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Directorate-General for Research

WORKING PAPER

Tax competition

in the European Union

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Preface

This working document consists of two sections.

Part I. General Introduction covers the recent history of tax policy within the European Union and discusses the main issues in the current debate on competition or cooperation in the tax field.

Part II. Taxes on Labour, on Savings and on Corporations is a detailed study of current systems of Direct Taxation within the European Union, and of recent policies in the field.

References to both sections are listed at the end (page 78).

A number of studies on Indirect Taxation have already been published in the same series:

> *Options for a Definitive VAT System* (E-5, 1996);
> *The Impact of VAT and Intrastat Obligations on SME's* (W-25, 1996); and
> *The Social Consequences of Changes in VAT* (ECON 103, 1998).

Summary and Conclusions

Part I: General Introduction

Some - but not all - tax competition can be harmful; and some - but not ubiquitous - cooperation may be beneficial. Put formally, tax coordination is desirable if the welfare gains from eliminating "*the inefficiency of non-cooperative behaviour"* exceed "*Leviathan's tendency to waste*".

These broad conclusions follow from an analysis of tax statistics for the last few decades.

- ♦ Tax competition has not had the effect of *reducing* tax bases, either within the EU or the OECD. Rather, the percentage of GDP taken in tax has shown a steady tendency to rise. However, the increase in overall taxation over the last ten years has only been marginal compared to that in the previous ten or twenty, and most EU countries have experienced a fall since 1996. This allows the possible conclusion that tax competition has effectively "capped" the tendency for taxes to rise in relatively high-tax countries, and produced a convergence within the EU.

- ♦ The figures do not show any recent tendency for direct taxes or social security contributions to rise more markedly than taxes overall. Over the period 1985-94 there was, however, a shift from taxes on labour to taxes on other production factors, though this was by no means so in all Member States. Falling rates of corporate taxes tend to confirm an average shift of the tax burden from the "mobile" to the "immobile" tax base.

- ♦ On the other hand, differing tax structures make for sharp variations in these effects. For example, countries like Denmark and the UK rely relatively less on direct social charges than countries like France. Factors such as this may well explain why tax competition classified as "harmful" by one Member State is not considered to be so by another.

Parliament's own resolution of 18th. June 1998 reflected this analysis, and gave general support to the approach of the Commission embodied in the "Monti package". Increasing competition between national tax systems, it pointed out, was likely "*as a result of the greater transparency achieved by the introduction of the single currency*"; and it welcomed

> "*beneficial tax competition among Member States as a tool to increase the competitiveness of the European economy confronted with the challenges of globalization*".

Coordination was, however, justified when the degree of competition resulted in

> *"a potential failure to harvest the full benefits which the single market can provide in terms of growth and employment, given the increased tax burden put on labour compared with the more mobile capital".*

Several features of tax systems may potentially distort competition; for example:

- "tax havens";
- the double taxation of both corporate and personal incomes;
- varying definitions of such tax concepts as basis of assessment, earnings and the rules on write-off;
- the exemption from taxation of non residents' savings income;
- taxing royalty and interest payments between associated companies;
- fiscal state aids; and
- the problems of corporate taxation covered by the Code of Conduct.

A broad measure of agreement exists on the elimination of "unfair competition" which arises from the complexity of tax systems. The more complex a tax system, the more scope it creates for (illegal) tax evasion, and the more incentive for companies, in particular, to devote resources to (legal) tax avoidance. Parliament's report criticised the dropping from the final Monti package of "*the measures designed to eliminate significant distortions in the area of indirect taxation*".

There is less agreement on the *rates* of tax. In the field of VAT, a 15% minimum rate was eventually set in 1992; but not the original Commission proposal for a 20% upper limit as well. A Commission proposal in 1995 to set a 25% upper limit was rejected by both Parliament and Council, in spite of the fact that no Member State in fact exceeds this level.

It would appear that, as far as *maximum* tax rates are concerned, there is a general inclination to leave this to competition and market forces. A natural upper limit in any case exists at the point when any *increase in rates* results in *falling aggregate revenue* from the tax concerned. There is reason to believe that this position may already have been reached in the case of some Member States' very high levels of excise duty on alcohol and tobacco (though governments may choose to maintain them at this level in pursuit of public health or social policy objectives).

On even minimum rates, however, there are widely differing views. Over the years, for example, the Commission has proposed rates of 15% and 20% on interest paid to non-residents. These have been criticised both as too low and too high (the rate which caused a massive flight of capital from Germany in 1989 was only 10%). There has been no agreement on any minimum rate of corporation tax, despite the recommendations of the Ruding and other reports.

The balance between competition and cooperation which emerges is as follows.

- Where particular features of tax systems distort competition - either inadvertently as a result of excessive complexity, or deliberately - there is a case for Community action.
- Experience indicates this action is more likely to be successful if it takes the form of cooperation (e.g. the Code of Conduct) than of formal harmonisation through legislation.
- In certain areas, however, legislation is inevitable, most obviously to remove differing and distorting application of existing provisions - e.g. in the case of VAT.
- Agreement on maximum tax rates is unlikely, and even on minimum "floor" rates extremely difficult. Tax rates are widely considered the proper preserve of national

sovereignty and of market forces.

Part II: Taxes on Labour, on Savings and on Corporations

An analysis of **Personal Income Tax** reveals important differences between Member States in matters such as tax allowances, minimum and maximum tax rates and tax schedules. The systems differ so widely that a single person on the average industrial wage may pay tax at rates varying from 7.2% in Portugal to 38.3% in Denmark.

However, national differences in Personal Income Tax do not appear to cause any discernable distortions of competition in the labour market, nor in the workers´ choice of work place, except in the case of frontier workers. In this case the differential in Social Security Contributions and Personal Income Taxes between border regions might create incentives to cross-border migrations for work. The Commission attempted to find a satisfactory solution to this problem with a Proposal for a Directive in 1979; and work on the issue continues.

Income from capital, particularly interest income from savings, forms the most mobile of tax bases, and differences in taxation may cause serious distortions to capital allocation and flows. The Commission has considered three possible ways to prevent the risk of increased tax evasion and tax-induced portfolio reallocation:

- ♦ increased cooperation and exchange of information between the tax authorities of the source and residence countries;
- ♦ automatic disclosure of interest earnings to the tax authority of the country of residence of the investor, supported by tighter limits on bank secrecy and bearer securities; and
- ♦ common minimum withholding tax on interest from deposits and securities imposed at source on all European residents.

These constitute the elements of the most recent form of the draft Directive covering the issue.

As far as the **harmonization of corporation taxes** is concerned, the issue has been debated by the Commission for almost 30 years, taking into account advice provided by independent experts: notably the Neumark Report, the Van den Tempel Report and the Ruding Report.

Rather than a legally-binding instrument, the latest initiative has taken the form of a politically-agreed Code of Conduct. This covers a large number of the points which have been the subject of past proposals - though not the formal approximation of tax rates.

Much will depend upon the ability of the "Primarolo Group", established by the Council to administer the Code, to induce Member State governments to take appropriate action.

Part I. General Introduction

Contents

Tables

Tax and the Single Market

The European Union's internal market is defined in Treaty Article 7a as

> *"an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured".*

Progress in achieving this objective has been substantial, if intermittent. The coming of the Single Market at the beginning of 1993 removed most of the "technical barriers to trade" - differences in industrial standards, health and safety regulations, professional qualifications, etc. - which had been targeted in Commissioner Lord Cockfield's White Paper of 1985. Economic and Monetary Union is now eliminating transaction and exchange costs, and helping to remove the last barriers to the free movement of capital.

The very fact of this progress, however, is focusing attention on a number of areas in which the Single Market is still incomplete. Of these, one of the most important is taxation.

The immediate requirement within the Single Market programme had been an end to tax and customs checks at internal Community frontiers. This meant changes to both the Value Added Tax and excise duty systems. Fortunately, a firm legal base existed for legislation in Article 99 of the Treaty.

Even so, it was only after prolonged negotiations that the necessary unanimity was found for even a "transitional" VAT regime, and the establishment of low minimum excise duties. The VAT legislation required the adoption, in due course, of a "definitive" system; and the Commission eventually published *A Common System of VAT: a programme for the Single Market* (1996) which outlined a timetable, running to mid-1999, during which the new system would be introduced. It is now far behind schedule.

Several studies by the Commission or specially-appointed groups of experts[1] had also, over the years, examined the need and scope for Community action in the field of both personal direct and corporate taxation.

Little by way of a legal base for such action is to be found in the Treaties, however; and it has generally been the assumption in all Member States that direct, as opposed to indirect, tax should remain the preserve of national fiscal sovereignty. A pre-1993 attempt to introduce a minimum withholding tax on interest paid by banks to depositors from another Member State failed to get the necessary unanimity in Council, and the same fate befell even limited proposals to prevent the double taxation of corporate royalty and interest payments.

Nevertheless, a number of economic developments have recently stimulated new Community initiatives.

[1] Notably, the Neumark Report of 1962; the Van den Tempel Report of 1970; and the Ruding Report of 1992.

- ♦ The **free movement of capital** has always been a fundamental aim of the European Community. It was not practically achieved, however, until 1994, by when it formed only one element of a general **globalization**. New telecommunications technologies have made possible the creation of 24-hour financial markets, within which funds can move between national tax jurisdictions in nanoseconds. The taxation of capital and of the income from financial assets has become increasingly difficult.

- ♦ The removal of legal and technical barriers to trade has made **companies and their production bases more mobile**: in theory (and subject to the constraints creates by language and cultural differences), the whole Single Market can be supplied from one Member State. Tax has therefore become an important factor in location decisions, particularly for companies based outside the EU (e.g. the US computer companies recently established in Ireland). This, in turn, has encouraged national, regional and local authorities to compete in **attracting firms to their areas through various "tax breaks"** - often in near-breach of Community competition rules.

- ♦ The **complexity of tax systems** and **high tax rates** have encouraged **tax avoidance** (legal) and **tax evasion** (illegal). The growing intricacy of Value Added Tax both at European Community and at national level, for example, has prompted companies to devote resources to "VAT planning"[2]. Likewise, the higher the levels of VAT and direct charges on labour, the greater the incentive for firms and labour to move into **the "black" economy**[3]. Finally, as a result of globalization, major companies have often found themselves subject to a multiplicity of tax jurisdictions, providing both the incentive and opportunity to minimise overall tax through **"transfer pricing"** and other devices.

- ♦ Finally, and most significantly, **unemployment levels** have risen in most EU economies. This, in turn, has drawn attention to the rising cost of employing labour within the European Union, and in particular to the "non-wage costs" of taxes and social security charges. The increasing difficulty of taxing capital was seen to have resulted in a steady change in **the structure of tax systems**: an increasing proportion of total taxation was falling on the relatively immobile factor, labour[4]. It became the stated policy of the Community to reverse this trend by shifting the tax burden from employment to, for example, the direct taxation of CO^2 emissions or energy[5].

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[2] This has been one explanation for the failure of VAT revenues to keep pace with GDP growth in a number of countries.

[3] Increasing discrepancies between the size of Member State economies as measured by GDP figures, and the size as measured by VAT receipts, was the principal reason for adding the GDP element to the Community's "own resources" under the Edinburgh agreement of 1992.

[4] Between 1980 and 1994 tax rates on labour rose by about 6%, while those on other production factors - notably capital - fell by 9%.

[5] A CO^2 tax was proposed by the Commission in 1992 (COM(92)0226), with a revised proposal, (COM(95)0172) appearing in 1995. Proposals for the "restructuring" of energy taxation effectively replaced the

The "New Approach"

These factors led the Commission, in 1996, to launch a new initiative on taxation. A "reflection document", *Taxation in the European Union* (1996), was approved by the Council of Economic and Finance Ministers (ECOFIN) at its meeting in Verona in April 1996. At the same time, the Council formally established a "High Level Group on Taxation in the European Union", consisting of Personal Representatives of the Finance Ministers, and chaired by taxation and Single Market Commissioner Mario Monti.

Following a request from the Florence Council in June of that year for a

> *"report on the development of tax systems within the Union, taking account of the need to create a tax environment that stimulates enterprise and the creation of jobs and promote a more efficient environment policy",*

the Commission then published, in October 1996, *Taxation in the European Union: report on the development of tax systems* (1996), which summarised the views up to that point of the High Level Group. The approach of the report was cautious, echoing a much earlier Commission paper, *The Scope for Convergence of Tax Systems in the Community* (1980), which had noted that:

> *"tax sovereignty is one of the fundamental components of national sovereignty",*

and pointed to widely differing ideas about the functions of taxation.

The High Level Group report accordingly observed that

> *"any proposal for Community action in taxation must take full account of the principles of subsidiarity and proportionality",*

and recommended that action should result in "coordination" rather than "harmonisation".

The "Monti Package" and the Code of Conduct

The package of measures which the Commission put forward in a new document - *Towards Tax Co-ordination in the European Union: a package to handle harmful tax competition* (1997) - was nevertheless quite wide in scope. It took up a number of "blocked dossiers" in the fields of both direct and indirect taxation, formal proposals on which had already, or were in due course, published (see under "Indirect Taxation" and "Direct Taxation" below).

The initial package, however, proved too extensive, and was eventually reduced to three concrete

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CO^2 proposals in 1997 (see COM(97)0030).

measures in a revised proposal: *A package to tackle harmful tax competition in the European Union* (1997).

These were:

- ♦ a code of conduct for business taxation;
- ♦ the elimination of distortions to the taxation of capital income (the minimum withholding tax on bank interest proposal); and
- ♦ measures to eliminate withholding taxes on cross-border interest and royalty payments between companies.

The indirect tax elements - increasing the powers of the VAT Committee; the taxation of investment gold, of passenger transport and of energy products; and the FISCALIS anti-fraud programme - were no longer included (although the Commission has continued to pursue them in the normal way). The Commission also accepted that action on fiscal state aids would need to accompany the code of conduct.

The central proposal of the slimmed-down package was the Code of Conduct. This was to cover

> "*those business tax measures which affect, or which may affect, the location of business activity in the Community in a significant way";*

and identified as

> *"potentially harmful those tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than that which generally apply in the country in question".*

Member States were to inform each other of any "existing or proposed" tax measures likely to fall within the scope of the Code. They were to undertake "not to introduce new tax measures.. harmful to the Community interest, including the effective operation of the Single Market"; and to "roll back" existing harmful provisions. The Code would also cover cooperation in the "fight against tax evasion and avoidance"; and would require "strict adherence" to Community rules on state aids under Articles 92-94 of the Treaty.

Finally, the Commission proposed the creation of a "follow-up Group" of national government representatives within which the day-to-day application of the Code could be discussed.

The "Primarolo Group"

The idea of the Code was immediately accepted by both Parliament and Council, and the final text was adopted by the Council of Finance Ministers on 1st December 1997. The "follow-up" Group was established by ECOFIN on 9th March 1998, and met for the first time on 8th May 1998, when it elected as its first chairman the UK Treasury Minister, Dawn Primarolo. It has therefore become known as the "Primarolo Group".

The Group's first task has been to examine a list, compiled by the Commission largely on the basis of information supplied by Member States, of national tax provisions which *prima facie* fall within the scope of the Code. The Commission has identified a number of tax schemes and classified them under five headings:

1. Intragroup services.
2. Financial and insurance services, including "offshore" financial services in territories under the jurisdiction of a Member States (e.g. in Gibraltar).
3. Special tax treatment for certain industrial or service sectors (e.g. the film industry).
4. Tax advantages for certain geographical areas (e.g. the Canary Islands).
5. Other measures, including tax incentives for certain kinds of company (e.g. "micro" enterprises).

The Group's first interim report was published at the end of November, 1998. The report identified 85 tax measures which were *prima facie* of a harmful nature. Of these, the measures in the first two categories were examined in more detail.

♦ 17 measures in the intragroup services category: 5 in the Netherlands, 3 in Belgium, 3 in Spain, 2 in France, 2 in Luxembourg and two in the UK.

