decision in a particular case is dependent on the latter's specifics, hence generic recommendation can be issued. One should keep nevertheless in mind that the disadvantages of a late adherence to such an initiative are very significant. For all practical purposes, the „founders” of an „enhanced co-operation” are the ones who set the rules to which those who join later are bound to acquiesce. Assuming that a group of Member States agree on a certain degree of harmonization of their tax rates and bases, and that this group consists of countries with high tax rates, it is to be expected that the harmonized rates agreed upon will be very high from the standpoint of other countries, triggering the need of an abrupt upwards adjustment of the fiscal burden of the latter countries, should they wish to align themselves to the same regime.¹⁶⁷

IX.2. The need for caution in the adoption of fiscal measures already contested successfully at the ECJ

The fiscal authorities as well as the courts in Romania confronted with fiscal cases will have to take into account the decisions of the ECJ, whose observation is mandatory for all member states, an obligation stipulated also in the Accession Treaty signed by Romania. The ECJ decisions are intrinsic part of the EU legislation and, moreover, are the only source for the interpretation of EU legal texts. The ECJ, which became operational in 1953, has pronounced, during more than 50 years of existence, an impressive number of decisions that are the basis of the interpretation and application of EU law. This new reality which Romanian judges are already obligated to take into account, creates a whole reference system to which all efforts of harmonization have to be related.

¹⁶⁷ Nico Groenendijk: *Enhanced Cooperation in Corporate Taxation: Possibilities and Possible Effects*, EUSA Economics Interest Section Research Seminar, Waterloo, Ontario, April 2006; p.21

Furthermore, the ECJ can decide on the applicability or conformity of national laws with the EU legislation. Obviously, the ECJ can neither decide on the abrogation of a law adopted by a member state nor suggest its abrogation, the decision remaining to the national authorities. However, once the ECJ declares a law as not being conformed with the EU legislation or to the principles and the fundamental freedoms stated in the Treaty, every act of enforcing that law can attract either complaints from the affected persons or infringement procedures from the European Commission against the Romanian state.¹⁶⁸ Such a situation occurred with the introduction by the Romanian government of *the tax on the first registration of vehicles* starting with 1 January 2007 (See Case Study).¹⁶⁹

Obviously, beyond this notorious case, there is need for a long and systematic process for the Romanian courts to start observing responsibly the ECJ jurisprudence. Moreover, an even greater process will be needed for the adaptation of the behavior of Romanian fiscal authorities to the EU fiscal rules. Currently, one can notice certain inertia of the fiscal authorities that ignore, sometimes deliberately, the ECJ jurisprudence, relying on the court's lack of efficiency in respect of the reference to EU cases.

The significant gap between the EU law and the ECJ jurisprudence on one hand and the Romanian authorities fiscal policies on the other, has been reduced to a certain extent through the programs of administrative cooperation and technical assistance during the pre-accession period and after 1 January 2007. Within the Ministry of Finance have been managed numerous framework programs and twinning projects, most of them financed with PHARE funds. The main objectives were:

- *Completing the harmonization of the tax legislation and strengthening the fiscal administration* (allocated budget of 1,2 mil. Euro);
- *Capacity building for the presentation of the financial consolidated statements and the consolidated reports regarding the budget implementation* (allocated budget of 0,7 mil. Euro) ;
- *Re-evaluation of the VAT framework* (allocated budget of 0,6 mil. Euro);
- *Fiscal control* (allocated budget of 1,2 mil. Euro);
- *Development and implementation of the integrated solution for the IT system, part of the IT Strategy of the Ministry of Public Finance* (allocated budget of 10 mil. Euro);
- *Support for the Strategic Plan of the Ministry of Public Finance* (allocated budget of 15,5 mil. Euro) etc.

All these programs and projects plus many others had an important role, reflected by the amounts allocated as well by the objectives proposed. However, in many cases the expected results didn't occur, which leaves a lot to be done in the direction of fiscal administration reforms. The programs contributed in a very limited extent to increasing the effectiveness of the relationship between the fiscal administration and the taxpayers, communication and transparency remaining very poor. Some of the shortcomings

¹⁶⁸ **Art. 226 TUE.**

¹⁶⁹ The special tax for motor vehicles, introduced by **Law no. 343/2006** and modified by the **Emergency Ordinance no.110/2006**.

occurred in the management of the programs of administrative cooperation and technical assistance are:

- the lack of a realistic evaluation regarding the concrete institutional drawbacks to which the reform should have been targeted;
- the lack of mechanisms for systematically motivating and involving the people in the fiscal administrations where the programs were managed (in many situations the Romanian public servants perceived the program activities as a burden added to their daily activities);
- the high degree of formalism in the evaluation of project's results;
- the poor system of communication with the taxpayers, the indirect beneficiaries of the administrative reform;
- the poor transparency and the poor dissemination of information regarding the projects which remained, the majority of them, unknown to the public and to the other institutions interested in the reform of the fiscal administration (although almost each project had among other objectives the dissemination of information regarding the process of fiscal harmonization and administrative reform).

