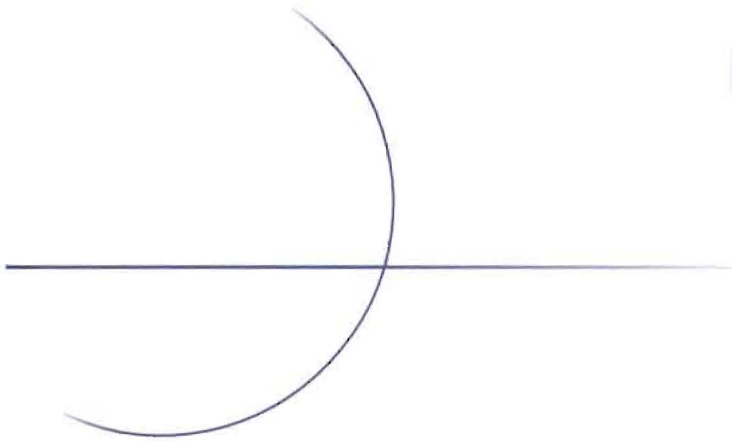
Europe on the move



Tax policy in the European Union

ECIS: 2

European Commission

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Cataloguing data can be found at the end of this publication.

Luxembourg: Office for Official Publications of the European Communities, 2000

ISBN 92-828-8734-0

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Printed in Belgium

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Tax policy in the European Union

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Taxation is central to national sovereignty, for without revenue governments cannot conduct policy. It is an instrument of economic regulation which can be used to influence consumption, encourage saving or shape the way in which companies are organised. Tax policy is essential to all Member States, and a country's actions can have an impact not only at home but also in neighbouring countries. In the European Union's single market, Member States need to work together and not strike out in different directions on tax policy.

In order to establish the internal market, the system of consumption taxes had to be as neutral as possible. Where tax rebates on exports of goods from one Member State to another were higher than the amounts actually paid they acted as export subsidies. For that reason the Community adopted the value added tax (VAT), although at the time it was introduced Member States were allowed to set their own rates.

Once the internal market became a reality and consumers were finally able to purchase goods in the Member State of their choice and take them home without having to stop at borders, differences in tax rates on various goods tended to divert business; and the resultant skewing of production and distribution can have wider social repercussions as well.

There was not at first sight thought to be the same need for coordination on direct taxes. But people may sometimes choose to live and work in a particular country in order to pay less tax, or companies may attempt to reduce their tax burden, all of which can lead to tax competition between Member States.

In what follows we look at all these issues and explore the legal and economic background to taxation in the European Union in terms of both EU and national policy, examining different types of tax and taxation systems rather than simply reporting on current tax rates and volumes of tax revenue.

As European integration progresses, encouraged by the introduction of the euro, the complex interactions between the 15 tax systems need to be analysed and perhaps managed. Member States will also increasingly have to take joint decisions to adapt their tax systems to changing social needs, for example the increase in the average age of the population, a challenge which goes beyond national borders.

Although EU tax policy may set new priorities in the future its central tenets will remain the same: to ensure some Member States' tax policies do not have an undesirable impact on others and to provide real sovereignty for EU citizens and their representatives through common action.

Diversity of tax systems

Legal basis for EU policy

Tax policy is a symbol of national sovereignty and part of a country's overall economic policy, helping finance public spending and redistribute income. In the European Union, responsibility for tax policy mainly lies with the Member States, who may delegate some of it from central to regional or local level, depending on the constitutional or administrative structure of government.

The European Union plays only a subsidiary role on taxes and social security contributions. Its aim is not to standardise the national systems of compulsory taxes and contributions but simply to ensure that they are compatible not only with each other but also with the aims of the Treaty establishing the European Community.

Article 269 of the EC Treaty requires the Community budget to be wholly financed from own resources. These

The different types of compulsory taxes and contributions

- Direct taxes: They are paid and borne by the taxpayer and include income tax, corporation tax, wealth tax and most local taxes.
- Indirect taxes: These are levied on production and consumption and are not borne by the 'taxable persons' (traders or industry) who pay them, collecting the tax on behalf of the government and passing it on in the price to the final consumer on whom the burden falls (examples include VAT and excise duties).
- Social security contributions: These are compulsory charges levied by social security organisations to pay for sickness, disability or unemployment benefits, workers to maintain insured persons' income in the event of certain risks (sickness, compensation and old age pensions, etc.). Social security contributions are paid by people in work and employers.

PHOTO EU

depend on Member States' capacity to contribute. At present these own resources consist of agricultural levies, customs duties, a percentage of VAT revenue calculated on a harmonised basis, and GNP-based resources. The European Union has no power to create or levy taxes.

However, in the single market it is important to see that Member States' tax measures do not hamper the free movement of goods, services and capital or distort competition. Progress on the harmonisation and coordination of taxation has been fairly slow, but this is due to the complexity of the issues involved and the fact that the relevant articles of the EC Treaty require unanimity for any change.

Indirect taxes

Article 90 of the EC Treaty prohibits any tax discrimination which would, directly or indirectly, give an advantage to national products over products from other Member States. Article 93 of the Treaty calls for harmonisation of turnover taxes, excise duties and other forms of indirect tax. VAT was the first tax to be harmonised, in 1977. It was adapted in 1992 to meet the requirements of the new single market, together with excise duties, which were also harmonised at the same time. These developments were accompanied by a partial alignment in the rates of the two types of indirect tax, and by arrangements for closer cooperation between national authorities. The single market, however, is only fully effective in areas where Community harmonisation of national legislation is complete.

Direct taxes

Indirect taxes require some degree of harmonisation because they affect the free movement of goods and freedom to provide services. This is not true to the same extent of direct taxes, and the EC Treaty does not specifically call for them to be aligned. Some aspects of direct taxation do not in fact need to be harmonised or coordinated at all and are left to the discretion of the Member States, in accordance with the principle of subsidiarity. The situation is somewhat different where direct taxation has an impact on the four freedoms provided for by the EC Treaty (free movement of goods, persons, services and capital) and the right of establishment for individuals and companies. National tax law must respect these fundamental freedoms. Community legislation on taxation has also been adopted under wider provisions, such as Article 94 and Article 308 of the EC Treaty.