♦ 13 measures in the financial, insurance and "offshore" category: 3 in the UK, 2 in Luxembourg, 2 in the Netherlands, and one each in Ireland, Italy, Finland, Greece, Portugal and Sweden.

The second interim report of the Primarolo Group is to appear in May 1999, with a final report in November 1999.

Other action

Meanwhile, a number of other studies are being undertaken either at the initiative of the Primarolo Group, or of the Council.

♦ The Commission has been asked to prepare a brief factual study of the cross-border effects of certain tax practices.

♦ Independent experts will analyse administrative practices arising from national tax schemes.

♦ The Commission will make a global study of business taxation in the European Union. Guidelines for the carrying out of this study were published by the Commission in November 1998[6]

[6] *Communication for the Commission on the application of the State aid rules to measures relating to direct business taxation*, SEC(1998)1800, of 11.11.1998.

In the context of the proposal for a witholding tax on savings income (see later section on "Direct Taxation"), the Commission is also to make "exploratory contacts" with certain countries neighbouring the European Union. Talks are to begin in early 1999 with Switzerland, Liechtenstein, Andorra, Monaco and San Marino. Wider contacts of the same kind - notably with the United States and Japan - may follow. The OECD has already adopted a Code of Conduct on business taxation which closely follows that of the EU.

Finally, acting under its powers under Treaty Article 93(1), the Commission has already begun a programme of action against the use of the tax systems to give illegal state aids. It has recently, for example, drawn to the attention of the Irish Government a number of measures which it needs to take concerning the preferential tax regimes applying in the Dublin International Financial Service Centre and the Shannon Customs-Free Airport Zone; and the preferential 10% corporation tax applied to companies in the manufacturing sector.

After the meeting of ECOFIN in Vienna on 26 September 1998, Commissioner Monti was able to tell the press that

> *"there is consensus on the new approach adopted on tax policy and on its general objective - to fight against harmful forms of tax competition without eroding the tax sovereignty of Member States".*

The tax base

Despite these developments, however, it would not be true to say that agreement now exists as to what constitutes "harmful tax competition".

Is it actually the case, for example, that national tax bases have been eroded as a result of competition between tax systems? Within the EU, total government revenues as a percentage of GDP currently vary from 40% in Spain to over 62% in Sweden. In most countries, these percentages have remained fairly constant over the last ten years. Overall in the EU there has been a marginal but steady trend upwards: from 41.4% of GDP in 1978 to 44.7% in 1988 and 46% in 1998 (see Table 1). The pattern is the same for OECD countries, with a gradual rise from 34.7% of GDP in 1981 to 37.8% in 1997.

These figures are hardly consistent with any theory of overall "tax degradation" as a result of competition between systems.

However, certain differences between Member States can be observed, and are perhaps of significance. Some countries - Denmark, Ireland, Luxembourg, the Netherlands and Sweden - have experienced a small reduction in the burden of taxation over the last ten years, with the fall being particularly noticeable in the last two or three. Except for Ireland, these countries were among the higher-taxed in the EU. There has thus been a marked convergence of total tax burdens overall, despite the continuing wide gap between highest and lowest percentages.

Table 1. Evolution of total tax receipts by EU Member States (% of nominal GDP)

	1978	1988	1998
Belgium	48.2	49	49.4
Denmark	48.4	59.9	57.6
Germany	44.8*	44.2*	44.9
Greece	24.7	30.6	38.7
Spain	27.4	37.7	40.8
France	43.1	49.2	50.7
Ireland	33.5	41.4	35.1
Italy	32.6	39.8	46.8
Luxembourg	51.2	50.5	46.1
Netherlands	50.5	53.2	47.4
Austria	45.5	47.8	50.4
Portugal	25.6	34.1	40.9
Finland	44.1	49.3	52.6
Sweden	58.6	62.9	62.1
UK	37.1	44.7	39.5
EUR 14**	41.4*	44.7*	46

** West Germany only*
*** excluding Luxembourg*
Source: European Economy, no. 65, 1998

It is also necessary to look at changes in the *structure* of taxation. EU statistics distinguish between "taxes linked to imports and production (indirect taxes)"; "current taxes on incomes and wealth (direct taxes)"; social security contributions; and "other current receipts".

Overall, **indirect taxes** in the EU have risen by 1.5 percentage points over the last twenty years: from 12.7% of GDP in 1978 to 14.2% in 1998. The increases, however, were concentrated in a limited number of Member States, notably Italy, Portugal and Spain.

Direct taxes have risen by marginally more: 1.6 percentage points, from 11.8% of GDP in 1978 to 13.4% in 1998. The pattern as between countries, however, is more complex, with the percentage having fallen in some countries over the years (Germany, Luxembourg, the Netherlands and the UK), and risen in others (e.g. Denmark, Greece, Spain, Ireland, Italy, Portugal and Austria).

In the case of **social security contributions** the overall increase has been by 1.4 percentage points: from 13.8% of GDP in 1978 to 15.2% in 1998. The UK (6.3% in 1998), Denmark (2.8%) and Ireland (4.2%) raise relatively little revenue in this category, and the percentage has remained more or less stable. Finally **other current receipts** have remained stable at 3.2% of GDP overall.

Table 2: Implicit tax rates on production factors

	Labour			**Other production factors**		
	level 1994	*change over 1995 (%)*	*Deviation from EU average*	*level 1994*	*change over 1995 (%)*	*Deviation from EU average*
Belgium	45.8	+ 1.5	5.3	38	-2.5	2.8
Denmark	46.6	+ 2	6.1	31.9	-5.1	-3.3
Germany	42.7	+ 3.2	2.2	40.9	-7.1	5.7
Greece	39.8		-1.7	8.7	-6.3	-26.5
Spain	38	+ 6.1	-2.5	26.6	+ 6.7	-8.6
France	44.4	+ 4	3.9	44.9	-6.6	9.7
Ireland	31.6	+ 1.4	-8.9	29.2	+ 3.6	-6
Italy	42.9	+ 6.3	2.4	34.8	+ 7.9	-0.4
Luxembourg	29.5	-3.1	-11	49.3	+ 16.4	14.1
Netherlands	51	+ 0.1	10.5	37.3	+ 6.8	2.1
Austria	43.4	+ 2.5	2.9	37.1	-3.8	1.9
Portugal	35.8	+ 14.4	-4.7	16.3	-8.2	-18.9
Finland	55	+ 12.1	14.5	21.3	+ 5.4	-13.9
Sweden	52.6	-0.1	12.1	34.7	+ 0.9	-0.5
UK	26.2	0	-14.3	32.4	-30.1	-2.8
EU average	**40.5**	**+ 3.1**		**35.2**	**-8.1**	

Source: European Commission

Even these figures, however, do not give a very precise picture. They fail to identify, in particular, differences within the direct taxation category between the taxation of personal incomes, the taxation of wealth, and corporate taxation.

The analysis carried out by the Commission in preparation for the "new approach", *Taxation in the European Union: report on the development of tax systems* (1996), made a distinction between **taxes on labour** and **taxes on other production factors** (notably capital). The results showed an average increase in the former between 1985 and 1994 of 3.1%; and an average fall in the latter of 8.1% (see Table 2).

The detailed figures, however, also showed certain important variations between countries.

In Luxembourg and Sweden labour taxes fell (in the latter case from a high level), and other taxes rose. Other taxes also rose in Spain, Ireland, Italy, the Netherlands and Finland, in all but the latter case by a greater percentage than the rise in labour taxes. Much of the overall EU figure was accounted for by a massive cut in capital taxation in the UK.

The figures also showed that the division between labour taxes and taxes on other production factors varied widely between Member States: in the case of taxes on labour between a 26.2% rate (UK) to 52.6% (Sweden); and in the case of other production factors between only 8.7% (Greece) and 49.3% (Luxembourg).

The overall levels, both in the case of taxes on labour, and in the case of taxes on other production factors, also deviated widely around the EU average.

Here, however, figures for **corporate tax rates** may also be relevant. In both EU and OECD countries they show a steady recent decline from rates of around 50% in 1985 to rates between 30-40% in 1995. Only in Italy was there an increase, from 46% to 52.2%, while Spain held the rate steady at 35%, and Germany introduced a split rate. In some cases the fall was dramatic: in Finland and Sweden, for example, the rates were more than halved, from 57% in 1985 to 25% and 28% in 1995 (see Tanzi, V. (1996)).

A similar picture emerges from changes in the **higher marginal rates of personal income tax**. These have come down sharply in all countries except Germany and Portugal, despite the fact that overall direct taxation has risen.

Table 3: Changes in certain direct tax rates, 1986-1997 (% points)

	Top marginal rates of personal income tax	Basic rate of corporation tax
Germany	-	- 11.0
France	- 11.0	- 11.7
Italy	- 11.0	0.0
UK	- 20.0	- 2.0
Austria	- 12.0	- 16.0
Belgium	- 15.3	- 6.0
Denmark	- 14.0	- 16.0
Finland	- 13.0	- 5.0
Greece	- 23.0	- 9.0
Ireland	- 10.0	- 12.0
Luxembourg	- 7.0	- 7.0
Netherlands	- 12.0	- 7.0
Portugal	-	- 6.0
Spain	- 10.0	0.0
Sweden	- 25.0	- 24.0

Source: OECD

What conclusions can be drawn from these figures?

♦ First, it is clear that tax competition has not had the effect of *reducing* tax bases, either within the EU or the OECD. Rather, the percentage of GDP taken in tax has shown a steady tendency to rise.

However, the increase in overall taxation over the last ten years has only been marginal compared to that in the previous ten or twenty, and most EU countries have experienced a fall since 1996. This allows the possible conclusion that tax competition has effectively "capped" the tendency for taxes to rise in relatively high-tax countries, and produced a convergence within the EU.

- The figures do not show any recent tendency for direct taxes or social security contributions to rise more markedly than taxes overall. Over the period 1985-94 there was, however, a shift from taxes on labour to taxes on other production factors in the EU as a whole, though this was by no means the case in all Member States. Falling rates of corporate taxes tend to confirm an average shift of the tax burden from the "mobile" to the "immobile" tax base.

- On the other hand, differing tax structures make for sharp variations in these effects. For example, countries like Denmark and the UK rely relatively less on direct social charges than countries like France. Factors such as this may well explain why tax competition classified as "harmful" by one Member State is not considered to be so by another.

Tax behaviour

To the picture given by these highly aggregated statistics must be added evidence, both statistical and anecdotal, about the effects of particular taxes, and the way in which they are administered. Although "tax competition" at this micro level may not have the effect of eroding tax bases overall, it is possible for them to distort economic behaviour of consumers, workers or investors in such a way as to prejudice the fair working of the Single Market.

Among the areas of most obvious concern have been:

- Large differences in indirect tax rates across particular borders, which can distort consumers' purchasing patterns.

- High marginal direct tax rates, which encourage those earning large salaries to become "tax exiles" in countries with lower rates.

- Untaxed and undeclared foreign earnings, particularly bank and other interest, which may both erode revenues and distort the market in savings.

- The failure of existing bilateral tax agreements to eliminate the double taxation of certain transactions, so maintaining trade barriers within the Single Market.

- Tax incentives designed to attract footloose investment, which can distort the capital market and lead to "tax-holiday[7] auctions" (but which are, on the other hand, often part of the Community's own policies for regional development).

- Disparities in income tax and social security systems which can penalise those working in a Member State other than the one of nationality, residence or domicile.

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[7] A "tax holiday" exempts firms from normal taxation for a period after establishment in a particular location.

Indirect Taxation

Article 99 of the original EEC Treaty provided for the Commission to "consider" the harmonization of "turnover taxes, excise duties and other indirect taxes in the interests of the Common Market". The Article was strengthened by the Single European Act of 1987 to make such harmonization mandatory where it was "necessary to ensure the establishment and functioning of the Internal Market."

Over the years, legislation under these provisions have ensured that the Community now has a - more or less - common system of Value Added Tax. Following adoption of the First VAT Directive of 11 April 1967, all Member States had introduced a VAT by the early 1970s. The main outlines of the common system now in effect were enacted in Directive 77/388/EEC of 17 May 1977 - generally known as the Sixth VAT Directive - which ensured that each Member State had a broadly identical "VAT base": i.e. levied VAT on the same transactions.

The Commission's original proposals within the context of the Single Market programme would have made a full change to an "origin" basis for the levying of VAT (see below). However, they proved unacceptable to Member State governments, which instead adopted the current "transitional" system. Under this, the origin principle generally applies to all sales to final consumers: that is, once VAT has been paid on goods in one country, they can be moved within the Community without further control or liability to tax. Commercial movements - that is, between VAT-registered traders - in general continue to apply the "destination" principle: that is, the VAT rate charged is that of the country to which the goods are delivered. VAT rates remained un-harmonised, though a minimum standard rate of 15% was agreed.

Successive subsequent Commission reports[8] on the VAT system have found that the abolition of tax checks at internal Community frontiers at the beginning of 1993 have resulted in no significant changes in cross-border purchasing patterns, nor any significant distortions of competition or deflections of trade through disparities in VAT rates. This has been despite the fact that very large differences in the rates on particular products can exist on either side of particular borders - for example, between goods rated at the standard VAT rate of 25% in Denmark, but the 7% reduced rate in Germany.

In the case of excise duties, however, the situation is not quite so satisfactory. Only the minimum agreement on systems and rates necessary to abolish frontier controls was reached within the context of the Single Market programme, with the result that very wide differences exist in the rates charged by different Member States. This has lead to considerable tax-induced movements across certain frontiers: notably of alcoholic beverages and tobacco products from France and Belgium to the UK. It has been estimated that some 1 million pints of beer are being brought

[8] For example, COM(94)584, COM(95)731 and COM(97)559.

across the Channel to England *every day*[9], about half of which is being illegally resold.

The main effect of such movements is the distortion of competition: legitimate traders, who pay full UK excise duties, are unable to compete with the lower-duty imports. In addition, movements of beer alone are said to be costing the UK Exchequer some £1.5 billion a year. According to the UK Treasury, this has not yet had the effect of eroding the tax base, in the sense that revenue would be increased by reducing the excise duty rate. This finding is nevertheless disputed by UK brewers; and the *reduction* in the UK excise duty on spirits in 1996 can be cited as evidence of tax competition within the Single Market.

Meanwhile, several other detailed VAT issues, on which both Commission proposals and opinions of the European Parliament exist, have remained unresolved. These include the tax-exemption thresholds for **SMEs** (*COM(87)525*); the definition of **non-deductible expenditure** (*draft 12th. VAT Directive, COM(82)870*), which has now been incorporated into the proposals for the reform of the 8th. VAT Directive procedure (see under *Special Tax Arrangements* below); the taxation of **passenger transport** (*COM(92)416*); and the tax on various **non-food agricultural products** (e.g. wool, flowers, timber) (*COM(94)584*). A decision on the taxation of **gold** (*COM(92)441*) is expected by the end of 1998.

Most recently, the growing importance of **information technology** has focused attention on the application of VAT in this area. The Commission has proposed a Directive on **value added tax arrangements applicable to telecommunications services** (COM(97)0004), following a decision by Council to apply a temporary derogation from the normal legislative provisions applying to services, and use a "reverse charge" procedure. The Commission has also published a Communication on **Electronic Commerce and Indirect Taxation** (COM(1998)374).

The most serious defect of the transitional VAT system, however, is its complexity, and the scope it allows for varying national interpretations of VAT law. The basic system established under the Sixth VAT Directive is riddled with derogations, exemptions, options and special régimes. In particular, there are widely differing applications of Annex H, which allows Member States the option of charging **reduced rates** on certain goods and transactions.

Further problems are caused by the application of the three "special regimes" established under the transitional system: **distance sales**, **tax-exempt legal persons**. (i.e. hospitals, banks, public authorities, etc.) and **new means of transport**. The first of these is the cause of particularly acute problems: mail-order or similar companies having sales over a certain threshold to any Member State must levy VAT at the rate applied in that country (i.e. where the goods are delivered); and if necessary, they must appoint "fiscal agents" to account for the tax. Consumers, meanwhile, have no way of knowing whether the correct rate of tax has been charged.