These elements are worth to be noticed both in terms of the efforts directed towards harmonization and in terms of the long term efforts of the Romanian fiscal administration for increasing transparency and effectiveness in view of the objective of reducing the fiscal burden from the Romanian taxpayer.

IX.3. As concerns the harmonisation of corporate income tax rates

Assuming that a decision on a minimum tax rate could come to be decided by qualified majority voting, this would be set about at the highest level among the countries composing the likeliest blocking minority, hence at that of the countries with the lowest tax rates. Considering the current tax rates in the EU, which have come down substantially over the last years, it is highly unlikely that such a harmonisation would take place at a significantly higher rate than that currently in place in Romania. Probably, the 20% level mentioned by the Dutch Finance Minister in 2004 is a realistic assumption. There are many good reasons why such a level has no reasons to be problematic for Romania, but on the contrary could engender some positive aspects.

To begin with, it is to be expected that a rate increase will lead to higher budget receipts which, given that Romania has the lowest aggregate fiscal burden (ratio of budget revenues to GDP) among all EU countries and that the requests for funds that the budget must accommodate are on the rise, could be a welcome solution. Extrapolating to Romania the results of simulations – carried out for the EU-25 countries – of the introduction of a harmonised rate set at the average level of the currently applied rates, we have good reasons to expect that the effects would be favourable. As indicated earlier, the only countries of the EU that stand to gain (even if only a little: half a percentage point) in terms of both GDP growth and budgetary receipts from such a harmonisation are Latvia, Lithuania and Hungary, that is, countries whose particulars are closest to those

of Romania from the standpoint of two essential parametres utilised in the model: the corporate income tax rate and the ratio of corporate income taxes collected in GDP.

Secondly, it should be emphasised that the positive effects of taxation rates on FDI inflows, which Romania will continue to require in view of the insufficient domestic saving and the still significant needs of technology and managerial know-how, only play „at the margin”, that is, whenever the other attractiveness factors of a national location are held constant. Empirical studies are almost unanimous in revealing that factors other than the level of taxation matter more for foreign investments: the market’s absorption capacity; the cost and quality of the workforce; infrastructure. Hence, for a country like Romania, enjoying a very good potential as concerns the first two above-mentioned factors, there are no convincing reasons to press the taxation lever as strongly as other EU countries are doing. Romania’s major locational disadvantage pertains, first and foremost, to infrastructure, and higher budget receipts – rendered possible, *inter alia*, by the increase of the taxation rate – could help alleviate this gap. In other words, using the taxation lever in order to develop the infrastructure and, in this way, attract increased foreign investments is preferable to engaging in a race towards lower taxes meant to attract foreign capital by, ultimately, effecting indirect public budget transfers destined to push up the return on the capital invested in Romania by multinational corporations.

Also in relation to the influence of taxation on FDI one should recall its asymmetric impact according to the type (horizontal or vertical) of the investments. The important absorption capacity of the Romanian market and its sustained pace of growth are anyhow acting as a „magnet” for horizontal inward investments, hence their additional stimulation by reduced taxes is not justifiable. It is true that vertical investments are likely to generate more significant spillover effects in the economy and are more sensitive to fiscal incentives but, as long as the relevant Community *acquis* (State aid rules and the Code of Conduct on Business Taxation) drastically curtail the possibility of using them selectively, the gains obtainable in terms of attracting additional vertical investments would be over-paid for by losses of budget revenues corresponding to reduced tax rates on practically guaranteed horizontal investments (which would take place anyway, even if taxation were heavier).

IX.5. As concerns the harmonisation of the bases for the taxation of corporate income

Romania has a strong interest in the resolution (or, at least, minimisation) of the problems arising from the excessive variety of taxation rules in the EU Member States. This is because the management of corporate income taxes is very sensitive to two of the implications of this diversity: the large tax avoidance opportunities enjoyed, against this background, by the multinational corporate tax payers; and the double taxation problems which might arise. Romania’s vulnerability to these problems is magnified by the important weight of multinational corporations in the enterprise sector and by the risk that, absent „communitarized” rules, the tendencies towards a firmer control of the two above-mentioned negative phenomena by enacting national norms could trigger disputes launched by the taxpayers in front of the ECJ, where the combination of the inherently reduced experience of the fiscal authorities in dealing with the issues in a manner

perfectly compatible with the existing *acquis* and of the long exercise of MNCs in successfully challenging national tax rules is likely to trigger negative results for Romania.

