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Tax co-ordination in the EU – the latest position

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Preface

This study is essentially an updated version of two earlier texts in this series: *Tax Competition in the European Union* (ECON 105 of October 1998) and *Tax Co-ordination in the European Union* (ECON 125 of January 2001). It covers much of the same ground as these studies, but takes into account recent developments both within European Union itself, and at the international level.

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EXECUTIVE SUMMARY

Divergent national tax systems and rates can distort competition within the Single Market and create barriers to cross-frontier economic activity. Neither national governments nor the general public, however, are anxious to see their taxes "set by Brussels". In any case, the Treaties provide little legal base for legislative action outside the fields of VAT and excise duties, and most recent progress has been achieved through inter-governmental co-ordination. There is now also the wider framework of international action against tax havens, linked to the fight against money laundering and terrorism.

The "Monti package" of 1997 gave rise to the Code of Conduct on business taxation and the continuing work of the Primarolo Group. In May 2001 the Commission published a Communication outlining new priorities for the years ahead. As well as listing initiatives in the fields of both direct and indirect taxation, it examined the scope for action other than through formal legislation.

Current Issues

The key unresolved element of the "Monti package" was the draft Directive on the **taxation of savings.** The agreement at Santa Maria de Feira of June 2000 has now been incorporated into a revised legislative proposal, under which Member States will exchange information on interest paid to the nationals of other Member States. Austria, Belgium and Luxembourg may instead charge a withholding tax during a seven-year transitional period. Adoption of the Directive, however, is conditional upon equivalent measures being adopted by third countries, notably Switzerland.

The Commission has also published a new programme of action in the field of **Value Added Tax**. Rather than a move to a "definitive" system based on the origin principle, the emphasis is on improving the existing "transitional" system, which Commission describes as "*complicated, susceptible to fraud and out of date*". Over twenty legislative proposals are listed as either definite or possible, some of which are already before Council. High priority is given to simplification and to rationalising exemptions, derogations and conflicting interpretations of VAT law, in particular the scope of reduced and super-reduced rates. Among the other VAT issues currently under discussion are the taxation of e-commerce; the right to deduct VAT paid in another Member State; and the taxation of Small and Medium-sized Enterprises (SMEs).

In the field of **Excise Duties**, the Commission is continuing its attempts to bring widely-diverging rates closer together. Proposals have recently been made on tobacco taxation, (but have been rejected by the European Parliament); and proposals on the taxation of alcoholic beverages are expected shortly. Proposals to develop the current excises on mineral oils into a general energy tax were made in 1997, but are still on the table.

Various measures are also being adopted to tackle **tax fraud** through improved exchange of information between national tax authorities.

In 2001 the Commission published a Communication on **the taxation of occupational pensions**, outlining a number of possible measures to remove obstacles to free movement. It advocated exempting contributions to pension funds from tax, but taxing the eventual pension, rather than the opposite system applying in Germany and Luxembourg. It also dealt with the problems of cross-frontier tax relief, accrued pension rights when an employee moves between countries, and the possibilities for "pan-European pension funds".

Action is still pending following a 1997 study on the **taxation of vehicles**. Among the outstanding problems are the segmentation of the Single Market as a result of varying

registration taxes; double taxation when vehicles are moved on transfer of residence between Member States; and free movement in the rental car sector. The issue of VAT on passenger transport remains unresolved, following the withdrawal of the draft 1992 proposals.

In the field of **Corporate Taxation** – on which a large number of proposals were made in the Ruding Report of 1992 – a substantial new study was published in October 2001. This was accompanied by a Commission Communication, outlining possible legislative and other measures. A key problem identified by the study was that European business has to operate in "*a single economic zone in which 15 different company tax systems apply*". Some of the difficulties arise from variations in the *tax base* (e.g. in provisions on losses, inventories, etc.); but to some extent these offset variations in *tax rates*, so that removing them without also aligning the rates themselves might actually widen disparities.

The Commission nevertheless does not propose the alignment of rates. Instead, it advocates a "twin track" strategy of targeted solutions to individual tax obstacles, and comprehensive solutions addressing the underlying causes. Options for the latter include home state taxation (mutual recognition); a new common tax code alongside the national codes; a fully harmonised tax code; and a separate European corporate income tax. The tax dimension of the recently-agreed European Company Statute, it notes, is still to be addressed.

The Belgian Presidency of the Council in the second half of 2001 has raised again the issue of a **"Community Tax"** to help fund the EU budget. Among the possible candidates would be a separate VAT; the suggested corporate income tax; environmental taxes; and an EU *vignette* for motor vehicles. More generally, Community tax might be levied on the basis of two principles: where a particular economic activity was wholly regulated at EU level; and where revenues collected in one Member State might otherwise have to be re-allocated to other Member States through some "clearing" mechanism.

