
Future of taxation in the single market

Fabian Zuleeg and Iva Tasheva

BACKGROUND

Lack of vision for future of taxation

In recent decades, taxation policy in the EU has developed in a complex and often inconsistent way. Whilst member states have preserved their sovereignty over tax policies, EU treaties emphasise the need to harmonise some rules to guard the single market's integrity. Some degree of harmonisation is required with regards to direct taxes, such as corporate tax, to remove tax obstacles to trade, double (non-) taxation, and prevent harmful tax competition. Harmonisation is also needed for indirect taxes (e.g. VAT) to limit single market distortions. Member states are also encouraged to shift taxes away from labour in the context of the European Semester. Thus, EU intervention in the area of taxation has increased together with its ambition to complete the single market and enhance the level of cooperation in the context of economic union.

Tax policies could play an important role as an enabler for growth and employment, to consolidate public finances and to support those at risk of social exclusion, as well as for infrastructure development and renewal. However, harmful tax competition, tax avoidance and tax evasion have made it clear that these objectives will not be met without adapting the existing tax tools and instruments to ongoing challenges related to budget deficits, labour market transformation, and digital disruption as well as globalisation.

In addition to broad political objectives, there is also a pressing demand from citizens to reform tax policies to focus on sustainability (economic, social, and environmental)¹ and to ensure tax justice², especially in times of austerity, budget cuts and rising inequalities.

Public and political pressures have placed the objective of fair taxation high on the agenda of the Juncker Commission. The EU is playing an active role in enhancing tax cooperation between member states, the transparency of tax policies, and reducing tax barriers to trade in the single market.³ Civil society supports these objectives, but a consistent and shared vision for the future of taxation in the EU is still needed.

STATE OF PLAY

Learning to share

In the tax area, the EU mainly relies on instruments developed by other international organisations such as the Organisation for Economic Cooperation and Development (OECD). In the OECD's Base Erosion and Profit Shifting (BEPS) framework, over one hundred countries collaborate to tackle tax evasion, tax avoidance and aggressive tax planning. This new comprehensive approach challenges long-standing principles and practices of international taxation. It also challenges the traditional view that any tax planning is acceptable as long as it is legal. In addition, the OECD is also the main international organisation to combat tax havens⁴, although efforts aiming to achieve this objective have not been very effective so far. Finally, with respect to harmful tax competition, the OECD has also produced a 'Model Tax Agreement on Exchange of Information in Tax Matters' – a non-binding instrument as a standard of effective exchange of information for bilateral and multilateral agreements. Although it is considered to be

a useful tool, it has limited effect given that it applies only to countries that entered an agreement and does not require an automatic exchange of information.

The taxation tools developed in the EU framework are relatively limited and the requirement of Council unanimity makes further tax harmonisation very complicated. Cooperation is also hampered by the fact that most instruments (e.g. Code of Conduct, country-specific recommendations) are non-binding. However, the Union has introduced a country-by-country reporting and re-launched a proposal to establish a Common Consolidated Corporation Tax Base (CCCTB), due for Council adoption in 2017, which aims to counter tax avoidance and improve transparency.

In general terms, the high level of tax fragmentation within the EU undermines Europe's potential. In order to identify what needs to be done to develop and follow a shared vision for the future of taxation, there is a need to shed light on some of the core challenges that the EU and its members are facing:

1. Fragmented tax policies undermine the single market

The fragmentation of tax systems damages the single market in a number of ways. First, it impedes market integration by creating barriers to trade, undermines efficiency through limited transparency and knowledge of the rules, and creates administrative burdens as it makes it difficult and costly for SMEs to operate across borders. Second, it creates legal uncertainty when national taxation rules are contradicting one another. Third, it risks double non-taxation (i.e. cross-border activity not taxed in any country) or other forms of corporate tax avoidance. Fourth, the different taxes on, for instance sugar or fat food distort the single market - in a single market with free movement of goods these taxes may also not achieve their important policy objective. More cooperation between member states and the Commission is needed to address these issues.

2. Challenges of digitalisation

The increasing digitalisation of the economy entails manifold opportunities, but also creates new challenges, such as job losses and an increasing gap between the digital revolution's 'winners and losers'. New business models challenge existing tax systems (e.g. Uber) and raise the need to strike a balance between the legitimate need to collect revenues and the freedom to innovate. There are some options to tackle this challenge by, for example, taxing the revenue (platform) and consumption (user). But if every member state adopts its own solution, this will further fragment the single market, create legal uncertainty, limit the SMEs cross-border expansion, and increase the risk of profit shifting and harmful tax competition. Tax systems need to respond efficiently and adequately to mitigate these risks.