The two initiatives of the Commission concerning the corporate tax bases currently under debate are: the home state taxation (HST) and the common consolidated corporate tax base (CCCTB).

There are strong reasons why Romania's position relative to HST should be negative, justifying both its non-participation in the pilot project proposed by the Commission in its December 2005, as well as its subsequent (past the experimental phase) opposition to the HST generalisation and formalisation as secondary legislation. This is because this „fiscal version” of the mutual recognition principle implies, in fact, the transfer of the burden of having to deal with 27 sets of different national fiscal laws from the taxpayers and onto the fiscal authorities, which have to display at least the capacity of checking whether the taxpayer located in their own jurisdiction which has availed itself of the right to apply its home state legislation does interpret and apply it correctly. For a country confronted with serious constraints (of an objective, as well as subjective nature) in developing a very efficient fiscal administration, as is Romania's case, such a situation is not desirable.

Secondly, since the number and importance of foreign-owned companies operating in Romania is out of proportion with the number of Romanian enterprises directly operating in the Community area, the application of HST would narrow down considerably the coverage of Romanian fiscal rules. This loss of fiscal sovereignty is seldom acceptable, because it would occur not in favour of rules devised at Community level, over whose formulation Romania would have its word to say, but in favour of other national fiscal rules, devised in different national contexts and serving priorities distinct from those of Romania.

As concerns the adoption of a common consolidated corporate tax base (CCCTB), the most appropriate position for Romania is that of a qualified availability. The favourable position is justified in view of the fact, already mentioned, that an initiative like the CCCTB may solve problems which are going to confront the Romanian fiscal administration to a growing extent from now on. By the same token, Romania should oppose the idea of the CCCTB being made applicable on a voluntary basis only.

Finally, CCCTB is likely to be a preferred alternative to the „discrete” resolution, via piecemeal Directives, of the various problems ensuing from the diversity of national fiscal rules. Thus, for instance, the definitive and „holistic” solution to the problem of the fiscal compensation of cross-border losses which the CCCTB provides is far superior to the palliatives that would be obtained further to the approval of the Commission's proposal to regulate this problem by means of a dedicated Directive.

Although the concrete way of solving various technical aspects concerning the definition of the common tax base may be important for Romania, it is clear that the most important stake, able to determine the agreement or the rejection of legislating at Community level this modality of harmonising tax bases, pertains to the allocation key of the consolidated tax base between the fiscal jurisdictions of the Member States.

First, there are reasons for Romania to support the allocation based on microeconomic indicators because, given its low level of GDP, macroeconomic indicators would tend to put it at a disadvantage. Such a preference also has the merit that microeconomic indicators are much more appropriate for this kind of exercise.

There is a large variety of distribution keys that can be devised by using microeconomic indicators, and their examination piece-by-piece risks proving fastidious. This is why the assessment of this topic should start from the solutions most likely to meet a larger acceptance of the Member States, i.e., from the versions which, in principle, are the ones offering more transactional opportunities, which tend to be those including several factors simultaneously. A version based on capital, labour and sales is the most likely, because it has a built-in element of balancing the interests of net producers and net consumers, respectively. The factor „capital” is not inherently advantageous for Romania but, given its impeccable theoretical justification, it is not realist to expect its exclusion from any formula. Under these circumstances, since Romania cannot compete from the point of view of tax rates with several small Member States (like Ireland or Cyprus), it would be important to secure the exclusion from this indicator of the most mobile assets, as is primarily the case of intangible assets.

The factor labour is extremely advantageous for Romania if defined in terms of number of employees, but disadvantageous if taken as „payroll”. The optimal solution would thus be to include this factor in the formula exclusively as defined in terms of number of employees but, in exchange for suitable compensations, one could accept a dual definition, but one in which the indicator „number of employees” would have a weight at least equal to that of the indicator „payroll”. Finally, the factor „sales” should be computed on the basis of the dimension of this indicator at the place of destination and not, under any circumstances, at the place of origin.

The weighting of the three factors is of course, very important at its turn, and Romania’s interest is that the factors most advantageous to it be relatively well represented. From the standpoint of considerations pertaining to the overall balance of concessions, but also in light of the precedent existing in the United States, the most likely modality of weighting that can be envisioned is the „Massachusetts formula”, in which the three factors would enter with equal weights.

IX.6. As concerns the measures combatting „harmful tax competition”

Together with the other Member States which have acceded to the EU over the course of this decade, Romania was placed from the outset in an asymmetric position relative to the „old” Member States. While the latter were subjected to a soft *acquis*, consisting of a Code of Conduct (for Business Taxation) lacking a mandatory character, hence not enforceable before the ECJ, and implemented on the basis of recommendations made by a Working Group and of resolutions adopted by the Council, where states applying contestable measures can defend their positions and initiate log-rolling-type transactions with other Member States, the new members had been forced, in the framework of accession negotiations, to assume legally binding commitments of eliminating fiscal measures of the same kind as those targeted by the Code of Conduct.