The SLIM group (which makes recommendation on the simplification of legislation) has recommended changing the fiscal agent arrangements; and also a reform of the system by which

[9] *Sunday Times*, 14th September 1997.

traders doing business in Member States where they are not VAT-registered get back the VAT incurred on inputs in those countries (the infamous **8th VAT Directive** procedure).

The Commission's VAT programme envisaged meeting these problems, in part, by allowing decisions on detail to be taken without the full application of Article 99. A draft Directive has been proposed which would give the **Committee on Value Added Tax,** which consists of national representatives and is chaired by the Commission, more powers of decision (COM(97)325). So far, however, Member States have been reluctant to take even this step.

Direct Taxation

There is no explicit provision in the Treaty for the harmonization of direct taxes. Action in this field has therefore necessarily been based on more general objectives: the **free movement of workers** (Article 48), **freedom of establishment** (Article 52), the **free movement of capital** (Article 67), the **functioning of the common market** (Article 100), **preventing distortions of competition (**Article 101). In addition, Article 220 requires Member States to "*enter into negotiations*" for "*the **abolition of double taxation** within the Community*", and Article 221 forbids **discrimination between the nationals** of Member States "*as regards participation in the capital of companies*".

Legislation on the **taxation of companies** has usually been based on Article 100 of the Treaty, which authorises

> *"directives for the approximation of such laws, regulations or administrative provisions of Member States as directly affect the establishment or functioning of the common market*".

As in the case of Article 99 - and in contrast to Article 100a under which most Single Market legislation was adopted - both unanimity and the consultation procedure apply.

Article 73d, introduced by the Maastricht Treaty, qualifies the **free movement of capital** by allowing Member States to

> "*distinguish between tax-payers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested".*

However, on 14th. February 1995 the Court ruled (Case C-279/93) that Article 48 of the Treaty is directly applicable in the field of tax and social security. The Article provides that freedom of movement for workers

> *"shall entail the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment".*

Most of the arrangements in the field of direct taxation, however, still lie outside the framework of Community law. An extensive network of **bilateral tax treaties** - involving both Member States and third countries - covers the taxation of cross-border income flows.

Within these constraints, only limited action has been possible at Community level. Following the publication of *Guidelines for Company Taxation* in 1990 (SEC(90)601) three already-published proposals in the field of **company taxation** were adopted later that year:

- the **"mergers" Directive** (90/434/EEC), which covered the treatment of capital gains arising when companies merge;

- the **"parent companies and subsidiaries Directive"** (90/435/EEC), designed to eliminate the double taxation of dividends paid by a subsidiary in one Member State to a parent company in another; and

- the **"arbitration procedure" Convention** (90/436/EEC), which introduced procedures for settling disputes concerning the profits of associated companies in different Member States.

Recent progress, culminating in the Code of Conduct, has been outlined above.

But in the field of **personal direct taxation** - notably income tax - there are continuing problems which await a solution.

For example, the **taxation of those who work in or draw a pension from one Member State, but live and/or have dependent relatives in another**, has been a continuing source of problems. Bilateral agreements avoid double-taxation in general, but fail to cover such questions as applying various tax-reliefs available in the country of residence to income in the country of employment. In order to ensure equal treatment between resident and non-resident workers the Commission in 1980 proposed, under Article 100, a *Directive on the harmonization of income tax provisions with respect to freedom of movement* (COM(79)737). This would have applied the general principle of taxation in the country of residence; but was not adopted by Council and was withdrawn in 1993. Instead the Commission issued a Recommendation under Article 155 covering the principles that should apply to **the tax treatment of non-residents' income**.

Meanwhile, the Commission has also brought infringement proceedings against some Member States for discrimination against non-national workers. The Court ruled in 1993 (Case C-112/91) that a country could tax its *own* nationals more heavily if they resided in another Member State. The Court has also found, however, that a country cannot treat a non-resident national of another Member State less favourably that its own nationals (see above: Case C-279/93).

The other main issue in the field of personal direct tax is the **taxation of bank and other interest paid to non-residents.** In principle, a taxpayer is required to declare such income when making normal tax returns. In practice, as the Ruding Report observed,

> "*the free movement of capital.. together with the existence of bank secrecy... will increase the potential for tax evasion by individuals.*"

Most Member States levy a withholding tax on interest; but when in 1989 Germany introduced such a tax at the modest rate of 10%, there was massive movement of funds into Luxembourg, where no withholding tax is levied, and the German tax had temporarily to be abolished.

That same year the Commission published a draft Directive for a **common system of withholding tax on interest income** (COM(89)60), levied at the rate of 15%. This was opposed by some Member States on the grounds that, based on the German experience in 1989, it would lead to a flight of capital from the Community. The proposal was eventually withdrawn, and a new one, **to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community** (COM(1998)295), has now been presented within the context of the "Monti package" (see above). The rate proposed is 20%; but there would be an alternative system of providing information on payments to the tax authorities of the saver's home state.

"Unfair competition"

To what extent do these issues, and the differences between Member States' tax systems and rates that lie behind them, amount to "unfair" tax competition?

It is perhaps useful to distinguish between

- ♦ competition between *tax systems as a whole*, including the overall level of taxation, the balance between direct and indirect, and the general structure of rates; and
- ♦ competition based on *special arrangements* for particular activities or areas, or administrative features that have the effect of distorting competition.

Competition between systems

Whether competition between tax systems can be considered "fair" or "unfair" is at heart a political question. Given that all EU Member States are democracies, it is hard to argue that they should not be able to make choices in favour of relatively low tax levels, or of particular tax structures, even if the result is an apparent competitive advantage.

It also worth remembering that it is not tax systems in isolation that are in competition, **but fiscal systems as a whole** - that is, the pattern of both revenue and expenditure. A choice in favour of low overall taxation implies a choice in favour of low overall public expenditure as well, with a trade-off between benefits and penalties. For example, low corporate tax rates may attract investment; but poor infrastructure and a poorly-educated workforce may repel it.

The details of such a trade-off can also be considered a matter for Member States' governments and parliaments alone. Only when there are spill-over effects - e.g., if the consequences of low public expenditure can be "off-loaded" onto neighbouring States, as in the case of measures to reduce pollution - is the case for harmonisation or coordination at an EU level clear-cut.

Choices concerning the **structure of tax systems** raise more complex issues. For example, certain Member States (e.g. Denmark) finance the bulk of their welfare systems out of indirect taxation, applying relatively high rates of Value Added Tax. Others (e.g. France) have chosen a system of high direct social security contributions. One effect of this, under the current VAT system, is to enable a proportion of the costs of the indirectly-financed social security expenditure to be rebated on exports to other Member States, which is not the case where the expenditure is directly financed.

The main effect in the case of divergent tax structures, however, is that competition is likely to exert pressure on the **rates of individual taxes** rather than directly on the overall tax burden.

For example, two countries, A and B, may both have a general level of taxation equal to 50% of their GDPs. Country A, however, may finance this through high rates of indirect taxation, with relatively low rates of corporate tax; country B in the reverse way. Tax competition will exert a downward pressure on indirect tax rates in country A, and on corporate rates in country B. The results will be:

6. downward pressure on the overall tax level in both countries; and
7. convergence of tax structures.

It is possible to welcome or to deplore either one of or both these consequences. Whereas a tax-sovereignty purist may reject any such pressures on the power of Member States to determine their own tax regimes - which often reflect long-standing political and cultural factors - a convergence of structures can be considered a natural consequence of the Single Market.

Similarly, many will welcome both the convergence of systems *and* the downward pressure on rates exerted by market forces. However, the erosion of revenues will also induce efforts to secure the convergence of systems *without* the downward pressure on rates - the primary objective, indeed, of coordination.

Special tax arrangements

It is these, rather than tax systems as a whole, that are generally meant when "unfair tax competition" is targeted. The previous sections have already outlined a number of specific examples. In eliminating them, however, two problems can be identified.

First, a distinction can be made between tax arrangements which distort competition as an incidental consequence of their main purpose, and which might be reformed to remove the distorting effect; and tax arrangements the primary purpose of which *is* to affect competition.

♦ A number of the problems involved in **the "transitional" VAT system** are examples of the first category. In the past, the actual level of VAT rates, or the method of collection, has been of less concern to national governments than ensuring that the revenue raised is paid into the correct national budget. Indeed, the main stumbling-block to a full origin system has been the perceived need for a "clearing system" to rebate VAT collected to the countries of final consumption.

This concern has led to such cumbersome procedures as that provided for in the 8th. VAT Directive. If a firm in one Member State pays VAT in another, it is entitled to claim this back as input tax. However, it cannot merely deduct the input tax from its VAT liability in the home country in the normal way, because nothing has been paid in there. Instead, it has to reclaim the tax from the second country - a procedure which can take months or even years. The effect is a disincentive to purchase certain services from a foreign supplier.

The Commission has recently proposed a simple reform to remove the distortion: i.e. the deduction of input tax being made in the normal way, with any revenue effects being sorted out through bilateral "clearing" between the relevant Member States - see Proposal for a Council Directive Amending Directive 77/388/EEC as regards the rules governing the right to deduct value added tax (1998); and Proposal for a Council Regulation (EC) on verification measures, measures relating to the refund system and administrative cooperation measures necessary for the application of Directive 98/xxx/EC (1998).

These are also an attempt to harmonise the rules on what expenditure is actually eligible for deduction as a business expense: e.g. cars, accommodation, entertainment, etc.

The Commission has also highlighted the differences in the **corporate tax base**, which result in a large number of marginal effective corporate tax rates. These can vary by around 200%, depending on industrial sector, mode of finance and category of investor; and can strongly influence the choice of tax jurisdiction in which companies invest.

♦ The most obvious example of the second category is **regional aid**, distributed *via* preferential tax arrangements rather than cash grants from national or the EU budgets. As the continuing debate over state aids in general has indicated, the moral and political position in such cases is not always clear-cut. On the one hand, there is no doubt that preferential treatment for one geographical area is "unfair" to others. On the other hand, this is usually the precise point of the policy. The creation of the euro area and the need to limit the danger of "asymmetric shocks" within it, is likely to heighten this dilemma in the future[10].

It can also be argued that **zero rates of witholding tax on interest paid to non-residents** are specifically intended to attract savings. The Commission, indeed, has referred to

[10] See "Adjusting to Asymmetric Shocks", *Economic Affairs Series*, Working Paper ECON-104, European Parliament, DGIV September 1998.

"unbridled tax competition for non-residents' deposits" as a factor both in the erosion of Member States' tax bases and the mis-allocation of investment. However, in this case the competition is not merely within the EU, but global.

Table 4: Witholding Tax on bank deposit interest

	Residents	Non-Residents
Belgium	15**	0
Denmark	*	0
Germany	30	0
Greece	15	10
Spain	25	0
France	20.9	0
Ireland	27	0
Italy	30	0 - 30
Luxembourg	0	0
Netherlands	*	0
Austria	25**	0
Portugal	25	15 - 20
Finland	28**	0
Sweden	30**	0
UK	25	0

* reporting system
** final tax
Source: European Commission

Secondly, the elimination of any specific tax distortion is likely to affect one group of Member States more than others, with possibly damaging effects on growth and employment, at least in the short term. Since these Member States will, on the face of it, gain nothing in return, there is little incentive for them to agree. An example of this is provided by the proposed withholding tax on interest paid to non-residents, which could have an immediate adverse effect on the significant financial services industry of Luxembourg.

It is for this reasons that the Commission has been attempting to make progress through "packages" of tax measures, in which the benefits and penalties are more or less evenly divided between Member States. The original "Monti package", for example, linked progress on the contentious issue of taxing interest paid to non-residents with parallel progress on the taxation of interest and royalties, the Code of Conduct, and improvements to the VAT system.

How far this tactic will succeed, however, is still an open question. The European Parliament's own resolution on the development of tax systems (1998) warned that the package:

> *"should be taken as a broad target to be achieved in the medium term, and not be used, on the contrary, as a tool by Member States to delay the approval of the various elements of the package".*

The original package was, in any case, trimmed back by the Council at an early stage (see above), while the Code of Conduct was adopted ahead of the rest.

Recent discussions in ECOFIN indicate that the new draft Directive on the taxation of savings is now running into much the same resistance from the Luxembourg and UK governments as its predecessor: disagreement about the rate and exemptions for eurobonds, and insistence on measures to prevent funds going "offshore". Agreement is not now expected before June 1999.

Competition or Cooperation?

Although many theoretical models exist, no clear-cut answer emerges from them to the

> "*deceptively simple question... : Is international tax competition... a good or a bad thing?* (Edwards and Keen, 1994).

It is evident that much depends upon the view taken of government in general, and of the functions of taxation in particular. Sinn (1993) envisages a situation in which

> *"...fiscal competition will wipe out redistributive taxes on mobile factors and reduce the tax system to one of mere benefit taxation".*

Other analyses disregard social or redistributive functions, and consider systems only in terms of a taxation/public expenditure trade-off: the benefits of high public provision have to be balanced against the effects of high consequent tax levels. The dangers of international tax competition in this context are considered to arise from countries

> *"attracting to them a larger share of the world tax base, thus exporting some of their tax burden."* (Tanzi, 1996)

At the other extreme, tax competition is seen

> *"as serving a valuable purpose in supplementing inadequate constitutional constraints on the intrinsic pressures towards excessively high tax rates implied by policy-makers' pursuit of their own interests."* (Edwards and Keen, 1994)

The assumption that all public expenditure is intrinsically beneficial - whatever the trade-off between expenditure and taxation as a whole - is consequently rejected. To the extent that a proportion can be considered "wasteful", welfare improvements cannot fully compensate for rises in the tax burden.

These sharply differing attitudes towards tax competition are reflected in similar views concerning the benefits of cooperation.

For some, the need for cooperation between states is an obvious consequence of economic integration. In the European Community, "*one member state's tax revenue becomes endogenous to other member states' tax policies"* (Deheijia and Genschel, 1996), so that

> *"like tectonic plates grinding against each other, the tax systems of different countries.. develop arbitrage pressures created by different tax rates, by differences in the bases that are taxed, by different possibilities of avoidance and evasion..."* (Tanzi, 1994).

The form of cooperation to which this situation is seen to lead need not take the extreme form of full harmonisation. The analysis of cross-frontier tax competition carried out by Kanbur and Keen (1991) prior to the completion of the Single Market, indeed, found that *common* rates of indirect tax produced overall losses; but that *minimum* tax rates, in contrast, produced overall benefit. This corresponded to the actual system adopted.

However, measures to coordinate tax regimes can also be regarded as the formation of "tax cartels", which use monopoly power to maximise revenues at the expense of other equally important economic requirements (corporate investment, private savings and consumption, etc.). A recent Kangaroo Group paper on taxation noted that:

> *"In practice, rather than compete, fiscal authorities are much more likely to copy each other's successful revenue raising measures. It was Adam Smith who observed that 'there is no art which one nation more swiftly learns of another than that of draining money from the pockets of the people'."*

Any assumption that cooperation will always produce a better overall outcome than competition must therefore be heavily qualified. For example

- ♦ Areas of cartelisation tend to become uncompetitive: i.e. *"If tax coordination remains limited to a subset of countries, there is no guarantee that the gains from coordination will not dissipate to outside countries"* (Dehejia and Genschel, 1996).

- ♦ The gains from cooperation are not necessarily shared equally between the participants, and can result in losses for some (i.e. those that would otherwise compete most effectively). Analysis by Dehejia and Genschel (1996) indicates that "small is competitive": i.e. that smaller economies gain from tax competition as opposed to larger ones, and consequently that larger economies gain from cooperation at the expense of smaller ones.

- ♦ Tax competition also provides one of the mechanisms by which a relatively poor country can institute a process of catching up.

> *"When capital is mobile and the country is small, the revenue cost to the country that provides tax incentives can be low or even negative if it succeeds in attracting foreign investment from other countries. If the country has high unemployment, the foreign capital can be combined with workers who would have been unemployed."* (Tanzi, 1996).