3. Consolidating public finances

The primary role of taxation is to provide governments with the resources needed to deliver public goods. But tax evasion, tax avoidance and tax authorities' inefficiencies in tax collection reduce public revenues and undermine public trust in the system. In addition, the fact that many governments have been forced to cut expenditures and increase taxes to consolidate public budgets is another major issue of concern.⁵ In parallel, globalisation has shifted the tax burden from mobile assets (capital) to immobile assets (labour)⁶, leading to growing inequalities and rising labour costs.

4. Considering the social impact

Taxation is also the tool to redistribute wealth in a society. However, this objective is undermined by the fact that poverty and inequality in the EU have increased since 2010 affecting those most in need of social protection (i.e. low-income groups, children and migrants). High levels of long-term and youth unemployment remain a legacy of the crisis. The rising level of working poor is a modern phenomenon, resulting from the combination of globalisation and technological developments, causing labour market transformation that is unaddressed in the tax system. In addition, the share of regressive taxes (i.e. social contribution, VAT) is on the rise⁷, limiting the capacity of governments to support social objectives.

5. Environment knows no borders, but taxes do

As market forces not always reward green investments, they need public financial support. Economic and fiscal instruments are key factors fostering the transition towards a more sustainable and environmentally friendly economy. Designing tax policies to shape the behaviour of consumers is thus a major key to success. Yet, experience has shown that these policies often address the short-term and focus on one target at a time. For instance, a

low-carbon mobility policy incentivising the use of electric cars may reduce the transport emissions but if electricity is produced by for instance burning coal, overall emissions may be higher. In more general terms, there is a need to use taxation as a means to achieve the EU's climate objectives given that the behavioural change required to fulfil the EU's international commitment to fight global climate change as agreed in the legally-binding Paris Agreement can hardly be attained without fiscal incentives.

PROSPECTS Action needed

Numerous crises and security concerns seem to divert the attention of political leaders away from taxation. The weak political momentum for further economic integration and the increased focus on national interests have discouraged EU leaders from pursuing a higher level of tax harmonisation. As a result of national concerns, the existing legal constraints at EU level make it very difficult to synchronise a modernisation of national tax systems. At the same time, the economic and financial crisis has increased the pressure on governments to do more about tax evasion and tax avoidance.

Tax reforms are no silver bullet to solve the manifold economic, environmental, social, and budgetary challenges that the EU and its members are currently facing. However, transparent, fair and effective taxation is a pre-condition for enhancing social justice and building public trust, and the basis for modernising tax systems aiming to serve three equally important strategic goals: economic stability, social inclusiveness and environmental sustainability. To achieve these aims, the EU should live up to its initial ambition and keep the completion of the single market high on the policy agenda, while being realistic given the legal and economic limitations. In more concrete terms, four priority actions seem particularly important and need to be further developed.

1. Shift the tax burden from labour to harmful environmental practices

A more systemic reform of tax systems shifting the burden from labour to harmful environmental and financial practices could serve as a powerful instrument to foster the transition towards a sustainability-driven system. It will also encourage citizens' positive behavioural change. As taxes on labour and capital are assumed to be more distortionary than environmental taxes, this could include shifting taxation from labour to for instance CO₂ emissions. The incentives to reduce pollution, together with the reduced distortion from high labour tax, would achieve a double dividend – an environmental benefit and efficiency gain from the tax shift. For instance, a fiscally neutral reduction of the labour costs by 2% could be compensated by an EU-wide CO₂ tax of EUR 40/tonne.⁸ Integrating the new environmental tax in the existing framework, looking at the cross effects of the other tools already in use (i.e. EU Emission Trading Scheme, EUETS⁹), and avoiding double taxation on the sectors covered by the EUETS is needed to avoid an additional layer of rules and single market fragmentation.

2. Reduce tax barriers to the completion of the single market

With member states providing different fiscal incentives and digitalisation unleashing the mobility of assets (e.g. mobile work), a future-proof taxation system needs to focus on consistency of rules while removing single market barriers. Every instrument at hand, including national and EU-wide taxation, should be used to support this objective. Aligned policies (e.g. no contradiction in different national tax rules) and simpler tax administration (e.g. working with one administration for all EU cross-border activities) could support the single market. Increased transparency and coordination on tax matters in the EU could limit the discrimination between SMEs competing under different fiscal rules and reduce single market distortions. To reach such an objective, the role of the European Commission as a platform for an exchange of best practices should be strengthened.