This asymmetry is not necessarily disadvantageous, however, and could be even used in the future in Romania's benefit. First, one should acknowledge that the proliferation in Romania, at the end of the former decade and the beginning of the current one, of numerous schemes of fiscal incentives (for „disadvantaged areas”, „SMEs”, „industrial parks”, „free ports”, „investments with significant impact in the economy” and, finally, „scientific and technological parks”) was profoundly irrational and harmful from an economic standpoint. On the one hand, they have weakened budget revenues, indirectly contributing to the delay of macroeconomic stabilisation. On the other hand, they have largely neutralised each other's effects, because the essence of the advantages offered by these schemes resides in the better treatment they provide *relatively* to the one reserved to those to which they are not applicable. Yet, if the latter may benefit of other incentive schemes, the size of this comparative advantage is reduced to the point of its eventual cancellation. No other New Member State has promoted in a manner more deprived of vision the concept of selective fiscal incentives. Several countries (Bulgaria, Czechia, Estonia and Lithuania) have only very parsimoniously had recourse to such measures, while the others, which have made more intensive use of such incentives, have concentrated them in a limited number of schemes, typically dealing with SMEs and „special economic zones”. There is no other case in the region of a co-existence, like it occurred for a while in Romania, of seven different schemes, of which five pursuing regional development objectives. It is obvious that, against such a background, the above-mentioned asymmetry has had rather beneficial effects for Romania.

Secondly, because it is now in a „cleaner” situation from the point of view of harmful tax competition measures than many old Member States, Romania, like other countries which have recently acceded to the EU, could and should use the lever of the Code of Conduct in order to secure corrections, similar to those operated by themselves, of the fiscal incentives having negative externalities which are still being applied by EU-15 countries.

IX.7. As concerns the transition to the „origin principle” for VAT collection

Switching to this principle is the only reasonable option if one wishes to curb a phenomenon generating an enormous waste of resources: fiscal fraud. Consequently, the need arises for putting in place a Community-level redistribution system of VAT receipts. Such a system would entail either a “micro” compensation, based on documenting intra-Community transactions, or a “macro” compensation, based on statistical data for aggregate consumption and intra-Community trade. As long as Romania will continue to record trade deficits in the exchanges with its EU partners and its fiscal administration will still remain relatively inefficient, the choice of a “macro” compensation system, based primarily on production and consumption data, is likely to better suit its interests.

Study Case – The tax on the first registration of motor vehicles

The tax on the first registration of motor vehicles, considered by the Romanian government as an environmental tax, obliges the person registering a motor vehicle to pay a tax calculated according to the type and the age of the car, the cylinder and the pollution norm. This tax and particularly its exaggerated level generated heated critique at national level and then from the European Commission who suggested in several occasions the elimination of the modification of the tax. The Commission considered that the concerned tax is against Art. 90 TUE¹⁷⁰ and against ECJ jurisprudence. The problems identified are related to the discrimination between second hand vehicles sold by Romanian citizens and the ones sold by the ones in other member states; furthermore, the level of the tax is higher than the residual value in the case of very old cars¹⁷¹. In March 2007 the Commission started the infringement procedure which implied discussions and negotiations with the Romanian authorities. After 28 November 2007 started the second stage of the procedure which offered a maximum of two months to the Romanian government to comply with the Commission's requirements, before the case would be brought to the ECJ.

Moreover, the commissioner for taxation and customs, Laszlo Kovacs, declared that the government would have not only the obligation to change the tax but also the responsibility to return the amounts paid unjustly. The commissioner gave the example of Hungary which was condemned by the ECJ following a similar situation. He emphasized that if the Romanian government would pass an emergency ordinance to modify the tax in order to bring it in line with the EU legislation, the infringement procedure would be abandoned but the amounts paid would still have to be refunded.

However, a technical problem to be found at the level of procedures in the case of an ECJ decision is that the decision will not be directly applicable to Romania citizens. Only the Romanian courts will have the right to decide on the specific cases, observing the relevant jurisprudence.

¹⁷⁰ This forbids to every member state to apply directly or indirectly an excessive taxation on the products imported from another state. **Art. 90 TUE** forbids any fiscal discrimination that would create a comparative advantage to the products of a member state.

¹⁷¹ The tax starts at 68 euro for new, very small cars and goes up to 8.586 euro for cars older than six years, with an engine capacity over 3.000 ccm.

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