Ireland provides the clearest recent example of this mechanism.

♦ In so far as the "profits" from tax cartelisation are larger revenues,

> "*some 'firms' in the tax harmonisation case may not desire to increase 'profitability'...: a desire to curb public spending by restricting the growth of taxation was certainly one of the motives underlying Britain's obstructive attitude under Mrs Thatcher during the debates on harmonisation between 1986 and 1990."* (McDowell and Thom, 1993).

Conclusions

The conclusions to which this analysis leads are unsurprising: that some - but not all - tax competition can be harmful; and that some - but not ubiquitous - cooperation may therefore be beneficial. Put formally by Edwards and Keen, some degree of tax coordination is desirable if the welfare gains from eliminating "*the inefficiency of non-cooperative behaviour"* exceed "*Leviathan's tendency to waste*".

This common-sense judgment was reflected in Parliament's own resolution of 18th. June 1998, which gave general support to the Commission's approach. Increasing competition between national tax systems, it pointed out, was likely "*as a result of the greater transparency achieved by the introduction of the single currency*"; and it welcomed

> "*beneficial tax competition among Member States as a tool to increase the competitiveness of the European economy confronted with the challenges of globalization*".

Coordination was, however, justified when the degree of competition resulted in

> *"a potential failure to harvest the full benefits which the single market can provide in terms of growth and employment, given the increased tax burden put on labour compared with the more mobile capital".*

The resolution also drew attention, in particular, to various situations where taxation clearly appears to be distorting competition:

- "tax havens";

- the double taxation of both corporate and personal incomes;
- varying definitions of such tax concepts as basis of assessment, earnings and the rules on write-off;
- the exemption from taxation of non residents' savings income;
- the taxation of royalty and interest payments between associated companies in different Member States;
- fiscal state aids; and
- the detailed problems in the field of corporate taxation covered by the Code of Conduct.

A broad measure of agreement indeed exists on the elimination of "unfair competition" which arises from the complexity of tax systems. The more complex a tax system, the more scope it creates for (illegal) tax evasion, and the more incentive for companies, in particular, to devote resources to (legal) tax avoidance. The Kangaroo Group paper's primary conclusion is that

> *"tax structure should be as simple and transparent as possible; and any proposals should seek to simplify them further".*

It was for this reason that Parliament's Secchi report strongly criticised the dropping from the final Monti package of "*the measures designed to eliminate significant distortions in the area of indirect taxation*".

When it comes to the *rates* of tax, however, there is less agreement. In the field of VAT, for example, a 15% minimum rate was eventually set in 1992; but not the original Commission proposal for a 20% upper limit as well. A Commission proposal (1995) to set a 25% upper limit was rejected by both Parliament and Council, in spite of the fact that no Member State in fact exceeds this level. In reaching its decision, Parliament was very conscious of the proposals then under discussion, in the context of Economic and Monetary Union, for a Stability Pact, which would limit the ability of Member States to run budget deficits. Upper limits on indirect tax rates as well, it was argued, would unduly restrict room for manoeuvre.

It would appear that, as far as *maximum* tax rates are concerned, there is a general inclination to leave this to competition and market forces. A natural upper limit in any case exists at the point when any *increase in rates* results in *falling aggregate revenue* from the tax concerned. There is reason to believe that this position may already have been reached in the case of some Member States' very high levels of excise duty on alcohol and tobacco (though governments may nevertheless choose to maintain them at this level in pursuit of public health or social policy objectives).

On even minimum rates, however, there are widely differing views. Over the years, for example, the Commission has proposed rates of 15% and 20% on interest paid to non-residents. These have been criticised both as too low and too high. There has been no agreement on any minimum rate of corporation tax at all, despite the recommendations of the Ruding and other reports.

The balance between competition and cooperation which emerges is therefore as follows:

- where particular features of tax systems distort competition - either inadvertently as a result of excessive complexity, or deliberately - there is a case for Community action;
- experience indicates this action is more likely to be successful if it takes the form of cooperation (e.g. the Code of Conduct) than of formal harmonisation through legislation;
- in certain areas, however, legislation is inevitable, most obviously to remove differing and distorting application of existing provisions - e.g. in the case of VAT.
- agreement on maximum tax rates is unlikely, and even on minimum "floor" rates extremely difficult. Tax rates are widely considered the proper preserve of national sovereignty and of market forces.

These are, indeed, the rough parameters of the Community's current tax policies. The Austrian Presidency summed up the position, following the Vienna Summit of 12/13 December 1998 by stating that:

> *"Cooperation in the tax policy area is not aiming at uniform tax rates and is not inconsistent with fair tax competition; but is called for to reduce the continuing distortions in the single market, to prevent excessive losses of tax revenue, and to get tax structures to develop in a more employment-friendly way".*

Appendix: Tax competition and capital taxation

Models of capital taxation make a number of basic assumptions:

- ♦ capital - and consequently the tax base - is mobile internationally;
- ♦ rates of return on capital are broadly determined within the international economy as a whole, on which the fiscal policies of any one country can have only very limited influence;
- ♦ tax can be levied on the income from capital at source (i.e. where the income is generated) and/or in the country of residence (i.e. where the investor is normally taxable);
- ♦ each individual country will try to optimise its position in terms of both tax revenues and the volume of domestic investment.
- ♦ revenue-maximisation will involve a trade-off between the rate of tax, and consequent gains or losses of tax base.

Given these assumptions, there are two limiting cases:

Model 1

Tax is levied in the country of residence, but not in the country of source. If any one country levies tax at a higher comparative rate, the post-tax rate of return on investment for residents of that country will be lower than in other countries.

The *investment effects* will be:

- a lower comparative level of investment by residents of that country, both domestic and abroad; but
- an unaffected level of direct inward investment.

The *revenue effects* will depend heavily on the extent to which tax can be levied on the foreign earnings of residents. In the absence of effective information-exchange systems between countries, or of an efficiently-policed system of tax returns, the regime will be vulnerable to tax evasion. (This is without taking into account the possibility of tax-payers themselves becoming mobile).

Model 2

Tax is levied at source, but not in the country of residence. If any one country levies tax at a higher comparative rate, the post-tax rate of return on all investment in that country will be lower than in other countries.

The *investment effects* will be both

- a reduced level of inward investment; and
- a flight of domestic capital to other countries.

The *revenue effects* will be initially neutral. However, the fall in the level of investment will erode the tax base over time, leading to progressively lower tax revenues.

Under Model 2, therefore, tax competition between countries will clearly result in a downward pressure on the rates of tax on investment. The same will be true, though to a lesser extent, under Model 1, particularly if there is no cooperation between national tax authorities.

This theoretical analysis, however, is subject to a number of practical qualifications.

♦ Capital is not perfectly mobile between countries. Distinctions have to be made between short and long-term capital: between, for example, bank deposits; portfolio investment in public debt and in equity; and the capital investment in plant, etc. of companies. Changes in comparative tax levels may have an instantaneous effect on "hot" money flows, but only affect the investment plans of multi-national companies over a period of many years

♦ A distinction has to made between investments where the return is entirely or largely in the form of income: e.g. bank interest; and those where the return is substantially in the form of capital growth: e.g. equities. In the second case, the tax regime applying to income payments can be of only minor significance, so that its taxation at source will lead to little comparative disadvantage.

♦ Most investors, particularly small investors, are inherently risk-averse. They will prefer to put their savings into securities which are familiar to them - local savings banks, national savings schemes, the equity of domestic companies, etc. - than into foreign assets, even at the cost of higher rates of tax. Exchange risk constitutes another important obstacle to mobility - though one that disappears within the euro area.

- ♦ For large investors - for example, institutional investors - portfolio diversification to spread risk can be as important as tax considerations. Tax planning will be just one element in the management of funds.

- ♦ The integration of markets is leading to an increasing exchange of capital between countries - higher levels of both inward and outward investment, cross-border take-overs and mergers, strategic investments by multi-nationals, etc. - unrelated to tax considerations. The opportunity for countries to obtain revenue by taxing foreign-owned investment can outweigh the fear of losing the investment through tax competition.

- ♦ In any case, the damaging effect of tax competition on taxation at source is largely removed if investors receive a tax credit for payments in the country of source to set against their liability in the country of residence. This is the objective of the existing network of bilateral tax treaties governing the international payment of dividends.

A system of tax credits generates a third, more realistic model:

Model 3

Tax is levied at source *and* in the country of residence. The tax paid at source can be offset against liability in the country of residence. Post tax returns in any given country will be the same whether the income is generated domestically or abroad.

The *investments effects* will be as in the case of Model 1.

The *revenue effects*, however, will no longer depend on the efficiency of tax collection. They will be determined by the relative levels of tax in the country of source and the country of residence.

By contrast with Models 1 and 2, tax competition will therefore result in *an upward pressure on rates of tax*, as countries attempt to maximise their share of revenues.

Tax competition, therefore, does not necessarily erode either the tax base or the rates of taxation on capital. Taxation in the country of residence combined with efficient cooperation between tax authorities, or taxation in both the country of source and of residence combined with tax credits can result in broadly neutral investment effects, and a neutral or upward pressure on tax rates.

Part II. Taxes on Labour, on Savings and on Corporations

Contents

Tables

Foreword

This study covers three main subjects: Taxes on Labour; Taxes on Savings; and Corporate Taxes. Each section provides a brief summary of the taxes in question and an overview of the relevant policies of the European Union; and concludes with an analysis of tax coordination techniques in each sector.

The information provided usually relates to tax regulations in force at the end of 1996. The countries surveyed include all European Union Member States, although in some cases data from Greece and Portugal were not available.

Some definitions

Brief definitions of some terms used in this study may be useful.

HARMONISATION**:** Convergence of systems as a result of legislative action at Community level. We can distinguish between **Full Harmonisation**, which produces identical tax bases, rates, systems, etc.; and **Partial Harmonisation** or **Approximation**, which involves something less: for example, minimum or maximum tax rates, the elimination of double taxation, etc.

COORDINATION: Measures to bring the tax practices of the EU Member States closer together, generally through non-legislative mechanisms like conventions, recommendations, guidelines, codes of conduct, etc.

COMPETITION BETWEEN SYSTEMS: A process by which convergence of tax systems is secured through the operation of market forces, without deliberate harmonization or coordination.

CONVERGENCE: A process whereby Member States´ tax bases, rates, systems, revenue yields, etc., grow closer together, irrespective of whether this happens as a result of EU action or the interplay of market forces.

SUBSIDIARITY**:** The principle that, in areas where the Community does not have exclusive competence, it should only act when, and to the extent that, the objectives cannot be achieved to a sufficient extent by the Member States. Complementary with the principle of subsidiarity is that of **proportionality:** no Community measure should exceed what is necessary to achieve the desired objective.

Taxes on Labour

Personal Income Tax constitutes, at the present time, the main element in Member States´ fiscal systems. The importance of Personal Income Tax has steadily increased in recent decades. Cnossen (1987) attributes this to:

- the fact that income is widely seen as the fairest basis for taxation; and
- the increasing use of deduction at source of taxes on wages (allied to the concentration of jobs in larger and increasingly well-organised production units).

Personal Income Tax is applied at central government level in most of the Member States. In some cases these taxes are supplemented with one or several local taxes, though in the majority of European countries personal income taxes at subordinate levels of government are either non-existent or relatively unimportant in terms of yield.

The Income Tax-to-GDP ratio varies enormously between countries. In 1994, the ratio ranged from 4.5 in Greece to over 27 in Denmark. Similarly the share of Income Tax as a percentage of total revenue ranged from 10.5 per cent in Greece to 53.8 per cent in Denmark.

Main Tax Elements

1. Tax unit

All countries apply the residence principle. Residents are taxed on all their income, independently of the country where income is earned. Non-residents are only taxed on their earnings in that country.

Each country, however, applies different criteria to determine if a person is resident in that country. The majority of Member States determine the residence of a person in the country where he/she possesses his/her habitual home or where he/she resides for a period of at least six months during the fiscal year. Also taken into account is the place where the centre of economic interests is situated, or where the partner and children reside.

TABLE 1. TAXES ON PERSONAL INCOME AS PERCENTAGE OF GDP AND AS PERCENTAGE OF TOTAL TAXATION

	% of GDP	% of total taxation
AUSTRIA	8.4	19.6
BELGIUM	14.5	31.0
DENMARK	27.7	53.8
FINLAND	17.5	37.0
FRANCE	6.2	14.0
GERMANY	10.4	26.5
GREECE	4.5	10.5
IRELAND	11.8	31.5
ITALY	10.6	25.4
LUXEMBOURG	9.7	21.5
NETHERLANDS	9.3	20.3
PORTUGAL	6.2	18.7
SPAIN	8.1	22.8
SWEDEN	18.7	36.7
UNITED KINGDOM	9.4	27.6

Source: OECD. Revenue Statistics, Paris, 1996.

The Netherlands, Italy, the United Kingdom, Belgium, Denmark, Austria, Finland and Sweden assess individually the earned income of spouses where both are gainfully employed. France, Portugal, Greece and Luxembourg use joint taxation, and in Spain, Germany and Ireland, there is possibility of election between individual or joint taxation. In countries using joint taxation, tax liability is calculated by applying the appropriate rate schedule to the aggregated taxable earned income of the spouses. Under individual taxation, liability is calculated by applying the appropriate rate schedule to the taxable earned income of each spouse separately.

In order to reduce the effect of cumulation of earned income under joint systems, most of the countries with joint taxation apply "income splitting", under which each of the spouses is deemed to have the same income, whatever their actual earnings may be. Where tax rates are progressive, this has the effect of reducing tax liability.

2. Incomes subject to tax

All countries tax employment income: wages and salaries. However certain income sources are generally excluded from total income to arrive at the income subject to tax.

Of special importance is the exclusion from taxation of certain social transfers: for example, family subsidies are excluded from taxation in France, Belgium, Germany, Denmark, Greece, Ireland, and Italy. Social transfers for sickness or invalidity are also exempted from taxation in the majority of countries. The situation in relation to social transfers is summarised in Table 2.

TABLE 2. MAIN SOCIAL TRANSFERS SUBJECT TO TAX

	A	**B**	**D**	**FI**	**FR**	**GE**	**GR**	**IR**	**IT**	**L**	**N**	**P**	**SP**	**SW**	**UK**
Unemploym.	N	S	S	S	S	N	S	N	S	S	S	S	S	S	S
Sickness	N	S	S	S	S	N	S	N	S	P	N	P	S	S	P
Invalidity	P	S	S	S	S	N	S	N	S	P	N	P	S	S	P
Fam. Transf.	N	N	N	N	N	N	N	N	N	S	N	P	N	N	N
Non monetary payments	S	P	S	S	S	S	S	S	S	S	P	P	S	S	S

S   Income source subject to tax.
N Income source not subject to tax.
P   Some components subject to tax, others not.

Source: Own elaboration from: *Taxation in OECD countries*, OECD, Paris, 1992*; Inventaire des Impôts*, Commission des Communautés Européenes, Luxembourg, 1994; and *IBFD. European Taxation,* Section B, Amsterdam. 1997

3. Tax rates

Tax rates are progressive in all the countries of this study, although there are important differences in maximum and minimum rates and number of brackets. The maximum number of brackets is 17, applied in Luxembourg and Spain, and the minimum is two, in Ireland. The average is approximately six brackets.

TABLE 3. RATES OF CENTRAL GOVERNMENT INCOME TAX (1)

	Number of brackets (2)	Maximum rate (%)	First positive rate (%)
AUSTRIA	5	50	10
BELGIUM	7	55	25
DENMARK	3	68	50
FINLAND	6	39	7
FRANCE	6	56.8	12
GERMANY	Var.	53	19
GREECE (*)	4	40	5
IRELAND	2	48	27
ITALY	7	51	10
LUXEMBOURG (*)	17	50	10
NETHERLANDS	3	60	7.05
PORTUGAL	4	40	15
SPAIN (*)	17	56	20
SWEDEN	2	(2).	(2)
UNITED KINGDOM	3	40	20

(1) Excluding zero rate as a bracket.
(2) The first positive rate is calculated: 100 Skr each 198.700 Skr and the maximum rate is 100 Skr 198.700 + 20 %.
(*) These countries have a zero rate bracket.