Social security contributions

There are no plans to harmonise legislation in this area. Social security contributions are not part of the tax system proper even if they are compulsory levies under national law (which in some cases enshrines agreements between social partners). The Community has concentrated on coordinating national systems (Regulation (EEC) No 140/71) to ensure that employees or self-employed persons moving within the Community do not pay social security contributions twice. The Court of Justice has on several occasions interpreted the clauses of the regulation dealing with the applicable law to achieve this effect.

Role of the Court of Justice

Building on the laws enacted by the Council, rulings by the Court of Justice spell out in greater detail how the ban on tax discrimination under Article 90 of the EC Treaty applies and define a number of important concepts inherent in tax directives.

The underlying concepts of Community legislation in the field of VAT (the scope, the place of taxation, the taxable amount, the taxable base and the right of deduction) have been defined in a raft of case law on the common VAT system.

In the field of direct taxation, the Court of Justice has been called upon to rule on the application of the Treaty articles covering the free movement of workers (Article 39 of the EC Treaty), the right of establishment (Article 43 of the EC Treaty) and freedom to provide services (Article 49 of the EC Treaty), all of which prohibit any discrimination, including tax discrimination, on the basis of nationality.

The impact of tax on other policies

Employment

The Community's guidelines on employment urge Member States to make their tax systems more job-friendly. On 22 October 1999 the Ecofin Council (Economic and Finance Ministers) approved Directive 1999/85/EC, allowing a reduced rate of VAT to be applied on an experimental basis to labour-intensive services. But tax systems in general need to be overhauled if proactive employment policies are to be successful. Such long-term structural changes are already having an impact on unemployment in some Member States.

Economic and monetary union (EMU)

If EMU is to be successful Member States have not only to comply with budget disciplines but also to deepen and strengthen economic policy coordination, particularly in the area of

PHOTO EU

taxation. The Council's annual broad economic policy guidelines contain recommendations on the volume and structure of national taxes and social security contributions and the increasing need for coordination between Member States. Tax systems have to be structured in a way which will promote economic growth, competitiveness and employment while at the same time bringing in sufficient revenue to finance social welfare spending. While budget discipline is crucial to EMU, a balance must also be struck between economic efficiency and social cohesion.

Environment

The use of tax to achieve environmental goals (by means of 'green taxes', CO_2 tax, vehicle or road infrastructure taxes, tax incentives) has been at the centre of discussions since the early 1990s.

Health

VAT and excise duties account for a large proportion of the retail price of tobacco and alcohol, and health and consumer protection policies are taken into consideration when setting tax rates in order to discourage the abuse of such products.

International competitiveness

Some charges, such as VAT, can be deducted on export, others are levied on the cost of production and therefore affect competitiveness. So the way taxes and social security contributions are structured can influence the competitive position of European economies. In times of public or private austerity a number of Member States have been able to maintain investment in research and development capacity by means of favourable tax measures.

Tax competition

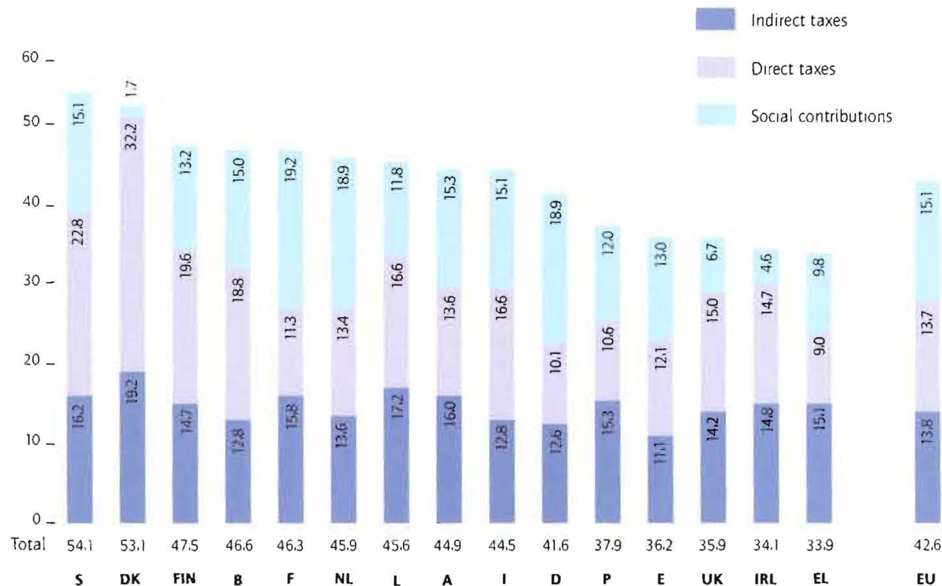
Decisions about the location of investment, business activities, jobs and earnings are sensitive to differences in national tax regimes and social welfare systems. With increasing mobility and differentials in tax bases, businesses can identify the components on which they are taxed (taxable bases) and shop around to find the country where tax is lowest. Such competition between Member States puts downward pressure on the level of tax and contributions which may be damaging if it is not regulated, as it undermines the fairness and overall efficiency of tax systems.

Differences between tax systems

Taxes and social security contributions are essential to the way in which European economies are organised.

One of the main factors underlying the differences between Member States' overall volume of taxes and social security contributions is whether major items of expenditure such as education, pensions and health care are publicly or privately financed. Pensions or health care, for example, may be financed partly by market mechanisms (group or individual insurance schemes, pension funds, etc.) rather than through the national budget.

Volume and structure of compulsory taxes and social security contributions as % of GDP (1997)



Source: Eurostat, *Statistics in Focus* – 30/1/1998 (Catalogue number: CA-NJ-98-030-EN-C).