3. Reform the EU's own resources

Fiscal constraints in the member states have increased the need for complementary EU investments. But the EU budget itself is mainly financed through national contributions. Additionally, member states are looking more so at the EU budget from a *juste retour* perspective, with a priority to secure the best possible individual net financial position. To get out of the 'net balance' trap and preserve the principles of solidarity and subsidiarity, the Union needs to consider alternative means to support its budget. The EU has no legal competence to levy direct taxes. But the present legal framework would allow for a revenue sharing arrangement through tax-based own resources. In January 2017, the High Level Group on Own Resources identified potential candidates for new own resources based, for example, on taxes or levies on electricity, motor fuel, carbon, risk (financial transaction) and corporate tax,

while advising to maintain some existing resources (e.g. customs duties, GNI-based own resources) and explore other potential revenues (e.g. linked to the digital single market or EUETS proceeds). Such reforms could potentially also help make the revenue side of the EU budget more instrumental in achieving the broader objectives described above and to improve the vertical fiscal coherence in the Union. Keeping this in mind, the UK's withdrawal as a net contributor to the EU budget might increase the need and political momentum for the EU to reform its revenues.

4. Exploit the digital opportunities to increase tax collection and expand tax base

The EU should focus on the opportunities related to digital innovations. Digitalisation removes physical borders and the single market completion benefits from this. Digital tools could also support transparency and citizens' access to public services (enabling connected public registries), tax administration (e.g. making tax collection less costly and more efficient), and help reduce the tax gap (better rate of due tax collection) and facilitate SMEs' access to the single market (i.e. one single portal for SMEs cross-border activities, one-stop-shop). While some member states (e.g. France, the Netherlands, Finland and Estonia) have become major drivers of change exploiting the economic benefits of digitalisation, the EU-wide approach could be more ambitious.

However, in spite of all the potential benefits of digitalisation, many of the new economic activities (e.g. sharing economy) often fall outside of the current tax systems. Consequently, there is a need to provide the basis for a coordinated response at EU level, to avoid creating another layer of market fragmentation (i.e. new activities taxed differently across the EU). Considering the fast changing environment, the EU should focus on supporting the design of flexible/more general rules, based on principles of what behaviour should be encouraged (e.g. environmental/economic/social sustainability), and on enhancing the cooperation between member states in fighting tax avoidance and evasion.

To sum up, the single market is one of the key projects delivering the EU's added value. To unleash its full potential tax-related distortions (e.g. market fragmentation, double (non-) taxation, harmful tax competition) should be reduced. Digitalisation could provide the means for this and increase transparency. Taxation could be used to address economic (stagnation), social (inequalities), as well as environmental (pollution) challenges. Public pressure to work towards fair and sustainable tax systems has created a fresh impetus for modernisation of EU tax policies. The adoption of a new Multiannual Financial Framework could be one opportunity for this and Brexit might create some political momentum for the introduction of new rules. But the EU still needs strong political support from stakeholders to achieve these ambitious objectives and substantial progress will be difficult to achieve in the context of the economic nationalism ideology prevailing globally and in the EU.

This paper builds on the outcomes of the EPC's "Modernising tax policies in the EU Single Market to achieve economic and social objectives" project, supported by Accountancy Europe (formerly the Federation of European Accountants), aiming to contribute to building stakeholder commitment to a changing European approach to taxation.

Fabian Zuleeg is Chief Executive and Chief Economist and Iva Tasheva is Junior Policy Analyst at the EPC.

The views expressed in this PolicyBrief are the sole responsibility of the authors.

- 1 Schratzenstaller M. (2015) Sustainable tax policy, Concepts and indicators beyond the tax ratio, Austrian Institute of Economic Research.
- 2 By addressing tax fraud, tax evasion, and tax avoidance.
- 3 E.g. Country-by-country reporting, automatic exchange of information on tax rulings, Common Consolidated Corporation Tax Base, definite VAT regime for cross-border trade.
- 4 No or nominal tax on the income, no substantial activities, lack of effective information exchange and transparency.
- 5 Tax Trends in the European Union 2014 and the Report Tax Reforms in EU Member States 2014.
- 6 Labour taxes represent 50,5% of EU member states' tax receipts in 2014, an increase of 0,4% for the EU, 0,7% for the Eurozone since 2004 while 21,5% are taxes on consumption and 25% on capital, European Parliament (2016) Taxation Trends in the EU.
- 7 Id. bid.
- 8 Luptáčík M. et al. (2015) Analysis and quantification of a new fiscally neutral European tax, European Economic and Social Committee.
- 9 European Commission (2016) EUETS.

European Policy Centre ■ 14-16 rue du Trône, 1000 Brussels, Belgium
Tel: +32 (0)2 231 03 40 ■ Fax: +32 (0)2 231 07 04 ■ Email: info@epc.eu ■ Twitter: [@epc_eu](https://twitter.com/epc_eu) ■ Website: www.epc.eu