Source: Own elaboration from: *Taxation in OECD countries*, OECD, Paris, 1992*; Inventaire des Impôts,* Commission des Communautés Européenes, Luxembourg. 1993*; The tax benefit position of production workers,,* OECD, Paris, 1995*;* and IBFD, *European Taxation*, Section B, Amsterdam, 1997.

The first positive rate is at its highest level in Denmark (50%) and the lowest in Greece (5%). The average is 18.3%. The top rate is at its maximum in Denmark, with 68%, and at a minimum in Finland (39%), Portugal, Greece and United Kingdom, with 40%. The average is 51.5%.

4. Tax reliefs: tax allowances and tax credits

European Member States provide tax reliefs in a variety of ways. The main distinction is between tax allowances and tax credits.

Tax allowances are one of the most frequently employed ways of implementing standard tax reliefs. Allowances take the form of deductions from income subject to tax, so that under progressive income tax schedules their value increases as income increases.

Tax credits are lump-sum deductions from payable tax, so that their absolute amount is unaffected by the taxpayers´ income.

Tax allowances and tax credits included in Table 4 refer exclusively to basic reliefs available to all taxpayers and basic reliefs for earned income, under individual taxation.

Most European countries apply tax allowances. Spain, Denmark, Portugal and Italy apply tax credits, although some of them apply both kinds of tax relief.

A more generalised method of giving relief is allowances related to earned income, subject to a maximum. Spain, Portugal, Belgium, Denmark, France, Finland and the Netherlands apply this method. There is also the possibility, in the last five countries, of deducting the actual costs of certain work-related expenses. In Germany, Greece, Ireland, Sweden and the United Kingdom there are allowances for work-related expenses, as well as in Luxembourg, provided that they exceed a minimal deduction. Italy and Spain apply tax credits for earned income.

Employees' Social Security contributions are deductible from the tax base in almost every European Member State, with the exception of the United Kingdom. In the Netherlands and Denmark, employees' Social Security contributions are included in Personal Income Tax, and in Germany and Ireland are deductible up to a limit.

TABLE 4. TAX ALLOWANCES AND TAX CREDITS

	Basic tax allowances (National currency)	Social Security contributions	Standard tax allowance for earned income.	Allowances related to earned income	Allowances for costs of certain work-related expenses	Tax credits (National currency)
AUSTRIA	1.638 + 1.800	C				8.840+ 5.500
BELGIUM	191.000	S		% variable max. 110.000 (*)		
DENMARK		S		3% max 3.800 (*)		8.849+ 4.249 (1)
FINLAND		C		3% max. 2.100	S	
FRANCE		C		Optional (2)		
GERMANY	5.616	C	2.000		S	
GREECE		S			S	
IRELAND	2.350	C			S	
ITALY		S				792.000
LUXEMBOURG		S	21.000 (*)		S	
NETHERLANDS	5.925	C		8% min 231 max 2.086(*)	S	
PORTUGAL		Optional (3)		Optional (3)		29.000
SPAIN		S		5% max 250.000		Variable (4)
SWEDEN		C			S	
UNITED KINGDOM	3.445	N			S	

S Deductible N Not deductible C Deductible subject to conditions
(*) In these countries applying allowances for actual costs if they are above a maximum limit is allowed.
(1) Denmark applies a tax credit of 14,5% of 29.300 in central government tax and of 30,2% of 29.300 in local tax.
(2) The taxpayer is allowed to apply: 10% of net earned income (minimum of 2.190 FF and maximum of 73.270) or actual costs.
(3) The taxpayer is allowed to opt between the allowance of 65% of the salary with a limit of 416.000 escudos or the Social Security contributions.
(4) In Spain the tax credit depends on earned income and others revenues

Source: Own elaboration from: *Taxation in OECD countries*, OECD, Paris, 1992*; Inventaire des Impôts*, Commission des Communautés Européenes, Luxembourg. 1993*; The tax benefit position of production workers*,, OECD, Paris, 1995*;* and IBFD, *European Taxation*, Section B, Amsterdam, 1997.

5. Effective average rates

Finally, a global comparison of workers´ taxation in the European Union requires calculation of effective average rates. This is based on the socio-economic group identified by reference to the average gross earnings from employment of all adult full-time production workers in the manufacturing sector.

Income tax payments are calculated in the following way: first the tax allowances applicable to a taxpayer with the characteristics and income level of an average production worker are determined; the schedule rate of tax is then applied; and the tax liability thus calculated is reduced by relevant tax credits.

The average effective rate is 18.1%. Spain, France, Netherlands, Italy, Luxembourg, Austria and Portugal are below that percentage, while Belgium, Germany, Denmark, Ireland, Finland and Sweden are higher. The figure for the United Kingdom is the EU average. Denmark applies the highest rate, and Portugal the lowest.

In the last column of Table 5, the employees' Social Security contributions have been added to effective personal income tax, expressed as percentage of gross salary. When studying personal income tax, employees' compulsory contributions to statutory social insurance schemes should be included in order to provide a basis for comparison.

Denmark, for instance, funds its insurance scheme almost entirely out of general taxation, and would thus perform very badly in an international comparison that overlooked insurance contributions.

The comparative data of effective tax rates and Social Security contributions, expressed on gross earnings, again show Denmark clearly in the lead, though the Netherlands, Germany, Belgium, Finland, Sweden and Ireland all exceed the EU average (30.7%), which is kept down by countries such as Portugal, Spain, Italy and France.

TABLE 5. EFFECTIVE AVERAGE RATES

	Effective average rate (%)	Effective average rate including employee´s Soc. Sec. contributions (%)
AUSTRIA	7.5	25.6
BELGIUM	24.2	37.3
DENMARK	38.3	45.2
FINLAND	28.5	37.1
FRANCE	8.7	27.3
GERMANY	18.8	38.2
IRELAND	23.1	30.8
ITALY	16.7	26.7
LUXEMBOURG	12.9	25.4
NETHERLANDS	7.8	41.3
PORTUGAL	7.2	18.2
SPAIN	12.9	19.5
SWEDEN	28.8	30.77
UNITED KINGDOM	18.1	26.5

Note: Data from Greece are not available.
Source: Own elaboration from: *Taxation in OECD countries*, OECD, Paris, 1992*; Inventaire des Impôts*, Commission des Communautés Européenes, Luxembourg. 1993*; The tax benefit position of production workers*,, OECD, Paris, 1995*;* and IBFD, *European Taxation*, Section B, Amsterdam, 1997.

6. Employers' contributions

In all countries except in Denmark, there are also very large employers' Social Security Contributions. It is possible to consider these as part of employees' income; but they have no tax implications for the employees themselves. From the point of view of employers, however, they can be considered as taxes on labour, adding to non-wage labour costs. They also, of course, contribute to total tax revenues.

TABLE 6. EMPLOYERS' SOCIAL SECURITY CONTRIBUTIONS

	Employers' Contributions (1)
AUSTRIA	17.85
BELGIUM	39.08 (2)
DENMARK	0.19
FINLAND	26.2 - 28.5
FRANCE	29.18 (3)
GERMANY	20.75
GREECE	27.96 - 31.11
IRELAND	12 (4)
ITALY	50
LUXEMBOURG	15.74 - 21.74
NETHERLANDS	11.28
PORTUGAL	21.25 - 23.75
SPAIN	30.8
SWEDEN	32.92
UNITED KINGDOM	3-10 (5)

Source: IBFD, *European Taxation,* Section A, Amsterdam, 1997.

(1) Social Security contributions to be paid by the employer on the gross salary of the employee.
(2) Total of the general contributions and the special contributions, up to 9 workers.
(3) For a salary up to FRF13.720 per month.
(4) On earnings up to IEP 26.800
(5) The rate is 3% up to £109.99 and 10% over £210.00.

The coordination of taxes on labour within the EU

The Single Market has several particular implications for the taxation of employment incomes.

♦ Incomes should not escape tax altogether, or be taxed at discriminatorily low rates, as a result of cross-border tax arbitrage, avoidance or evasion.

♦ Equally, frontier workers and other non-resident taxpayers should not be taxed at discriminatorily high rates. Problems such as the double taxation of the same income and the lack of co-ordination for individuals who pay taxes in one Member State and social security contributions in another act as a barrier to free movement.

♦ Differentials in social security contributions and personal income taxes between neighbouring countries, especially in border regions, can create tax-induced incentives to cross-border migration for work. As the internal market continues to develop, similar problems may affect larger groups, since labour mobility can be expected to increase. Thus, the countries with a high fiscal pressure in workers´ taxation could see their revenue levels diminished.

Several measures, both on a bilateral basis between Member States or at a Community level, have already been taken in the first of these two fields (see next section). In the third case, however, there are conflicting pressures.

At the very highest levels of income, avoidance of tax through "tax exile" is a well-known international phenomenon. Stars of sport or entertainment operate within a global market, and are to some extent able to choose where they will be taxed.

Diverse factors and circumstances, however, influence most workers' movements. Among them are cultural and linguistic differences, which remain significant despite the efforts of the European Union to reduce the barriers and boost labour mobility. Even those who do become migrant workers retain roots in their places of origin, and often repatriate much of their income.

For this reason, the likelihood of tax-induced mass labour migration within the European Union is actually quite small. Even skilled workmen will hardly emigrate for tax reasons alone: gross wages and the cost of living will exert at least an equal influence on any such decision.

It must therefore be concluded that national differences in Personal Income Tax are unlikely to cause any discernable distortions of competition in the labour market or in the workers´ choice of work place, except in the case of frontier workers.

Various reports, such as that of the Neumark Committe of 1963, have come out in favour of introducing a uniform type of personal income tax with the same pattern of charges but differing rates of taxation. The Commission´s harmonization programme of 1967 also advocated measures of this kind; but deferred implementation to an unspecified time in the future.

However, in the opinion of experts in the field such as Komar (1983), a European Tax System should, initially at least, cover taxes that are easiest to harmonise; and this does not include Personal Income Tax. Moreover, income taxes are of particular importance to national budgets and are considered matters of national economic sovereignty and prestige.

Harmonization of Personal Income Tax is therefore neither necessary nor practicable. The most that is required, in the view of most experts, is the rationalisation of certain aspects.

Income Tax can therefore remain a primary means of pursuing national economic policy objectives. This seems be confirmed by the Commission´s attitude during the last decades.

Decisions adopted in Personal Income Tax area

1. Measures in relation to frontier workers[11]

Frontier workers are distinguished from traditional migrant workers by the fact of living in one State and working in another. They are accordingly covered by the Community such as the Regulation on freedom of movement for workers within the Community (1968). They have the right of residence in the country of employment and must be treated on an equal footing with workers of that country, enjoying the same social and tax advantages as national workers.

Taxation is one of the major problems facing frontier workers. Bilateral agreements between the Member States aim at preventing double taxation of income. These agreements are based on the principle that taxation must be payable either in the country of work or in the country of residence. Nevertheless, frontier workers quite often feel that the current tax rules discriminate against them. The Commission unsuccessfully attempted to find a solution to the problem arising in this connection with a Proposal for a Directive in 1979 (COM/79/0737).

The living and working conditions of frontier workers have since been the subject of a steady flow of studies and reports from the Economic and Social Committee, the European Parliament and the European Commission. Following the recommendation made at the European Council in Fontainebleau, the European Commission presented a Communication to the Council on the question of frontier populations (COM/85/529 final), analysing the various problems and stating the European Commission´s position of possible courses of action. The Economic and Social Committee adopted an *Opinion on cross-frontier labour market problems*, (88/C95/06, OJ C95 of 11-4-1988); and the European Parliament a *Resolution on transfrontier cooperation at the internal borders of the Community* (Part-session of 12 March 1987; EP 112.804) and a *Report on the problems of cross-frontier workers in the Community,* adopted on 16.12.1988.

In 1990, the Commission presented a Communication on the living and working conditions of Community citizens resident in frontier regions, with special reference to frontier workers (COM/90/561 final).

2. Cooperation and exchange of information

In order to increase cooperation and exchange of information among national tax authorities, the Community adopted Directive 77/799/EEC Concerning Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation. However, tax authorities are not required to obtain for, and transmit to, other tax authorities information that they are prevented from collecting under their own laws or administrative practices. In 1989 a proposed amendment to this Directive would no longer have allowed tax authorities of Member States to refuse to share information on the grounds of administrative impediments.

[11] See *Frontier Workers in the European Union*, Social Affairs Series, European Parliament Working Paper W-16, European Parliament, DG IV, Luxembourg, 1997.

3. Social Security Contributions

A Council Regulation (1408/71/EEC)[12], with amendments, on the application of social security schemes within the European Union has been in force since 1971. The regulation covers a broad range of topics regarding the application of social security schemes to individuals who choose to work in another Member State.

4. Recent measures

The evolution of taxes on labour over the last decade shows a substantial increase in these taxes in most European countries. However, while the taxation of labour has been increasing, the taxation of production factors other than labour has shown an overall decrease.

This lack of symmetry between the trend of taxes on labour and the trend in taxes on other production factors has had repercussions:

- ♦ on the distribution of wealth: lower relative taxation of income from capital benefits the already well-off;
- ♦ on employment: it has encouraged the substitution of capital for labour, so increasing unemployment rates;
- ♦ on tax avoidance and evasion: high taxation of labour encourages tax evasion and, in particular, rising recourse to the untaxed "black economy".

In June 1996, the Commission proposed a European Confidence Pact for Employment. This highlighted the need to reverse the tendency of taxation systems detrimental to employment, as part of a wide ranging strategy to create more jobs in the European Union. The Commission, however, emphasised that, in accordance with the principle of subsidiarity, Member States should have flexibility in choosing the method of reducing taxes on labour and the means of financing those reductions.

The obvious options for financing reductions in taxes on labour are public expenditure cuts and increased taxation elsewhere. Public expenditure cuts may contribute, but are unlikely on their own to be able to fund significant tax reduction on labour. Alternative tax sources are also controversial: higher VAT rates or an energy tax.

Reversing the tax burden on labour could, however, to some degree be self-financing as increased employment levels increase tax revenues.

The European Council held on 20/21 of November 1997 in Luxembourg confirmed the need to reverse the trend towards increasing the tax burden and stressed in this context the importance

[12] Council Regulation (EEC) N° 1408/71 of 14 June 1971 on *the application of social security schemes to employed persons, to self-employed persons and to members of their families moving within the Community* (OJL 149, 5-7-1971, p.2). The text of this Regulation has been amended several times. The most recent updated version is Council Regulation (EC N° 118/97 of 2 December 1996 (OJL 28, 30-1 -1997, p.1)

of coordinated action by Member States. The European Council recalled its previously expressed concern to bring to an end unfair tax competition liable to harm employment, making the taxation system more employment friendly and reversing the long-term trend towards higher taxes and charges on labour. Each Member State has undertaken to set a target, if necessary and taking account of its present level, for gradually reducing the overall tax burden. Where appropriate, a target is also to be set for gradually reducing the fiscal pressure on labour and non-wage labour costs, in particular on relatively unskilled and low-paid labour.

This must, however, be without jeopardizing the recovery of public finances or the financial equilibrium of social security schemes. The possibilities for introducing new, alternative sources of finance - for example, EU-wide taxes on energy, or on pollutant emissions - have since been the subject of intensive examination.

Taxes on Savings

The importance of saving lies in its potential to cause macroeconomic imbalances in the short term, and its key role in capital accumulation and economic growth in the long term.

General economic principles suggest that ideally the taxation of income capital should not influence economic decisions made by economic agents and should not interfere with the optimal allocation of capital across countries. Tax differences may cause inefficiencies in the real economy.

One of the main objectives in this chapter is to identify differences in the tax treatment of savings: interest and dividend income among the European Union Member States.