The current situation in the Community

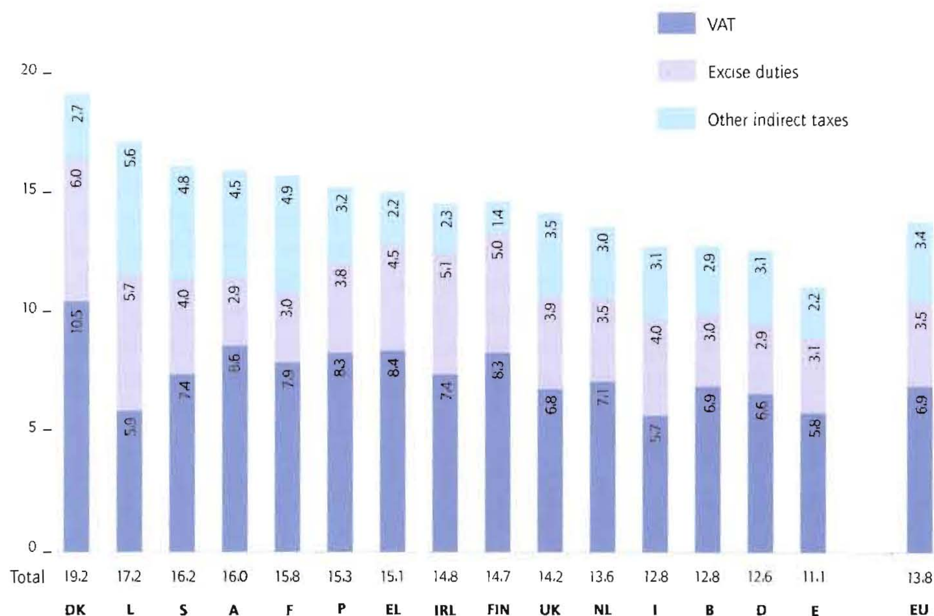
Indirect taxes

In 1997 indirect taxes accounted for around EUR 1 000 billion (13.8 % of EU GDP). They tend to remain more or less at the same level over time, although there are national variations around the European average.

One of the first tax harmonisation measures introduced at Community level concerned indirect taxes on the raising of capital (Directive 69/335/EEC, last amended by Directive 85/303/EEC). The aim was to harmonise the indirect tax ('capital duty') levied by Member States on the raising of capital for companies. Transactions covered by Community legislation include the formation (or conversion) of capital companies, increases in capital, shares issues and generally any such transaction which increases a company's capital.

Since 1986 it has been up to Member States to decide whether they apply capital duty on transactions covered

Indirect taxes as a % of GDP (1997)



Source: Estimate by the Taxation and Customs Union DG on the basis of the Eurostat publication referred to earlier.

by the directive. If they choose to do so, a single rate of duty not exceeding 1 % must be applied to all transactions. Some transactions, primarily company mergers and transfers of assets, are automatically excluded from capital duty. All taxes other than capital duty, such as tax charged for the registration of companies which is not considered to be payment for a service rendered, are prohibited.

Following the introduction of this first measure, Community efforts at harmonisation have focused on two important taxes: VAT and excise duty.

Value added tax

VAT was introduced in the European Economic Community in 1970 by the first and second VAT directives and was intended to replace the production and consumption taxes which had hitherto been applied by the Member States. The cumulative effect of these cascade taxes was to create a barrier to trade, particularly imports and exports between Member States, as it was difficult to calculate the exact amount of tax incorporated in the price of goods and services. VAT, on the other hand, has the advantage of making the tax content of a product visible at each stage in the production or distribution chain. It was chosen as a method of indirect taxation because it avoided the cumulative effect of cascade taxes and ensured tax neutrality both nationally and in trade between Member States and with non-Community countries.

The decision taken in 1970 to allocate a proportion of VAT revenue calculated on a unified basis to finance the Community budget (part of the Community's 'own resources') paved the way for harmonisation of VAT. The sixth VAT directive (77/388/EEC) ensured that the tax was applied to the same transactions in all Member States, so that they formed a common basis for funding the Community, and introduced a common assessment basis. Not only does the sixth directive represent a body of law laying down Community definitions of important concepts, it also paved the way for subsequent measures working towards a goal set as early as the first VAT directive: the abolition of tax frontiers.

With this in mind the Commission in 1987 proposed an early move to origin-based taxation (i.e. charging the tax in the country of sale), backed up by a clearing system designed to prevent significant shifting of revenue between Member States. Inability either to agree on a clearing system or to align rates, however, ruled out any rapid move in this direction. An interim solution was therefore introduced combining origin-

Main features of VAT

VAT is a general consumption tax which is directly proportional to the price of goods and services. It is collected fractionally, i.e. on each transaction in the economic chain, and is neutral.

- It is a *general* tax applying in principle to all commercial activities involving the production and distribution of goods and provision of services.

- It is a *consumption* tax because it is borne ultimately by the final consumer. It is not a charge on companies.

- It is *charged as a percentage of price,* which means the actual tax burden is visible at each stage in the production and distribution chain.

- It is collected *fractionally,* via a system of deductions whereby taxable persons (i.e. VAT-registered businesses) can deduct from their VAT liability the amount of tax they have paid to other taxable persons on purchases for their business activities. This mechanism ensures the tax is *neutral* regardless of how many transactions are involved.

VAT rates in the Member States (1)

Member State	Reduced super rate	Reduced rate	Normal rate	Parking rate (2)
Belgium	1	6	21	12
Denmark	–	–	25	–
Germany	–	7	16	–
Greece	4	8	18	–
Spain	4	7	16	–
France	2.1	5.5	20.6	–
Ireland	4	12.5	21	12.5
Italy	4	10	20	–
Luxembourg	3	6	15	12
Netherlands	–	6	17.5	–
Austria	–	10/12	20	–
Portugal	–	5/12	17	–
Finland	–	8/17	22	–
Sweden	–	6/12	25	–
United Kingdom	–	5	17.5	–

(1) At 1 May 1999 (source: Taxation and Customs Union DG).
(2) In the Member States which initially applied a reduced rate to non-eligible goods.

and destination-based taxation and making it possible to abolish controls at tax frontiers. Free movement of goods within the Community meant trade between Member States could no longer be treated as imports or exports. Thanks to the existing (transitional) system, the crossing of a border is no longer treated as a taxable event; tax liability is incurred by transactions, as it is under a national system.

PHOTO EU

Since 1993, private individuals going to another Member State have been able to buy goods or services for their personal use and be taxed in the same way as its nationals. They can then return home with their purchases without being taxed again. There are a couple of exceptions, however.

- The purchase of new vehicles (less than six months old or with less than 6 000 kilometres on the clock) in another Member State. This transaction is taxed in the Member State of destination at its rates and in accordance with its rules. The vehicle has to be registered and taxed in the country where the buyer is normally resident.

- Mail order sales by a company located in another Member State. Where the seller takes responsibility for transporting the goods ordered, VAT will be charged either at the rate applying in the country where the buyer is resident or at the rate in the seller's country, depending on the seller's annual sales volume in the country of destination.