International developments

The OECD published its second progress report on tackling **harmful tax practices** in November 2001. This outlined some modifications to the agreed criteria for identifying "tax havens" established in 1998, and extended the deadline to February 28 2002 for those territories identified as "uncooperative" to commit themselves to action. Of the 34 jurisdiction black-listed in 2000, Aruba, Bahrain, the Isle of Man, the Netherlands Antilles, the Seychelles and Tonga have now been removed.

In parallel with the action against tax havens, more extensive action is also being taken by the Financial Action Task Force (FATF) on **Money Laundering**, which is established under the umbrella of OECD. In September 2001, 19 jurisdictions were identified as "non-cooperative" in this field, including large countries like Egypt, Nigeria, the Philippines, Russia and the Ukraine. The events of 11 September 2001 have also given a new impetus to international action against financial crime of all kinds, in particular the funding of terrorist groups.

Measures against tax havens, and against money laundering and the financing of terrorism, share certain features. Key factors in identifying "uncooperative" jurisdictions are a lack of transparency in financial activities and an unwillingness to provide information. An important requirement in both is application of the "know your client" principle.

There are certain difficulties, however, in applying the same criteria to tax matters as to money laundering and terrorism. Tax *evasion* is illegal; but tax *avoidance* is not. A tax offence in one country may be prudent – and perfectly legal – tax-planning in another.

Finally, there is a continuing debate on the relative merits of tax competition and tax coordination. The arguments are summarised in the following Table.

Table 1. Tax Competition or Tax Coordination?

Arguments for Competition	Arguments for Coordination
Constrains the pressure for ever-higher taxes, and limits the scope for wasteful public expenditure.	Countries may design taxes specifically to attract a larger share of the world tax base, so "exporting" their public expenditure costs.
Is in accordance with decentralisation and subsidiarity. The "mix" of public spending/taxation will correspond more nearly to citizens' local preferences.	The public spending/taxation mix chosen by one country may have spill-over effects on neighbours: e.g. in the case of pollution.
Measures to harmonise or coordinate taxation create tax cartels, which maximise revenues at the expense of other important economic objectives (e.g. competitivity).	Tax competition will produce a "race to the bottom", eroding tax bases and undermining public services.
The gains from coordination are not necessarily shared equally. Tax competition is one of the ways in which smaller, poorer countries can catch up.	Where one factor is mobile (capital), and another not (labour), tax competition will shift the tax burden from the former to the latter, increasing unemployment.
Where wide discrepancies exist in taxes, these are more likely to be narrowed by opening up systems to competition than by attempts to harmonise. Competition also promotes more efficient tax systems.	Widely varying tax systems create costs for businesses operating on an EU or international scale. Incompatibility and complexity are an incentive to tax avoidance, and increase the costs of tax administrations.
Democracies have the right to choose their own tax systems. Electorates cannot be prevented from voting for lower, or higher, tax rates.	Unrestricted tax competition can promote economic efficiency at the expense of other social and political objectives: e.g. the redistribution of income or wealth.

The Tobin Tax

The proposal for a tax on currency transactions to "*throw some sand in the well-greased wheels of international finance*", first made by Professor James Tobin in 1972, refuses to die. It is once again being considered at EU level in the context of possible measures to reduce the volatility of international capital flows.

Such a tax would raise large sums of money, which could be used to fund international aid. On the other hand, a Tobin Tax could present almost insuperable problems of definition and administration.

Introduction

The issue of taxation has in recent years acquired an increasingly high profile within the EU.

The steady removal of barriers to trade as a result of the Single Market programme, and the elimination of exchange-rate costs within the euro area as a result of the Single Currency, have focused attention on remaining barriers. One of these has appeared to be the distortion of competition as a result of divergent national taxation systems. The free movement of capital, in particular, has raised the fear that the tax burden is shifting to less mobile factors, notably labour, so increasing non-wage costs and raising unemployment.

Yet, at the same time, moves to harmonise tax systems and tax rates have been largely rejected. Even the more modest goals of "approximation" or "co-ordination" have proved extremely difficult to achieve in practice. The reasons have been in part economic – for example, the need for Member States to retain flexibility in the setting of tax rates in order to meet the strict limits on budget deficits set by the Stability and Growth Pact (see below). In part they have been legal and constitutional – the maintenance of democratic control over the public purse by national parliaments. Governments, indeed, have only been reflecting the views of their electorates: "*Europe's citizens, generally speaking, do not want their taxes set by Brussels*" (Ussher, 2000). Tax competition has also been widely seen, not as harmful, but as a healthy mechanism for restraining what Adam Smith called "*the profligacy of Princes*".