The first part of this chapter provides a brief description of the basic provisions concerning the taxation of interest and dividend income from both domestic and foreign sources in European Union Member States. The information provided usually relates to tax regulations in force at the end of 1996. The countries surveyed include all European Union Member States, although in some cases data from Greece and Portugal were not available.

Secondly, the coordination of this type of tax is analysed.

Taxation of domestic interest income

There is no withholding tax on interest income in Denmark, Luxembourg and the Netherlands. Income from interest is included in the taxable income of the resident individual investor. Tax is calculated in accordance with progressive income tax tables with maximum ordinary tax rates ranging up to 60% in the Netherlands, 58% in Denmark and 50% (plus additional 2,5% unemployment funds) in Luxembourg.

Interest withholding tax is not final in Germany (30%), Spain (25%), and the United Kingdom (20%), but treated as a prepayment to the income tax liability. The tax withheld on the interest is credited against the resident investor´s final income tax liability. The withholding tax is the final income tax for resident individuals in Austria (25%), Belgium (15%), Finland (28%), Ireland (15% or 27%), Italy (12,5% to 30%), Norway (28%) and Sweden (30%). In France, a final withholding tax of 19.4% on interest income is optional, and the ordinary income tax may be replaced by this withholding tax.

TABLE 7. DOMESTIC TAXATION OF INTEREST INCOME

	Withholding Tax		Personal Income Tax		
	Final	Not Final	Maximum Rate	Reduced Rate	Basic Tax-free amount
AUSTRIA	25%	-	50%	-	-
BELGIUM	15%	-	55%	-	First BF 50.000
DENMARK	-	-	58%	40% (for capital income)	-
FINLAND	28%	-	56.5% (1)	28% flat rate on capital income	-
FRANCE	19.4% (optional) (2)	-	56.8%(optionally replaceable by a final withholding tax)	-	FF 8.000 for single individuals and FF16.000 for married couples
GERMANY	-	30% (35%)	53% (+ surcharges)	-	DM 6.100 for individuals and DM 12.200 for married couples
IRELAND	27% or 15%	-	48%	-	-
ITALY	12.5%, 25%, or 30%	-	51%	-	-
LUXEMBOURG	-	-	50%(+ 2.5% unemployment fund contribution)	-	LUF 60.000 for individuals and LUF 120.000 for married couples
NETHERLANDS	-	-	60%	-	Dfl. 1.000 for individuals and Dfl. 2.000 for spouses
SPAIN	-	25%	56%	-	First 25.000 ptas. of interest together with dividends tax free
SWEDEN	30%	-	56%	30% on capital income	-
UK	-	20%	40%	20%	-

Note: Data from Greece and Portugal are not available.
(1) 56.5% in 1996 and 55.5% in 1997.
(2) 19.4% in 1996 and 20.9% in 1997.

Source: The Taxation of Savings, Confédération Fiscale Européenne, C.F.E. Paris, 1997.

Taxation of domestic dividend income

There are four different systems of dividend taxation:

- ♦ partial imputation systems
- ♦ full imputation systems
- ♦ shareholder relief systems
- ♦ classical system

These very different ways of treating dividend income provide varying degrees of relief from double taxation. Only the Netherlands operates a classical corporate tax system, under which profits distributed in the form of dividends are fully taxed twice, once at the corporate level, and again at the shareholder level. The other countries provide varying degrees of relief.

Ireland, Spain and the United Kingdom apply partial imputation systems, allowing part of the corporate tax paid on distributed profits to be credited against the resident investor´s personal income tax liability. Spain levies a withholding tax of 25% on domestic dividends, which is credited against the resident investor´s personal income tax. Ireland and United Kingdom do not levy withholding taxes on dividends paid to shareholders by domestic companies; the company must, when it pays a dividend, make a prepayment of its corporate tax liability as advance corporation tax (ACT). Residents in receipt of such dividends are subject to income tax on the gross dividend, then a tax credit is obtained against the individual´s tax liability for the credit on the dividend.

Under the full imputation system, as operated in Finland and Germany, the entire tax paid by the company on its distributed profits is credited against the shareholder´s personal income tax liability. This eliminates the double taxation of dividends in full. France and Italy are quite close to full imputation. Germany and Italy are subject to withholding tax at 25% and 10%, respectively. In these countries the tax imposed on dividends is credited against the resident investor´s tax liability. For personal income tax purposes, the dividend is included in the total taxable income of the taxpayer. Shareholders are entitled to a full tax credit, which amounts to 3/7 and 9/16, respectively, on the dividend paid.

In Finland, income from dividends is taxed at 28%, dividends appear to be tax-free for shareholders, who only need to state the amount of the dividend in their income tax return, the authorities then gross up this amount and net off the corporate tax (also 28%). In France, no withholding tax applies to dividends from domestic source to French residents. Dividend income is included in total personal taxable income. Avoidance of double taxation is accomplished by granting resident shareholders a tax credit equal to 50% of the dividend paid.

The withholding tax on dividend income is final in Austria (25%) and Belgium (25%, in some cases reduced to 20% or 13%). These countries provide no imputation tax credit, but rather achieve relief from double taxation by applying the above reduced final tax rates on domestic dividend income of resident investors. In Luxembourg, shareholders are taxed only on 50% of the gross amount of dividends received. The withholding tax of 25% levied at source by the corporation on the gross dividend is deducted from the final tax of the recipient. In Denmark, dividends are subject to a 25% withholding tax. If the investor´s total income from shares does not exceed a limit, the withholding tax is a final tax. Any income in excess of this limit is taxed at a maximum ordinary tax rate for dividend income of 40%. Sweden, in principle, also falls into this category (final taxation at 30%). However, individual shareholders are exempted from payments of any tax on dividend income from Swedish companies.

In 1997, the Netherlands changed over to a mixed system: a new shareholder relief system for shareholders with a participation of 5% or more was introduced, and the old classical system continued applying to all other shareholders. Under the new Dutch system, there is a final withholding tax of 25% on qualifying dividends, and any capital gain realised by the investor is subject to the same rate of 25%.

TABLE 8. DOMESTIC TAXATION OF DIVIDEND INCOME

	Withholding Tax		**Personal Income Tax**			
	Final	Not Final	Maximum Rate	Reduced Rate	Imputation Tax Credit	Basic Tax-free Amount
AUSTRIA	25%	-	50%	-	No Tax credit	-
BELGIUM	25% (1)	-	55%	-	No Tax credit	-
DENMARK	25% (2)	Only if limit is exceeded	40% on dividend income	-	No Tax credit	-
FINLAND	-	-	56.5% (3)	28% for capital income	Full imputation	-
FRANCE	-	-	56.8%	-	Tax credit equal to 50% of the dividend paid	FF 8.000 for single and FF16.000 for spouses
GERMANY	-	25%(+ surcharges)	53%(+ surcharges)	-	Tax credit equal to amount of corporation tax paid on distributed profits (full imputation)	DM 6.100 for individuals and 12.200 for spouses
IRELAND	(4)	(4)	48%	-	Tax credit equal to the ACT paid (partial imputation)	-
ITALY	12.5% (if final)	10% (if not final)	51%	-	Almost full imputation)	-
LUXEMBOURG	-	25%	50% (+surcharg es)	-	-	(5)
NETHERLANDS	25%(in case of participatio n of minimum 5%	25% in other cases	60%	25% (under new system)	Classical system or shareholder relief under new system	Dfl. 1.000 for individuals and Dfl 2.000 for spouses

SPAIN	-	25%	56%	-	Gross dividend multiplied by 140%, then imputation credit of 40%	First 25.000 ptas of dividend and interest income tax-exempt
SWEDEN	30%		56% and 30% for capital income	-	-	-
UNITED KINGDOM	(6)	(6)	40%	_	Tax credit equal to the ACT paid (partial imputation system)	-

Note: Data from Greece and Portugal are not available.
(1) In some cases, reduced to 20 or 15%.
(2) 25% of final taxation if dividend income is below inflation adjusted limit.
(3) 56.5% in 1996 and 55.5 % in 1997, but not applicable to dividend income.
(4)There is no withholding tax in Ireland, however a company must make a prepayment of corporation tax (ACT). ACT equal to 23/77 of dividend paid.
(5) 50% of the gross dividend is exempted and LF 120.000 for married couples, and LF 60.000 for investment in shares of resident companies and of "Société Nationale de Credit et d'investissement".
(6)There is no withholding tax in United Kingdom, however a company must make a prepayment of corporation tax (ACT). ACT equal to 20/80 of dividend paid.

Source: The Taxation of Savings, Confédération Fiscale Européenne, C.F.E. Paris, 1997.

Tax treatment of interest income from foreign sources

Generally, individuals are taxed on their worldwide income, from whatever source; so resident investors who invest abroad are subject to tax on interest income in both the country of residence and the country of source. However, bilateral tax treaties have in most cases brought withholding taxes on interest payments down to low levels, quite often to zero. If the interest is still subject to tax in the source country, the country of residence usually gives a credit against the domestic tax liability for tax charged by the foreign jurisdiction . Countries typically impose a limitation on these foreign tax credits, which in most cases is equal to the domestic tax liability on the foreign-source income.

In Austria (25%), Belgium (15%), Finland (28%), France (19.4%), Ireland (27 or 15%), Italy (12.5 to 30%), Sweden (30%), Norway (28%), domestic interest received is subject to a final withholding tax at the indicated rate. By contrast, interest income from foreign sources in principle is considered as ordinary income and taxed as such at progressive rates. Only Belgium and Finland tax foreign interest at the same rate. Other countries - that is, Germany and Luxembourg - tax all interest income, whatever the country of source, at progressive income tax rates. In some countries foreign interest income cannot benefit from the tax allowances attributable to domestic savings income. In France the option to have the withholding tax as a final tax is not available for foreign interest income.

Tax treatment of dividend income from foreign sources

The tax treatment of dividend income from foreign sources depends on the system applied in the investor´s country. If the investor lives in a country with a classical system - e.g. the Netherlands- there is in principle no discrimination between domestic and foreign source dividend income. No matter whether dividends are distributed from domestic or foreign companies, they are fully taxed twice, once at the corporate level in the country of source and again at shareholder level in the country of residence of the recipient of the dividend.

If the investor lives in a country with an imputation system, when a domestic company distributes foreign source income to domestic shareholders, it is usually fully taxed, because there is no imputation tax credit for foreign corporation taxes paid. This results in discrimination against investment in foreign companies.

Where domestic dividend income is subject to a final reduced tax and where no tax credit is granted in respect of corporate income tax already paid, discrimination against foreign dividends is, in principle, avoided - provided that the same tax rates apply to domestic and foreign source dividends. This is the case in Belgium, where dividend receipts are subject to a final tax of 25%, whatever the source.

Other countries like Austria and Sweden, despite operating a similar tax system, discriminate against ownership of shares in foreign companies. Austria applies a final withholding tax rate on domestic dividends of 25%, while foreign source dividend income is taxed at progressive tax rates. In Luxembourg, only 50% of the gross dividend received from resident companies is taxable, whereas foreign dividends are fully taxable. In Sweden, individual shareholders are exempted from payments of any tax on dividend income from Swedish companies, but this treatment is not applicable to foreign dividends.

TABLE 9. TAX TREATMENT OF INTEREST INCOME FROM FOREIGN SOURCES

	Taxation at progressive income tax rates		**Reduced Rate**	**Credit for foreign tax**
		Maximum Rate		
AUSTRIA	Yes	50%	25% if interest credited to Austrian bank account	-
BELGIUM	No	55%	15%	-
DENMARK	Yes	58%	-	-
FINLAND	No	56.5% (1)	28%	Yes
FRANCE	Yes or by lump-sum payment at 19.4%	56.8%	-	Yes
GERMANY	Yes	53% (+ surcharges)	-	Yes
IRELAND	Yes	48%	-	-
ITALY	No	51%	In general 12.5 or 30% final taxation	-
LUXEMBOURG	Yes	50%(+ 2.5% unemployment fund contribution)	-	-
NETHERLANDS	Yes	60%	-	-
SPAIN	Yes	56%	-	Yes
SWEDEN	No	56%	30	Yes
UNITED KINGDOM	Yes	40%	-	Yes

Note: Data from Greece and Portugal are not available.
(1) 56.5% in 1996 and 55.5% in 1997.

Source: The Taxation of Savings, Confédération Fiscale Européenne, C.F.E. Paris, 1997.

TABLE 10. TAX TREATMENT OF DIVIDEND INCOME FROM FOREIGN SOURCES

	Taxation at progressive income tax rates		Reduced Rate	Credit for foreign tax
		Maximum Rate		
AUSTRIA	Yes	50%	25% if interest credited to Austrian bank account	-
BELGIUM	No	55%	25%	-
DENMARK	Yes	58%	-	-
FINLAND	No	56.5% (1)	28%	-
FRANCE	Yes	56.8%	-	-
GERMANY	Yes	53% (+ surcharges)	-	-
IRELAND	Yes	48%	-	-
ITALY	No	51%	In general 10% final taxation	Yes
LUXEMBOURG	Yes	50%(+ 2.5% unemployment fund contribution)	-	-
NETHERLANDS	Yes	60%	-	-
SPAIN	Yes	56%	-	-
SWEDEN	No	56%	30%	-
UNITED KINGDOM	Yes	40%	-	-

Note: Data from Greece and Portugal are not available.
(1) 56.5% in 1996 and in 1997 is 55.5%

Source: The Taxation of Savings, Confédération Fiscale Européenne, C.F.E. Paris, 1997.

Coordination of taxes on savings

Coordination of capital income taxation constitutes an important element in fully realising the Single Market. Capital income, particularly interest income from savings, forms the most mobile base of all, and differences in taxation can cause serious distortions to capital allocation and flows.

General economic principles suggest that, ideally, the taxation of income from capital should not interfere with the optimal allocation of capital across countries. For economic efficiency the before-tax returns of capital should be equalised across countries. If the marginal productivity of capital were higher in one country than in the rest of the world, global welfare could be increased by transferring capital from where it has a low productivity to where it has a high one. The ideal system would therefore ensure that the post-tax marginal productivity of capital is equalised across countries.

The Commission has considered three possible ways to prevent tax-induced portfolio reallocation and corresponding loss of tax revenue:

- increased cooperation and exchange of information between the tax authorities of the source and residence countries;

- automatic disclosure of interest earnings to the tax authority of the country of residence of the investor, supported by tighter limits on bank secrecy and bearer securities; and

- common minimum withholding tax on interest from deposits and securities imposed at source on all European residents.

In order to increase cooperation and exchange of information among national tax authorities, the Commission approved the Directive 77/799/EEC Concerning Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation. However, under this Directive, tax authorities are not required to obtain for, and transmit to, other tax authorities information that they are prevented from collecting under their own laws or administrative practices. In 1989 a proposed revision to this Directive would no longer have allowed tax authorities of Member States to refuse to share information on the grounds of administrative impediments.

The problems in securing agreement on such a proposal, however, show that effective international cooperation is difficult to achieve. The basic problem has been described as "asymmetry of enforcement": that no country alone has an interest in making the effort to ascertain the income of non-residents, since the increased tax revenue goes to a foreign government. Moreover, countries that do not tax non-residents attract international financial intermediaries, so creating employment.

The second solution was seen as placing a heavy administrative burden on financial institutions and running counter to a long-standing tradition of bank secrecy in some Member States.

Following the third solution, the Proposal for a Council Directive on **a Common System of Withholding Tax or Interest Income** (COM(89)60/3 final revision), envisaged the establishment of a common minimum withholding tax on interest income for European Union residents that would be set at 15%. The tax could be imposed as a final tax or as an advance payment creditable against ordinary income tax. Where the withholding tax was allowed as a credit or was refunded in another Member State, the source country would bear the budgetary cost of crediting or refunding the tax, unless differently agreed under a bilateral treaty.

Because of the risk of capital outflows to third countries, the proposal provided for numerous exemptions that would have diluted its effectiveness considerably. The proposed directive only applied to debt instruments issued by European Union residents, and it deferred to national authorities the tax treatment of interest from Eurobonds, interest received from non-European Union residents, interest on small savings deposits, interest received by non-European Union residents, interest received by own residents when full taxpayer identification exists, and intra-enterprise interest income. The proposal did not preclude the possibility of multiple rates, higher rates on own residents than on non-residents, or exemption when full taxpayer identification exists.