While origin-based taxation remains a basic principle of the common VAT system for private individuals, the transitional system kept various parallel destination-based methods for companies, the aim being to ensure that the VAT levied in each Member State reflected the volume of consumption there. Problems quickly became apparent and two further directives were adopted in 1992 and 1995 to streamline the system and remove the most blatant distortions. However, it was impossible to achieve any radical simplification because the parallel origin and destination-based taxation regimes continued to apply, Community legislation was not applied uniformly and rates remained too far apart. As a result, the existing VAT system is cumbersome for traders and the single market is, to some extent, still fragmented.

Under Community law there are also two permanent special schemes, one for second-hand goods, works of art, antiques and collectors' items, and the other for gold purchased for investment purposes.

• The work programme on a new common VAT system presented by the Commission in 1996

Following the Council's adoption of the transitional VAT system the Commission, in July 1996, proposed a package of measures which would be introduced in stages to deal first with immediate problems and then move towards a common origin-based VAT system.

To improve on the transitional system and meet the needs of the single market, the new VAT system must:

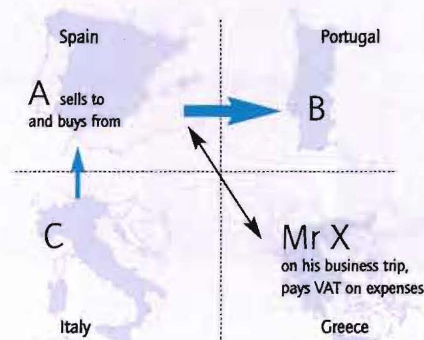
- put an end to the segmentation of the market into 'national' tax areas;
- be simple and modern;
- ensure equal treatment for all transactions within the Community;
- guarantee effective taxation and controls to maintain the level of VAT revenue.

The programme focuses on three areas of Community action:

- uniform application;
- modernisation of VAT;
- a change to origin-based taxation.

What does the new common VAT system mean for traders?

Imagine a typical week in the life of manufacturer A in Spain. In addition to selling in Spain, A sells goods to retailer B in Portugal and buys raw materials from C in Italy. A is also attempting to break into the Greek market and sends out a representative, Mr X. In Greece Mr X incurs accommodation, travel, repair and printing costs on which he has to pay VAT like any other consumer.



Under the present VAT system

- A must check that B is liable for VAT. A then sells to B free of VAT, and sends a declaration to the Spanish authorities. A must prove that the goods have actually left Spain.
- A buys raw materials from C without VAT but must also declare and deduct VAT at the rate applying in Spain (and B does the same for purchases from A).
- Mr X cannot deduct the expenses he incurred in Greece on his normal VAT declaration in Spain, but has to submit a separate application for a refund in Greece under the 8th VAT directive.

Under the proposed new system

- Each trader applies VAT at the local rate without any other formality.
- Each trader deducts the VAT paid anywhere in the European Union on his normal VAT declaration.

In order to achieve this goal, all the options and exemptions (transitional or definitive) that Member States are currently allowed to apply will have to be reviewed. VAT will have to be applied uniformly and consistently and levied and collected more efficiently, through closer cooperation between officials.

The Commission has proposed a number of procedural improvements and simplifications following a survey known as 'SLIM' – Simpler Legislation for the Internal Market:

- *greater cooperation ('mutual assistance') on VAT collection* between Member States;

- *replacing the current refund procedure* by a new mechanism allowing traders to deduct VAT paid anywhere in the Community in their own Member State;

- *abolition of the rule that Community traders carrying out taxable transactions* in a Member State where they are not established must appoint a tax representative there;

- creation of single contact points in each Member State to make it easier for companies to register, and the introduction of new tax arrangements for electronic invoicing.

The need to update VAT legislation reflects a number of underlying developments including the trend towards privatisation, developing case law and new information technology.

Examples in two fields illustrate the sort of changes that are taking place.

• Telecommunications

In order to put an end to distortions of competition in this sector, the Council adopted rules in 1999 making telecommunication services provided to European customers liable to tax in the EU and removing tax from services to non-EU customers.

• E-commerce

The plan is that e-commerce will be taxed neutrally in relation to conventional trade and VAT will be applied at the place of consumption, subject to a number of adjustments. Electronic transmissions will be taxed as services.

The authorities also intend to make greater use of electronic invoicing and declarations to improve tax compliance, and will encourage taxpayers to do likewise.

• Progress with the 1996 programme

The gradual approach proposed in 1996 has proved extremely difficult to implement. Member States have shown little enthusiasm for the proposals in Council meetings and, as was the case with the transitional system, have been reluctant to accept the greater harmonisation of VAT rates and tax structures which is a prerequisite for the definitive system.

The Commission itself has not given up the long-term goal of origin-based taxation but plans to follow a strategy based on simplification, modernisation and more uniform application of the present VAT system coupled with a fresh approach to 'administrative cooperation' between officials.

Excise duties

A common system of excise duties was introduced on 1 January 1993 when the single market came into being. It applies to three main categories of product: manufactured tobacco, alcoholic drinks and mineral oils. Member States can, however, continue to levy other (unharmonised) taxes on these products (green taxes), and others, such as vehicle registration or road taxes, fees, etc., provided they do not constitute either a turnover tax or a barrier to trade.

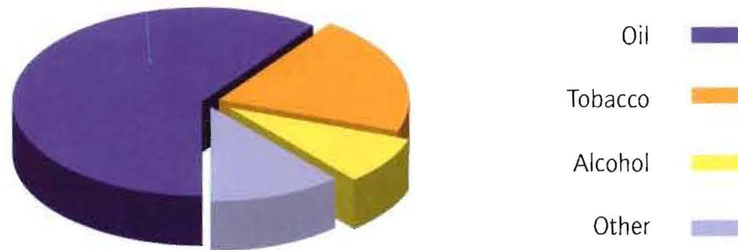
Main features

Excise duties are special taxes levied on particular consumer products: manufactured tobacco, alcoholic drinks, mineral oils, etc. Their rates are usually expressed in an amount per unit of product, although sometimes a percentage of the value is used instead.

The choice of excisable products is partly dictated by public health, environmental and energy-saving considerations. The rate of excise duties varies from one Member State to another but they are an important source of revenue, accounting for EUR 248 billion in 1997 for the European Union as a whole.

Excise duty EU 15 in 1997

(Breakdown of revenue by volume)



Source: Estimate by the Taxation and Customs Union DG based on Eurostat statistics.

The Community rules cover:

– *harmonised tax structure* (definition of products, units of measurement, exemptions);

– *tax rates.* In 1992 the Council adopted common minimum rates for the Member States (with a number of exemptions), giving them a degree of discretion to set their own rates of excise duty, while taking due account of the international environment;

– *movement* of excisable product between Member States.

The taxable event is usually the production of goods or import into the Community. However, payment is generally suspended until the goods are declared for release for consumption (i.e. put onto the market), usually at a later stage in the commercial chain. This rule ensures that excise duty is always paid in – and to – the Member State where the goods are consumed.

In other words, excise duty is not usually paid on goods leaving manufacturers or wholesaler until after the storage and forwarding stage. Goods imported from outside the EU can move within the EU under tax suspension arrangements until they are officially released for free circulation.

PHOTO EU

A common system of excise duties for manufactured tobacco, alcoholic beverages and mineral oils.

Harmonised procedures based on existing national rules are designed to ensure that products supplied to the final consumer are actually taxed. They involve:

- a linked system of tax warehouses for the storage and movement of goods in bond, on which tax has been suspended;

- warehouse keepers authorised by national authorities, who are responsible for payment of tax and have to provide a financial guarantee;

- official stock records kept by warehouses;

- an administrative document drawn up by consignors, which accompanies the goods.

More flexible rules apply to occasional purchasers. Private individuals going to another Member State can buy an unlimited quantity of excise-paid products for their personal use; if they are buying for commercial purposes (or by mail order), on the other hand, the excise duty has to be paid in the country of destination.

PHOTO: ARIE WAPENAAR, VLAARDINGEN – NEDERLAND

Taxation can have a significant impact on energy consumption.

Energy products

The June 1992 UN Conference on the Environment and Development in Rio (the 'Earth Summit') called for a global strategy to reduce greenhouse gases, including the use of economic instruments. At the time, the Commission was proposing a new harmonised carbon and energy tax aimed at stabilising CO_2 emissions in the Community in the medium term. Even after amendment, however, the proposal met consistent opposition and the Ecofin Council, feeling unanimous agreement was out of reach, asked the Commission to table another proposal based on the current system of excise duty for mineral oils.

The new proposal (COM(97) 30) reflects environmental concerns but is

essentially shaped by the need to ensure that the internal market operates correctly. The main idea is to extend the Community system of excise duty on mineral oils to cover natural gas, coal and electricity, raising the minimum duty on mineral oils and setting minimum rates for the others. At the same time, however, taxes on labour would be reduced to ensure the overall tax burden does not rise.

The proposal is part of a coordinated plan aimed at meeting the targets set by the 1997 UN Conference on Climate Change in Kyoto, where the Community undertook to reduce greenhouse gases by 8 % from 1990 levels between 2008 and 2012.

Tax fraud

Tax fraud is a problem of increasing concern in the Community. By eroding tax revenue in the Member States it has increased the burden on employees. Measures to combat fraud now form part of overall Community tax policy, and a number of initiatives are already under way on VAT and excise duties.

The aim is to encourage closer cooperation between Member State authorities and to provide training for national officials aimed at familiarising them with different types of fraud and developing prevention, detection and investigation methods based on risk analysis.

European Parliament and Council Decision 888/98/EC instituted a multiannual Community action programme (Fiscalis) to improve the operation of indirect taxation systems in the single market. The programme is designed to help Member States ensure that all EU officials have a good grasp of Community law, to secure wide-ranging and effective cooperation between Member States and with the Commission, and to improve administrative practice.

International VAT fraud, particularly on sales and deliveries within the EU, has led to serious losses of revenue. It also distorts legitimate trade and official employment figures and erodes confidence in the single market. National administrations and the Commission need to cooperate and exchange information on a much greater scale

PHOTO: AUSTRIAN MINISTRY OF FINANCE

Cigarette smuggling is a serious problem in the European Union.

in order to target and combat fraud more effectively, and better coordination is needed at Community level.

Tobacco and alcohol fraud has reached serious proportions, causing a loss of revenue (excise, VAT and customs duties) for the Member States and the Community – of some EUR 4.8 billion in 1996. A group of senior officials studied the problem, looking simultaneously at customs duties, excise duties and VAT. On the basis of their work the Ecofin Council on 19 May 1998 approved a coordinated response comprising:

- a feasibility study on a computerised system for the movement and control of excisable products;
- a system of advance notification to improve the tracking of movements of goods;
- a code of practice to be drawn up governing the approval or withdrawal of authorisations for warehouse keepers and checks on goods in bond;
- protocols to be negotiated by Member States with manufacturers and traders to improve cooperation and gain information making it easier to detect unusual or suspect movements.

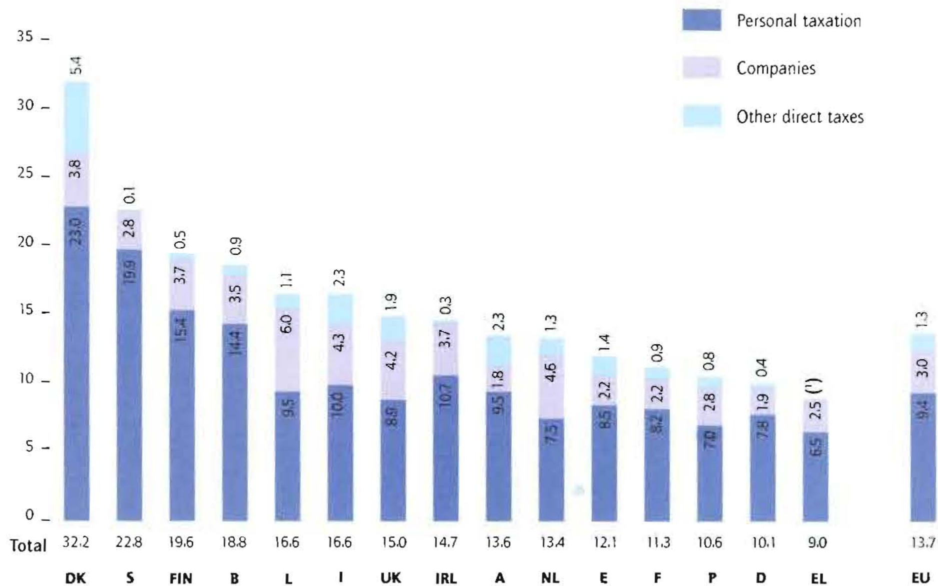
Direct taxes

Direct taxes totalled EUR 1 000 billion (13.7 % of European GDP) in 1997, reflecting the general rise in tax and social security contributions (albeit in personal income tax rather than corporation tax).