As a result of discussions in the Taxation Policy Group (the so-called "Monti Group") a new basis was agreed for revised proposals[13].

- The scope of the directive should be limited to interest paid in one Member State to individuals who are non-resident for tax purposes in that State but who are resident in another Member State, in order to focus primarily on redressing the possible non-taxation of non-residents.

- The proposed Directive should be based on the so-called "coexistence model". Under such a model each Member State will operate either a minimum withholding tax or provide information on savings income to other Member States, in order to ensure at least some effective taxation of non-residents income from savings within the Community. A Member State may combine the elements, with the combination of the two also being possible

- Any withholding tax on interest payments made to residents of other Member States would, in principle, be levied by the paying agent. Refinement of the method might be needed in order to counter tax avoidance and evasion more effectively and to avoid double taxation. The arrangements for checking the fiscal residence of beneficiaries should not be cumbersome.

- The provisions of the directive would take into account the need to preserve the competitiveness of European financial markets in a global context. The elements described above should be adopted as soon as possible. To this end, Member States would promote their adoption at international level and in particular in their dependent or associated territories.

The text of the revised Directive was presented in early 1998, **to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community** (COM(1998)295). The rate now proposed is 20%; but the text also provides for the alternative system of providing information on payments to the tax authorities of the saver's home state.

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[13] "Elements for a minimum Community solution in the area of the taxation of savings" is included in the Annex 2 of *Europe Documents* N° 2057, 14 November 1997.

Corporate Taxes

Corporation Tax can be considered an essential adjunct to personal income tax. Where the latter taxes individuals or families as legal entities, corporate taxes are levied on commercial bodies having legal personality.

Such bodies are generally, of course, owned by individuals, the shareholders, who are taxed on the dividends they receive. In principle, therefore, such corporate income has a double liability; but a number of arguments can be advanced for this situation.

- ♦ It enables taxation to be levied on retained profits, which can accrue to shareholders in the form of capital appreciation, and would not be taxed (if at all) until the appreciation was realised[14].

- ♦ It taxes pure profits or rents, defined as the difference between the accrued revenue of a firm and the full imputed cost of producing that revenue. It is argued that if the corporate tax base could be restricted to pure profits or economic rents, the tax would not affect investment decisions.

- ♦ Corporate tax can be used as an instrument of economic policy to influence the allocation of capital within the private sector[15].

There are many differences in the corporate tax systems operated by each Member State, including considerable variations in the tax rates and tax base. In addition to these differences, there are, more specifically, differences in other aspects of corporate taxes. This chapter provides a brief summary of the key features of the systems in the European Union[16].

Structure of corporation tax rates

All EU countries levy corporation taxes at the central government level. The rates vary in European countries from 25% (Finland) to 37% (Italy). In Belgium, Ireland, Netherlands and United Kingdom, rates are progressive, the maximum rate being 41% in Belgium, and the minimum rate 23% in United Kingdom. Germany distinguishes between retained income (45%), distributed income (30%), and non residents companies (40%), and Greece applies a rate of 35% for resident companies, and 40% for non resident companies. Germany, Austria, Italy, Luxembourg and Portugal levy a tax at the local level, and in most of these countries the rates at the local level vary from region to region.

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[14] This argument was considered by the Carter Commission to be the only real function of the corporate tax. See Report of Royal Commission on Taxation. Ottawa. Queen´s Printer. 1966.

[15] A more detailed description of the various functions of corporate taxes can be found in the Mead Committee Report published by the Institute for Fiscal Studies and Report of the Committee of Independent Experts on Company Taxation. Commission of the European Communities. Luxembourg. 1992.

[16] See Di Malta, P., *Droit fiscal européen comparé*, Presses Universitaires de France. Paris, 1995; and IBFD, *European Taxation. Taxation of Corporations*, Section A., Amsterdam. 1997.

TABLE 11. CORPORATION TAX RATES AT THE CENTRAL GOVERNMENT LEVEL

Country	Rate (%)
AUSTRIA	34
BELGIUM (1)	28-41
DENMARK	34
FINLAND	28
FRANCE	33.33
GERMANY	30-45 (2)
GREECE	35-40 (3)
IRELAND	28-36 (4)
ITALY	37
LUXEMBOURG	32
NETHERLANDS	35-36 (5)
PORTUGAL	36
SPAIN	35
SWEDEN	28
UNITED KINGDOM	23-35.5 (6)

(1) In Belgium, the rates are progressive:first BEF 1.000.000: 28%; next BEF 2.600.000: 36%; next BEF 9.400.000: 41%; excess over 13.000.000: 39%
(2) Retained income: 45%; Distributed income: 30%; Non-resident companies 40%
(3) Non- resident companies: 40%
(4) First IEP 50.000: 28%; Excess thereover: 35%
(5) First NLG 100.000: 36%; Excess thereover: 35%
(6) Up to £300.000: 23%; Next £1.200.000: 35.5%; Excess over £1.500.000: 33%

Source: European Taxation, Section A: Taxation of Corporations, IBFD, Amsterdam. 1997.

Corporation tax base

Taxable income is calculated in similar ways under the different tax regimes. Income arising from all sources, including non-business income as well as business or trading income, is normally included in the base. Taxable income is computed on the basis of ordinary principles of sound commercial accounting practice, and is generally based on the profits shown in the company accounts. In order to arrive at the profit for tax purposes, some adjustments are often required by statute. The general rule is that expenses incurred in earning taxable income, and in maintaining the assets used in the company´s activities, are deductible.

In all Member States there are some measures which have the effect of correcting for inflation. Correcting for inflation may be relevant to three aspects of the measurement of the tax base:

- the depreciation system;
- capital gains taxation; and
- the treatment of stocks.

In order to achieve the objective of taxing real income, capital gains in most countries are partly exempt. Depreciation rules and rates may be favourable (accelerated depreciation). As regards the treatment of stocks, the use of the LIFO method in some countries provides some adjustment for the impact of inflation on the cost of stock replacement.

Treatment of interest

Interest payments are deductible in all Member States if incurred for business purposes, and if the capital amount is used for generating taxable income. Belgium and Portugal provide for some restriction on the amount of interest that may be deducted.

In Italy interest expenses are deductible. However, if a company receives exempt interest from public or private bonds, interest paid is not deductible up to the amount of the exempt interest. Any excess interest paid is deductible for an amount corresponding to the ratio of gross taxable income to total gross income (including the exempt interest).

Treatment of losses

All countries allow a company to carry the amount of trading losses forward, and some allow a carry back of trading losses. The number of years over which trading losses can be carried forward ranges between five years and indefinitely. Germany, France, Ireland, Netherlands and United Kingdom allow the carrying back of trading losses, the period varying from one to three years. In some countries there are, however, limitations for certain types of losses.

TABLE 12. TREATMENT OF TRADING LOSSES

	Carry forward (maximum years authorised)	**Carry back (maximum years authorised)**
AUSTRIA	7 (1)	Not allowed
BELGIUM	Unlimited (2)	Not allowed
DENMARK	5	Not allowed
FINLAND	10	Not allowed
FRANCE	5	3 (with certain limitations)
GERMANY	Unlimited (3)	2
GREECE	5 or 3 (4)	Not allowed
IRELAND	Unlimited	(5)
ITALY	5	Not allowed
LUXEMBOURG	Unlimited (6)	Not allowed
NETHERLANDS	Unlimited	3
PORTUGAL	5	Not allowed
SPAIN	7	Not allowed
SWEDEN	Unlimited	Not allowed
UNITED KINGDOM	Unlimited	3

(1) Prior to 1 July 1996, a loss carry-forward was generally available for the following 7 years. Due to budgetary constraints, however, no carry forward is available for the assessment year 1996 through 1998. The deduction of losses incurred from the years 1989 and 1990 is postponed to the year 1998, and such losses must be spread over 5 years.

(2)The previous limitation on the amount of losses that could be carried forward has been completely abolished with effect from the assessment year 1998 onwards. For the assessment year 1996 the annual deduction of losses carried forward was limited to BEF 20 million or, where the taxable income exceeded BEF 40 million, to 50% of the taxable income. For the assessment year 1997, the limitation will not applicable for losses incurred during a financial year related to the assessment year 1996.

(3)Restrictions apply to the set-off of losses derived from foreign operations.

(4) 5 years in the case of an industrial or production company and 3 years in the case of a trading company.

(5)A loss incurred in the last year of trading can be set off against trading profits of the 3 prior years.

(6) Losses sustained in tax years ending after 31 December 1990 may be carried forward indefinitely. Previously, the carry-forward of a loss was restricted to 5 years.

Source: Taxation in OECD countries, OECD, Paris, 1993*;* and *European Taxation, Section A: Taxation of*

Corporations, IBFD, Amsterdam. 1997.

Depreciation allowances

An allowance for the depreciation of assets is given in all countries. A variety of systems is used in different countries, the most frequent being straight-line depreciation (equal allowances over a number of years) and declining balance. In the latter case the actual allowance will be larger in the initial year and gradually diminish in subsequent years.

Machinery is generally depreciated through the declining balance method, except in Austria, Italy and Greece, which use the straight line method . In a number of countries taxpayers have a choice of depreciation method.

For **buildings** the straight line method is the more common way of depreciation. If the tax authorities allow the declining balance method, in some cases a change to the straight line method is allowed or prescribed. Some countries allow accelerated depreciation: this is the case in Germany, Belgium, France, Finland, Luxembourg and Italy. In most, however, it is only allowed in some exceptional cases and under certain restrictions.

TABLE 13. DEPRECIATION SYSTEMS

	Method of depreciation		Rate of depreciation (%)			
			Machinery		*Buildings*	
	Machinery	*Buildings*	SL	DB	SL	DB
AUSTRIA	SL	SL	10		2-4	
BELGIUM	SL/DB	SL/DB	10-33	2xSL	3-5	2xSL
DENMARK	DB	DB		30		4-8
FINLAND	DB	DB		30		4-20
FRANCE	SL/DB	SL	(1)	2.5-3.5xSL	(1)	
GERMANY	SL/DB	SL/DB	10	3xSL	2-4	2.5-10
GREECE	SL	SL	10-15		5-8	
IRELAND	SL/DB	SL	15	20	4	
ITALY	SL	SL	20-25		3-7	
LUXEMBOURG	SL/DB	SL/DB	10-25	3xSL	2-5	3xSL
NETHERLANDS	SL/DB	SL/DB	(2)	(2)	(2)	(2)
PORTUGAL	SL/DB	SL	12.5-33.33	0.5-1.5x SL	2-5	
SPAIN	SL/DB (3)	SL	8-30	0.5-1.5xSL	2-3	
SWEDEN	SL/DB	SL	20	30	1.5-5	
UNITED KINGDOM	DB	SL		25	4	

Symbols: SL: straight line; DB: declining balance.

(1) Rates in this method are computed by dividing the expenditure by the estimated useful life of the asset.
(2) No official guidelines for depreciation exist; in practice, the rates are agreed upon between the taxpayer and the tax authorities.
(3) And also the sum- of- the- years´-digits method.

Source: Taxation in OECD countries, OECD, Paris, 1993; and *European Taxation, Section A: Taxation of Corporations*, IBFD, Amsterdam. 1997.

Treatment of inventories

There are a variety of methods to value stock for tax purpose. Inventories can be valued according to the FIFO method in all European countries. The LIFO method is allowed in Germany, Belgium, Austria, Italy, Greece, Portugal, Denmark, Luxembourg and the Netherlands, though some of them impose severe restrictions on the use of this method. In France, LIFO can be authorised in some exceptional cases.

TABLE 14. TAX TREATMENT OF INVENTORIES

	Methods of evaluating cost		
Country	**FIFO**	**LIFO**	**Cost price or market value**
AUSTRIA	Yes	Conditional	Yes
BELGIUM	Yes	Yes	Yes
DENMARK	Yes	Conditional	Yes (1)
FINLAND	Yes	No	Yes
FRANCE	Yes	No (2)	Yes
GERMANY	Conditional	Yes	Yes
GREECE	Yes	Yes	Yes
IRELAND	Yes	No	Yes
ITALY	Yes	Yes	Yes
LUXEMBOURG (3)	Yes	Yes	Yes
NETHERLANDS	Yes	Yes	Yes
PORTUGAL	Yes	Yes	Yes
SPAIN (4)	Yes	Yes	Yes
SWEDEN	Yes	No	Yes
UNITED KINGDOM	Yes	No	Yes

Note: In some countries, other methods may also be allowed. In most countries, whatever method is adopted, it must be consistently applied from year to year and may not be changed without the approval of the Directorate General for Taxes.

(1)In Denmark, the value may, for tax purposes, be reduced by up to 16%in 1995, 12% in 1996 and 8% in 1997.

(2)In some exceptional cases can be authorised.

(3)LIFO, HIFO, FIFO and averages cost method are generally allowed, however, the base-stock method is not.

(4)Inventory is generally valued according to the weighted average cost method, but other methods, like LIFO and FIFO are also accepted.

Source: Taxation in OECD countries, OECD, Paris, 1993*;* and *European Taxation, Section A: Taxation of Corporations,* IBFD, Amsterdam. 1997.

Treatment of provisions

The rules for the treatment of provisions for contingencies vary considerably from one country to another. Germany, the Netherlands, and Luxembourg could be considered liberal, while other countries, such as Italy, Belgium and France are rather restrictive. According to some estimates, the percentage of the tax-free provisions as a proportion of balance sheet value is 27% in Germany and only 6% in Italy and Belgium.

Special incentives

Current expenditures on **research and development** are generally deductible in the year in which they are incurred, except in the Netherlands, where in some cases costs must be spread over a number of years. Research assets qualify for accelerated depreciation or shorter agreed useful lives in a number of countries, whereas in others, special tax credits are applied.

Certain countries have special tax regimes for **specific locational zones**. A number of Member States have created special advantages for financial and management activities. These advantages may be in the form of partial or total exemption from corporate tax, special definition of the tax base, etc.

TABLE 15. GENERAL INVESTMENT RELIEFS

Country	General investment allowance available	General investment credit available	General cash grants available irrespective of sector or activity
AUSTRIA	12% of the costs of acquisition or production of qualifying assets which have a minimum useful life of 8 years.	No	No
BELGIUM	Normal investment deduction of 13.5% for investments in patents and research, and for small and medium sized companies may take a deduction of 3% on investment in other assets. There is special investment deduction for certain companies.	No	No
DENMARK	No	No	No
FINLAND	No	No	No
FRANCE	No	A tax credit for research and development equal to 5% of the difference between the expenditure during the year and the average during the preceding 2 years.	No
GERMANY	No	No	No
GREECE	Between 40% and 100% of the amount invested	No	No
IRELAND	No	No	No
ITALY	No	No	No
LUXEMBOURG	No	Two investment tax credits: 12% of supplementary investment in qualifying assets, other than buildings, livestock, and mineral deposits, and 6% of investments in qualifying assets, with a limitation.	No

NETHERLANDS	The investment deduction is calculated as a percentage of the cost price of total annual investment. The deduction is only available if the total amount is between certain limits. (1)	No	No
PORTUGAL	No	Tax credit equal to 5% of the amount by which the investments of the current year in new tangible fixed assets.	No
SPAIN	No	Tax credit of 5% of investments in new tangible fixed business assets and 20% for research and development expenses.	No
SWEDEN	Yes, investment reserve provisions	No	No
UNITED KINGDOM	The investments incentives mainly take the forms of the enterprise investment scheme.	No	No

(1) The deduction is only available if the total annual amount is between NLG 3.600 and 534.000. From 3.600 to 61.000, the percentage is 24%, and for excess this percentage is lower.

Source: Taxation in OECD countries, OECD, Paris, 1993*;* and *European Taxation, Section A: Taxation of Corporations*, IBFD, Amsterdam. 1997.