There has been no harmonisation or coordination of direct taxes in the Community. Such progress as there has been is no more than a partial response to the specific situations of double taxation and cross-border economic activity. On income tax, Member States have endorsed a non-binding recommendation made by the Commission in 1993 in which it proposes a number of rules differentiating between residents and non-residents for income tax purposes.

The impact of corporation tax on competitiveness was first studied in 1962, when working parties were set up to discuss tax bases and instances of favourable tax treatment. Attempts to harmonise corporation tax (1975), the rules governing carry-over of losses (1984 and 1985) and the tax bases for companies (1980) failed.

Direct taxes as % of GDP (1997)



(¹) Data not available for Greece.

Source: Estimate by the Taxation and Customs Union DG based on Eurostat statistics.

EU Member States do, nevertheless, realise that economic integration will require greater cooperation on tax collection, and Council Directive 77/799/EEC provides for mutual assistance between national tax authorities.

Taxation of groups of companies

On the tax front the main problem for companies wishing to take advantage of the single market is probably the difficulty of cross-border cooperation between companies established in the Community, and in 1990 the Council adopted two directives to remove some of the obstacles.

- The *Merger directive* (90/434/EEC) is designed to cut down tax measures that might hamper business reorganisation.

- The *Parent-subsidiary* directive (90/435/EEC) abolishes double taxation of profit distributed between parent companies in one Member State and their subsidiaries in another Member State.

The Member States have also concluded a convention (90/436/EEC) based on Article 293 of the EC Treaty, introducing an arbitration procedure to prevent double taxation in connection with the adjustment of profits between associated enterprises from different Member States.

Corporation tax

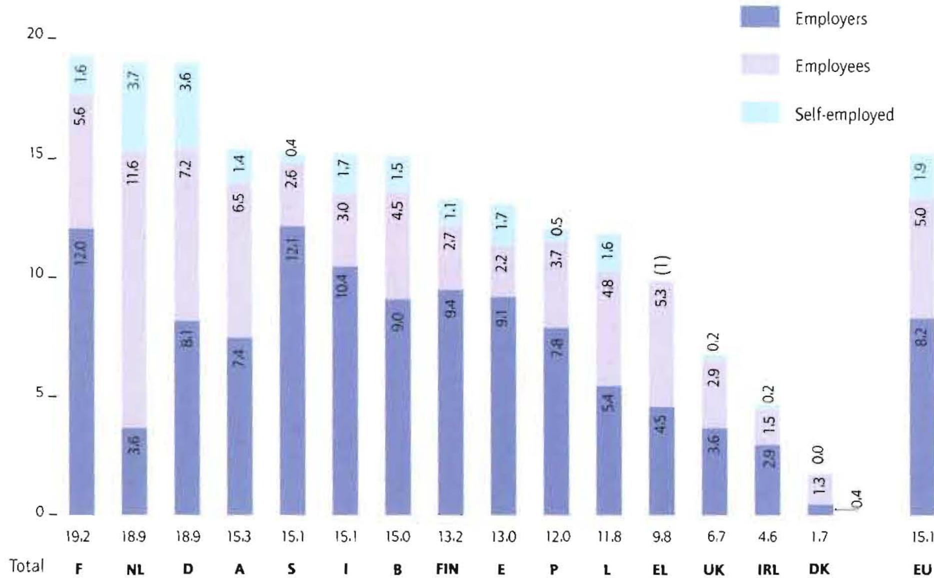
Differences in taxation between Member States can influence companies' investment decisions and create distortions of competition. In 1990 the Commission asked a committee of independent experts chaired by former Dutch Finance Minister Onno Ruding to examine whether differences in corporation tax caused distortions in the single market, particularly as regards investment decisions and competition, and to suggest ways of overcoming this problem. Despite a measure of convergence between tax systems, individual action by Member States was unlikely to prove effective in eliminating major tax distortions. The committee made specific recommendations designed to eliminate double taxation of cross-border income flows and harmonise three components of corpora-

tion tax: the rates, the assessment basis and the administrative collection system. Essentially, it suggested that the key components of Member States' corporation tax systems be harmonised. Its proposals to eliminate double taxation dealt with abolition of charges, regulation of transfer pricing, treatment of losses abroad and completion of the network of bilateral tax agreements. The need to eliminate double taxation, ensure effective taxation and prevent tax evasion is recognised by the Council.

Social security contributions

These represent the largest compulsory levy in value terms (over EUR 1 000 billion in 1997), accounting for 15 % of European GDP.

Social security contributions as % of GDP (1997)



(') Data not available for Greece.

Source: Estimate by the Taxation and Customs Union DG based on Eurostat statistics.

A new approach

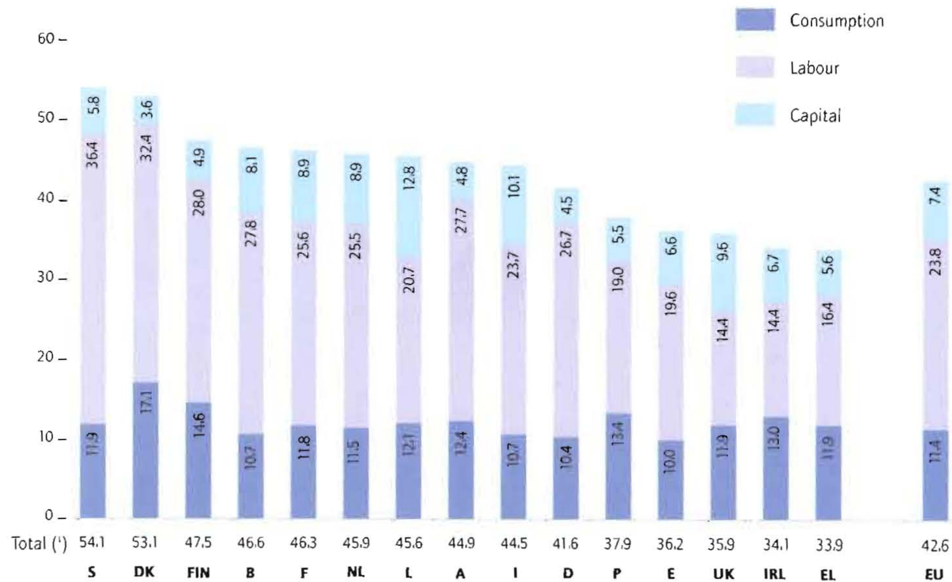
Background

Magnitude and breakdown of compulsory taxes and social contributions

Having risen steadily over a number of years, compulsory taxes and social contributions stood at EUR 3 000 billion (42.6 % of European GDP) in 1997, more or less equally spread between direct taxes, indirect taxes and social security contributions. Alongside this traditional classification, however, it is worth seeing how taxes and social contributions break down between consumption and the main production factors.

In Europe taxes and charges on employees account for the largest share of compulsory levies, to a greater extent than in the United States or Japan. Charges on other factors of production consist largely of taxes on various forms of capital: tax on transactions, tax on

Breakdown of taxes and social contributions by economic category of the tax base
As % of GDP 1997



(¹) Including tax on transfers.

Source: Eurostat, Statistics in Focus (1998) and Structures of the taxation systems (new edition to be published shortly).

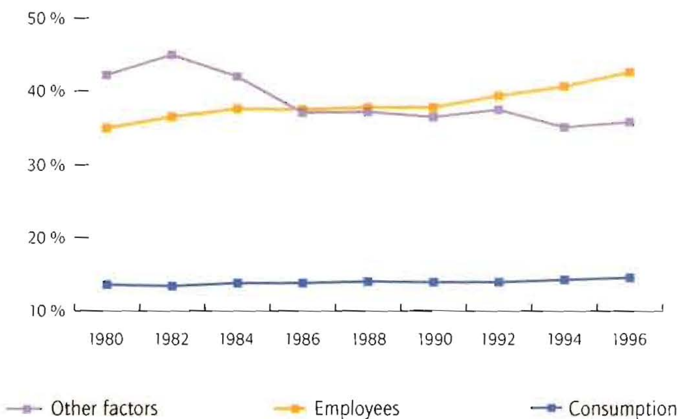
moveable property or wealth tax. Their relative share of overall taxes and social contributions is lower in Europe than in the United States and Japan.

Trends in effective taxation of economic bases (implicit rates)

As the breakdown of GDP by economic category (consumption, labour and capital) varies over time, tax/GDP ratios cannot be used to assess the effective taxation of these economic factors. Implicit tax rates, defined as the relationship between the tax burden and the share of each economic function in GDP, provide a set of consistent and internationally comparable indicators of effective tax levels.

Over the last 15 years tax systems (including social security contributions) have tended to work against the creation of jobs in most Member States. On average in Europe between 1980 and 1996 the implicit tax rate for employees rose significantly (from 35 % to just under 43 %) but fell (from 42 % to less than 36 %) for the other factors of production (primarily capital) and remained stable (around 14 %) for consumption.

Implicit tax and social contribution rates 1980–96



Source: Eurostat, Structures of the taxation systems in the European Union – 1970–96, Luxembourg, 1999.

PHOTO: AIRBUS INDUSTRIE

The single market offers new opportunities for cooperation at European level.

The challenges facing tax policy in the European Union

A new strategy

Changes in the structure of taxation systems and the need to make progress in completing the single market prompted the Commission in 1996 to propose a new strategy. A Commission paper (SEC(96) 487 -- Taxation in the European Union) underlining the need to promote growth and employment, stabilise tax systems and complete the construction of the single market was favourably received by economic and finance ministers meeting in Verona on 13 April 1996, who decided to pursue discussions on that basis. In essence it envisages a twofold approach.

- **The smooth functioning of the single market**

Differences in national tax law remain a serious obstacle to the completion of the single market, as incompatible systems hamper trade and tend to compartmentalise the EU market. These anomalies lead to poor resource allocation and weaken the international competitiveness of EU firms. The introduction of the euro, greater market transparency and tougher competition have made the distortions created by tax barriers even plainer.

PHOTO UE

- **Stabilising Member States' tax revenue and promoting employment**

Member States wanting to stabilise tax revenue face a number of problems: ageing populations, the gradual erosion of some tax bases and the adverse effect on jobs of the increasing taxation of labour. The situation is further complicated by harmful tax competition between Member States. In a climate where capital is highly mobile and labour much less so, stability and in some cases growth of overall tax revenue has been achieved by effectively shifting taxation so as to increase the pressure on the less mobile tax base. Higher welfare spending has been accompanied in some countries by an increase in the charges borne by labour, since a significant share of that spending is financed directly by social security contributions, while at the same time the tax shortfall resulting from erosion of other more mobile tax bases has been partly offset by overtaxing labour.

If this trend is to be reversed, however, a way must be found to make up the loss of revenue caused by lessening the burden on labour. The shift can only come about gradually and improvements would have to be targeted initially at the low-paid and low-skilled workers whose jobs are most vulnerable to 'rationalisation' or displacement by capital.

Coordination of tax policies

The Commission paper discussed in Verona in 1996 made it clear that the constraints on tax coordination at EU level were twofold: the need for unanimous approval of any decision and the lack of a comprehensive strategy for tax policy. The Commission and Member States agreed that a concerted approach to tax would ensure there was no involuntary loss of national sovereignty to market forces, and set up a high-level group to discuss ways of coordinating tax policies more closely.

Results of the new strategy

The tax package of 1 December 1997

The EU's pragmatic approach was formalised in a Commission communication (COM(97) 564) on a package of measures to combat harmful tax competition in the European Union. The tax package approved by the Ecofin Council on 1 December 1997 consists of:

- a code of conduct for business taxation;

- measures to remove distortions in the taxation of income from savings;

- measures to abolish withholding tax on cross-border payments of interest and royalties between companies.

The Commission has also drawn up guidelines on 'fiscal State aid' (tax incentives) and their compatibility with the EU State aid rules (communication 98/C 384/03).

The code of conduct for business taxation

The code of conduct is not a legally binding instrument. It represents a political commitment by Member States to refrain from harmful tax competition, and includes evaluation and review procedures. Dealing with tax breaks that may have a significant effect on business location in the EU, it regards as potentially harmful those that result in a lower effective level of taxation than is usual in the Member State concerned and gives a definition of what constitutes 'harmful' competition.

In March 1998 a high-level group comprising representatives of the Member States and the Commission was set up to discuss and review tax measures which might fall within the scope of the code.