The coordination of corporate taxes

The European Union Treaty assigns to the European Commission the task, in consultation with the Member States, of eliminating distortions in competition due to differences in the law and administrative practices of those states, in order to establish and maintain a common market. The result has been many initiatives to coordinate Member State legislation, including tax law.

The first proposals in the field of corporate tax harmonization were contained in a report prepared in 1962 by the Neumark Committee, which recommended that corporation tax systems be harmonised along the lines of a split-rate system, with a lower rate of tax on dividend distributions that on retained profits.

In 1969, proposals for directives on parent-subsidiaries[17] and mergers[18] were tabled. This was followed by the Van den Tempel Report of 1970, which advocated a classical corporation tax system throughout the Community. A subsequent resolution by the Council in 1971, concerning economic and monetary union, called for the harmonization of corporation tax systems, and of those types of taxes likely to have a direct influence on the movement of capital within the Community, namely withholding taxes on dividends and interest.

In 1975 the European Commission released a proposal on the harmonization of systems of company taxation and withholding tax on dividends[19]. Its aim was to eliminate economic double taxation on dividends through the concept of a centralised harmonization of tax systems. In the draft directive, the Commission proposed a common partial imputation system of company taxation, with statutory rates within a band of 45-55%, and a tax credit, also within a band of 45 to 55% for dividend recipients, irrespective of the Member States in which they resided. At the same time, it was also proposed that all Member States should levy a 25% withholding tax on dividends distributed by their resident companies.

This draft directive was criticised because it made little sense to harmonise corporation tax systems and statutory tax rates as long as differences continued to exist among Member States in the rules for computing the tax base. The importance of a common tax base was subsequently acknowledged by the Commission in its 1980 *Report on the scope for convergence of tax systems in the Community.*

In the late eighties a new concept of economic integration was defined. Priority has now been given to coordination and mutual approximation of the Member States tax systems rather than a systematic harmonization imposed at the European Union level. This new concept has been developed under the principle of subsidiarity. Accordingly, the 1975 proposal was withdrawn by the Commission in April 1990.

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[17] Draft Directive Concerning the *Common System of Taxation Applicable in the Case of Parent and Subsidiaries of Different Member States*, COM (69) 6 final.

[18] Draft Directive Concerning the *Common System of Taxation Applicable in the Case of Mergers, Divisions and Contributions of Assets Taking Place Between Corporations of Different Member States*, COM (69) 5 final.

[19] Draft Directive Concerning *the Harmonization of Systems of Company Taxation and of Withholding Tax on Dividends*, COM (75) 392 final.

In 1988 the Commission began to draft a proposal to harmonise the rules for the determination of the corporate taxable base. The initial draft contained guidelines about depreciation allowances, capital gains, inventory valuation, reserve provisions, valuation adjustments, and overhead costs. The basic purpose was to establish a more uniform and transparent tax treatment of corporate income, which would pave the way to a harmonization effort along the lines of the 1975 proposed directive. The draft proposal would have limited the scope for indirect subsidization through the tax base, and tax incentives would have had to be provided in the form of cash grants, investment tax credits, or preferential statutory tax rates, rather than through accelerated depreciation or other adjustments of the tax base. In 1991 the earlier proposal was withdrawn.

In July 1990 the European Commission submitted new proposals concerning company taxation:

- The Parent-Subsidiary Directive[20] dealing with the tax treatment of cross-border dividend payments between parent companies and subsidiaries and the taxation of parents on income received from subsidiaries and the taxation of parent companies on income received from subsidiaries.

- The Merger Directive[21] aimed at the deferral of capital gains taxation in case of certain cross-border transactions related to the restructuring of groups of companies.

- The Convention on the elimination of double taxation with the adjustment of profits of associated enterprises[22].

The European Commission also released a proposed Directive on the set-off of losses sustained by branches and subsidiaries (COM (84)404 final) and a proposed Directive on the abolition of withholding taxes on interest and royalty payments between parent companies and subsidiaries (COM(90) 571 final).

In addition to tax treaties, mutual assistance can currently be based on the Directive for mutual assistance in direct tax matters[23]. This Directive provides for the exchange of information, response to inquiries, and the presence of an agent of one Member State on the territory of another Member State with a view to monitoring the activities of multinational corporations.

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[20] Council Directive of 23 July 1990 on the *Common System of Taxation Applicable to Parent Companies and Their Subsidiaries of Different Member States*, 90/435/EEC, Official Journal of the European Communities, n° L225 (August 20, 1990).

[21] Council Directive of 23 July 1990 on the *Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States*, 90/434/EEC, Official Journal of the European Communities, N° L225 (August 20).

[22] Convention on the *Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises of Different Member States*, 90/436/EEC, Official Journal of the European Communities. L225 (August 20).

[23] Directive 77/799/EEC, Concerning *Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation and Value-Added Tax.*

The Ruding Report

In March 1992 a Committee of experts chaired by Mr. Ruding released a report of conclusions and recommendations on company taxation within the European Union - *Report of the Committee of Independent Experts on Company Taxation* (1992). It advocated that action should concentrate on the following **priorities**:

- ♦ removing discriminatory and distortionary features of countries´ tax arrangements that impede cross-border business investment and shareholding;
- ♦ setting a minimum level for statutory corporation tax rates and also common rules for a minimum tax base, so as to limit excessive tax competition between Member States intended to attract mobile investment or taxable profits of multinational firms, either of which tend to erode the tax base in the Community as a whole; and
- ♦ encouraging maximum transparency of any tax incentives granted by Member States to promote investment with a preference for incentives, if any, of a non-fiscal character.

To ensure the elimination of **withholding taxes** levied by source countries on dividends paid by subsidiaries to parent companies, the Committee also recommended:

- ♦ that the scope of the parent-subsidiary Directive be extended to cover all enterprises subject to corporate income tax irrespective of their legal form; and that
- ♦ a substantial reduction should be made in the participation threshold prescribed in the parent-subsidiary Directive.

To combat **tax evasion,** the Committee recommended:

- ♦ that the Commission should propose a uniform withholding tax of 30% on dividend distributions by resident European companies, subject to waiver where appropriate tax identification is provided.

To eliminate **double taxation**, levied by source countries on payment between enterprises in different Member States, the Committee recommended:

- ♦ that the proposed interest and royalties Directive be adopted and that the scope of the Directive be extended to encompass all such payments between enterprises, together with accompanying measures to ensure that the corresponding income is effectively taxed within the Community when it is in the hands of the beneficiary.

To eliminate **double taxation arising from transfer-pricing disputes**, the recommendation was:

- ♦ that the Commission urge all Member States to ratify the Arbitration Convention as soon as possible; and
- ♦ that the Commission take action together with the Member States to establish appropriate

rules or procedures concerning transfer-pricing adjustments by Member States.

To reduce **impediments to cross-border investments** likely to generate losses in early years, the recommendations were:

- ♦ that Member States adopt the draft directive dealing with losses of permanent establishments and subsidiaries in other Member States;
- ♦ that all Member States introduce full vertical and horizontal offsetting of losses within groups of enterprises at the national level; and
- ♦ that the draft directive should be extended to allow full Community-wide loss offsetting within groups of enterprises.

To ensure that **bilateral agreements for minimizing double taxation** are on a proper footing, the Committee urged:

- ♦ Member States not only to conclude bilateral income tax treaties where none exist between them, but also to complete those where coverage is limited; and
- ♦ action by the Commission in concert with Member States aimed at defining a common policy on double taxation agreements with respect to each other and also with respect to third countries.

To reduce discrimination between **the tax treatment of domestic and foreign source income**, the Committee recommended:

- ♦ that existing discrimination in the taxation of dividends from profits earned in another Member State be removed. Member States which applied imputation taxes on the distribution of profits earned in another Member States should be obliged, on a reciprocal basis, to allow such tax to be reduced by corporate income tax paid in another Member State in respect of dividends remitted by a subsidiary, or profits earned by a permanent establishment. Member States with various forms of tax relief for dividends received by domestic shareholders from domestic companies, should be obliged, on a reciprocal basis, to provide equivalent relief for dividends received by domestic shareholders from companies in other Member States.

To achieve a more fully **harmonised corporation tax system** within the Community, the Committee recommended:

- ♦ that the Commission and the Member States examine alternative approaches to determine the most appropriate common corporation tax system for the Community.

To reduce the risks of serious **erosion of corporate tax revenues**, the Committee recommended:

- ♦ that a draft directive be prepared by the Commission prescribing a minimum statutory corporation tax rate of 30% and a maximum of 40%, in Member States for all companies, regardless of whether profits are retained or distributed as dividends;

- that there should be only one kind of tax on corporate income in Member States. If this can not achieved, local income taxes should be taken into account when fixing the statutory corporation tax rate so that the combined rate of tax falls within the range of 30% to 40% prescribed by the Committee. In addition, there should be:

- a set of minimum standards for the tax base to cover: depreciation practices, leasing, stock valuation, provisions, business expenses, headquarters costs of enterprises, pension contributions by or for expatriate workers, carry-over of tax losses, and capital gains.

The Committee also recommended:

- that the Commission should take appropriate measures to reduce the differences between commercial accounts and the accounts used for tax purposes;

- that the Commission should propose measures by way of a directive on depreciation practices. This should provide for historical cost at the basis for depreciation. It would allow a free choice for the taxpayer between declining-balance and straight-line depreciation for all depreciable assets other than buildings. Declining-balance depreciation rates should not exceed three times the rates applicable for straight-line depreciation. At the same time all special depreciation rules with an incentive effect should be abolished;

- the introduction of a free but irrevocable choice for business enterprise to use the following methods of stock valuation: FIFO, LIFO, average cost or base stock;

- that the Commission should propose common rules by way of a directive for the deduction of business expenses related to a trade or business should be deductible;

- that Member States adopt the draft directive on the carry-forward and carry-back of losses of enterprises; and

- that the Commission propose by way of a directive a proposal to the effect that in the absence of reinvestment within a certain period of time all capital gains realised on fixed assets and controlling shareholdings be taxed at the ordinary rate of corporate income tax and that for all gains realised on fixed assets and on all financial holdings that do not constitute treasury placements, inflation should be taken into account by indexing the cost of acquisition. At the same time losses should be made deductible.

Finally, the Committee recommended that the Commission should seek to establish common rules, by way of directive, to **harmonise the dates** at which taxes of common application are payable.

In summary, the recommendations of the Committee included:

- extending of the scope of the Merger Directive and the Parent-Subsidiary Directive;
- adoption of the proposed Directives on intercompany set-off of losses;

- ♦ adoption of the proposed Directive on intercompany payment of interest and royalties;
- ♦ elimination of fiscal discrimination between domestic-source and foreign-source dividends at a shareholder level; and
- ♦ establishing a minimum and maximum corporate income tax rate.

In June 1992 the Commission published its first reactions to the Ruding Committee report. Among the most important measures favoured by the Commission were:

- ♦ adoption of the proposals concerning abolition of withholding taxes on interest and royalties as well as cross-border set-off of losses within a group;
- ♦ extension of the scope of the Merger Directive to cover all types of companies, as well as expansion of the scope of the parent-subsidiary Directive to cover all parent companies subject to corporation tax;
- ♦ the introduction of a consultation procedure to be followed prior to any adjustment of transfer prices which would supplement the procedure for the retroactive elimination of double taxation provided for by the 1990 Convention;
- ♦ a uniform approach to the definition and treatment of thin capitalization;
- ♦ the establishment of uniform rules which would govern the allocation of head office expenses and a uniform definition of the expenses borne by the shareholder;
- ♦ completion of the network of tax treaties between Member States. The Commission felt that, in addition, the agreements concluded by Member States with non-Member States should be in accordance with non-discrimination rules contained in European law;
- ♦ commencement of discussions on neutrality as between domestic-source and foreign-source dividends with a view to preventing the latter from being more heavily taxed; and
- ♦ a decrease in the minimum corporation tax rate for corporations proposed by the Committee, as the Commission is of the opinion that a rate of 30% was too high.

The Code of Conduct

The Commission proposed a new and comprehensive view of taxation policy in its reflection document: *Taxation in the European Union* (1996). This was then transformed into a formal Communication to the Council: *Towards tax co-ordination in the European Union, a package to tackle harmful tax competition*" (1997). The "package" of measures envisaged covered the withholding tax and interest and royalty payments Directives (amended versions were published in 1998), and a "code of conduct" for business taxation

This represented a completely new strategy. Instead of legally-binding instruments, the Code of Conduct has taken the form of a political agreement, that engages Member States to respect principles of fair competition and to refrain from tax measures that are harmful.

The Council recognised as being potentially harmful those tax measures which provided for a significantly lower effective level of taxation, including zero taxation, than that which generally applied in the country in question. These measures particularly highlighted are:

- benefits that are given only to non-residents of the country in question; or are given only in respect of transactions carried out with non-residents;

- benefits that are otherwise ring-fenced from the domestic economy so that they do not affect the national tax base;

- benefits that are available without there being any real economic activity;

- a basis of profit determination in respect of activities within a multinational group of companies that departs from internationally-accepted rules;

- measures that lack transparency, including where benefits are given by relaxing statutory rules at an administrative level in a way that is not made public.

The Code includes national anti-abuse measures; and there is agreement that Member States should be informed of tax measures which might be harmful so as to allow them the opportunity to comment. The Council requested the Commission to coordinate the exchange of information between the Member States.
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The Council emphasised the need to asses the effects which tax measures have on other Member States; and, in so far as they used to support the economic development of particular areas, to evaluate the extent to which the measures are effective in achieving their aims.

The Council also stressed its commitment to full co-operation in the fight against tax evasion and avoidance, notably in the provision of information to other Member States in accordance with national legislation.

In November 1997, the European Commission adopted the final version of the "Monti package". The revised Code provided for an initial freeze on all harmful tax measures; and then the dismantling of existing measures within two years (a longer period is possible in specific cases to take into account the legitimate expectations of operators). A special group is responsible, within the Council, for supervising the communication of information on tax measures covered by the Code and evaluating these measures. This was established in 1998 (the so-called "Primarolo Group"). Provision was made for review of the code by the Council after two years of operation..

The Code was finally agreed at the Ecofin Council meeting of December 1997.

Summary and Conclusions

The analysis of **Personal Income Tax** reveals important differences between Member States in matters such as tax allowances, minimum and maximum tax rates and tax schedules. The systems differ so widely that a single person on the average industrial wage may pay tax at rates varying from 7.2% in Portugal to 38.3% in Denmark.

However, national differences in Personal Income Tax do not appear to cause any discernable distortions of competition in the labour market, nor in the workers´ choice of work place, except in the case of frontier workers. In this case the differential in Social Security Contributions and Personal Income Taxes between border regions might create incentives to cross-border migrations for work. The Commission attempted to find a satisfactory solution to this problem with a Proposal for a Directive in 1979 (COM /79/0737). The Commission intends to continue with measures to eliminate discrimination under certain national rules detrimental to frontier workers.

Income from capital, particularly interest income from savings, forms the most mobile of tax bases, and differences in taxation may cause serious distortions to capital allocation and flows. The Commission has considered three possible ways to prevent the risk of increased tax evasion and tax-induced portfolio reallocation:

- ♦ increased cooperation and exchange of information between the tax authorities of the source and residence countries;
- ♦ automatic disclosure of interest earnings to the tax authority of the country of residence of the investor, supported by tighter limits on bank secrecy and bearer securities; and
- ♦ common minimum withholding tax on interest from deposits and securities imposed at source on all European residents.

These constitute the elements of the most recent form of the draft Directive

As far as the **harmonization of corporation taxes** is concerned, the issue has been debated by the Commission for almost 30 years, taking into account advice provided by independent experts: the Neumark Report (1962), the Van den Tempel Report (1970), and the Ruding Report (1992).

Rather than a legally-binding instrument, the latest initiative has taken the form of a politically-agreed Code of Conduct. This covers a large number of the points which have been the subject of past proposals - though not the formal approximation of tax rates.

Much will depend upon the ability of the "Primarolo Group", established by the Council to administer the Code, to induce Member State governments to take appropriate action.

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