Taxation of savings

Income from interest on capital is one of the most mobile tax bases, and tax competition is rife. If the single market is to operate properly, investment decisions must be based on the intrinsic qualities of available products, and not on opportunities for tax evasion. In 1998 the Commission tabled a proposal (COM(1998) 295) designed to ensure an effective minimum level of taxation of savings income in the form of interest in the EU, while simultaneously holding talks with countries outside the EU to persuade them to adopt comparable measures. The proposal incorporates the coexistence model endorsed by the Member States in December 1997, and is based on the 'paying agent' principle. Under the coexistence model Member States can choose either to provide information to other Member States about their nationals' interest income or impose the minimum 20 % withholding tax proposed by the Commission. Information would be collected and the withholding tax applied by the paying agent in the EU, i.e. the person responsible for payment of the interest. The proposed directive applies to interest paid to individuals resident in an EU Member State other than the one where the interest is paid.

Payment of interest and royalties

Withholding tax on interest and royalty payments between companies of the same group established in different Member States causes difficulties for business, including time-consuming formalities, cashflow losses and sometimes double taxation. Following the Ecofin Council in December 1997 the Commission presented a proposal for a Council directive (COM(1998) 67) in March 1998 calling for a common tax system abolishing such withholding tax.

Looking ahead

Cardiff.

Economic and structural reform

Taxes and social security contributions strongly influence patterns of saving, consumption, investment and employment, and thus shape the operation of markets for goods, services, capital and labour. The reforms launched by the Cardiff European Council of June 1998 are designed to ensure that the differences between systems that have become even more apparent since the introduction of the euro do not hamper trade, result in fragmentation of the single market or prevent the efficient allocation of resources.

National tax and social contribution systems have other aims than simple market operation, however, and have to be judged in the light of different criteria which will vary in importance from one Member State to another. Only through closer coordination of national tax policies can a balance be struck between the diversity of Member States' tax and social contribution systems and the right to untrammelled freedom of establishment and movement throughout the EU.

PHOTO EU

Computers are changing our view of the world.

Economic globalisation and new technology

The global village

The free movement of capital and freedom to provide financial services, combined with the new opportunities offered by information technology, are likely to affect the EU's competitive strength and make the conduct of national tax policies even more difficult. Bilateral agreements between Member States are not enough to ensure coordination between tax systems. Only an approach coordinated at Community level and carried through on the broader international arena can be effective.

The aim is to allow the free movement of capital while preventing this being used for tax evasion. The action plan for a single financial market presented by the Commission in May 1999 provides the beginning of a response to these issues, calling for further progress on tax coordination to remove distortions in the taxation of cross-border financial products.

E-commerce

The development of e-commerce is a challenge for current tax systems. Online transactions must comply with the same tax rules as traditional ones so as not to distort competition, but the tax rules must not discourage the development of Internet business.

These matters have been discussed by international organisations such as the World Trade Organisation (WTO) and the Organisation for Economic Cooperation and Development (OECD). A Commission communication (COM(1998) 374) calls for e-commerce to be taxed neutrally in relation to traditional commerce. VAT would apply at the place of consumption, and electronic transmissions would be taxed as services. The Commission is discussing these issues with the Member States and business to find appropriate solutions; it may be necessary to change the law.

Making the tax authorities more efficient

European tax authorities are already using new technology to improve their own efficiency and their interaction with taxpayers. The next step is to allow taxpayers to make their declarations on line; this means establishing unified rules for electronic invoicing and giving taxpayers the right to access official databases.

Enlargement of the European Union

Aspiring EU members are required to take over the whole body of EU law (the *'acquis'*) and to refrain in the run-up to membership from introducing any measures which conflict with that law. The current 'candidate countries' are continuing the work of adapting to EU law and ensuring that any new tax measures they introduce are compatible with Community rules on business taxation. This is one of the priorities for the 'partnership' arrangements adopted by the European Union to help these countries prepare for future accession.

The Commission has drawn up a detailed strategy, including analysis and monitoring of changes to the prospective members' tax systems and administrations, and assistance with training for their officials. The European Union is preparing the authorities of these future Member States for the new responsibilities they will take on once they join by working with them on projects under the Phare programme, involving tax officials in its Fiscalis programme, and organising joint activities between the administrations of the Member States and those of the candidate countries.

PHOTO EU

Time for reflection.

Demographic crossroads

Europe's ageing population and structural changes in the organisation of work and working time have created a new – and extremely worrying – problem in many Member States: how to finance pensions. Globalisation and the development of private financing instruments (such as insurance schemes, pension funds and financial products) are obliging the European Union to look at these issues as well. There must be consistency between financial matters which are largely regulated at EU level (directives on freedom to provide financial services) and those dealt with primarily by Member States (e.g. welfare systems), which often have a redistributive role. Sensible use of tax instruments can help to reconcile an efficient internal market with the requirements of national solidarity.

Conclusion

The links between tax policy and other areas of EU policy are becoming clearer as European integration proceeds. There is now a considerable body of EU law on various tax-related matters, and citizens can invoke this if Community law is breached in a Member State. To ensure that this body of rules keeps pace with social change, and in the interests of greater simplification, the EU is also introducing new tax policy instruments which will enable it in the coming years to cope with new challenges:

– setting up a permanent forum for Member States to exchange information on direct taxes in particular and maintaining an active presence in international bodies such as the OECD;

– establishing a dialogue with the public and business to inform them of their rights in other EU countries;

– ensuring that national tax systems are compatible and consistent with EU objectives, so that economic and monetary union becomes a reality;

– enabling European industry to compete internationally;

– enlarging the European Union to include new Member States;

– fighting fraud and dealing effectively with other irregularities.

See also…

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European Commission, 'A package of measures to tackle harmful tax competition in the European Union', communication from the Commission to the Council and to the European Parliament, COM(97) 564, 5 November 1997.

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Internet sites:

http://europa.eu.int/en/comm/dg21/dg21.html

http://europa.eu.int/citizens

http://europa.eu.int/business

European Commission

Tax policy in the European Union

Series: Europe on the move

Luxembourg: Office for Official Publications of the European Communities

2000 — 38 pp. — 16.2 x 22.9 cm

ISBN 92-828-8734-0

The European Union has a single market and single currency but needs a tax policy. What will this involve?

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CQ-26-99-102-EN-C

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OF THE EUROPEAN COMMUNITIES

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ISBN 92-828-8734-0