This division of opinion has placed the Commission in a difficult position. In 1987, for example, the then Single Market Commissioner, Lord Cockfield, outlined bold plans for the harmonisation of both VAT and excise duties (Commission 1987a). In the case of VAT, all products moving between Member States would have been treated in exactly the same way as those moving within Member States (the "origin" system); and the standard and reduced rates would have been aligned within two narrow bands. Excise duties would have been set at the EU average.

The story since then has been one of steady retreat in the face of insuperable political obstacles. In the case of VAT, 1993 saw the introduction of a "transitional" system, originally due to end in 1996, but which now appears to have been indefinitely prolonged. Even much-needed reforms to the transitional system itself have made painfully slow progress.

Legislation and Co-ordination

One major difficulty is the Treaty itself. Article 93 provides for the harmonisation of *"turnover taxes, excise duties and other indirect taxes in the interests of the Common Market"* where this is "*necessary to ensure the establishment and functioning of the Internal Market*." It also provides, however, that any measure must be adopted by unanimity in Council; and all proposals to change the Article have been strongly resisted by national governments at successive IGCs[1].

In the case of direct taxation the Treaty has provided hardly any legal base at all. It has been necessary to justify legislative action in the field as being in pursuit of more general objectives: the free movement of workers (Art.39); freedom of establishment (Art.43); the free movement of capital (Art.56); the functioning of the common market (Art.94); and preventing distortions of competition (Art.96). The relations between Member States in matters of direct taxation – as well as their relations with third countries – are largely governed by a network of bilateral tax treaties.

[1] Inter-Governmental Conferences. These negotiated the Maastricht, Amsterdam and Nice Treaty revisions.

It is not surprising, therefore, that most recent developments in EU taxation policy have taken place outside the normal Treaty framework. In the field of corporate taxation, for example, the most important initiatives have been the Code of Conduct adopted in December 1997 (Council 1998c), and the subsequent work of the Primarolo Group. Both have been strictly inter-governmental: their legal base has been a resolution of Council, and the mechanism of enforcement peer-pressure rather than the law. Other major objectives – for example, the reform of tax systems in order to reduce the cost of labour and encourage employment – have been pursued through independent national initiatives.

At the same time, Economic and Monetary Union has created a new focus for taxation policy, which has in part stemmed from the limitations placed by the Maastricht Treaty on the conduct of national fiscal policies. The fiscal convergence criteria – a 3% of GDP upper limit on budget deficits, and a 60% of GDP "reference rate" for public debt – were subsequently strengthened by the Stability and Growth Pact, which aims for balanced budgets over the economic cycle. Similarly, the procedures for annually-updated Stability Programmes[2], and for the establishment of Broad Economic Policy Guidelines (BEPG), are developing instruments for the co-ordination of national policies.

Co-ordination in the field of taxation, however, is made especially difficult by wide differences between national systems. Though these share many common features by comparison with third countries like the US and Japan (notably a significantly higher tax-to-GDP ratio and a greater reliance on consumption-based taxes), the details vary considerably, notably in the field of corporate taxation.

Similarly, all Member States to some degree face a "demographic time bomb" in coming decades, as ageing populations alter dependency ratios. The impact on fiscal policy and the tax burden, however, varies between countries as a result of differences in the degrees of funding, the system of taxing pensions, and the relationship between the "three pillars" of state schemes, occupational schemes and personal savings.

The International Dimension

Many elements of EU tax policy have now, in any case, been subsumed in initiatives at an international level. For example, the increasing mobility of capital arising from technological advances, and the consequent difficulties of taxing it, have not been confined to the European Union. As a result, a determined effort has been under way for several years within the framework of the OECD to regulate various "tax havens" throughout the world, and make the banks that operate in them disclose information on depositors. In turn, the feasibility of legislation on the taxation of savings within the EU has in effect depended on the success of such broader developments.

The initial driving force behind such international action was not, however, taxation. Rather it was the war against the laundering of money derived from criminal activities, in particular from drug trafficking. In 1989 the Group of Seven leading industrialised countries, joined by eight other countries and by the EU Commission, established a Financial Action Task Force on Money Laundering under the umbrella of the OECD. This developed a code of 40 principles covering financial regulation, law enforcement and co-operation with other authorities; and a blacklist of "non-co-operative" financial centres, against which various sanctions may be taken. The membership of the FATF has since expanded to 28 countries.

[2] Convergence programmes in the case of Denmark, Sweden and the UK, which remain outside the euro area.

For its part, the EU adopted a Directive on money laundering (Council 1991), which is now being strengthened by an amending Directive (Council 2001d). Such legislation, originally aimed at drug trafficking, now covers crime in general, including corruption, counterfeiting the euro and trafficking in human beings.

In addition, the principle of banking secrecy applied by a number of international financial centres has been under increasing pressure. It has been obliged to give way in the face of, for example, claims on funds deposited by Holocaust victims and investigations into the offshore accounts of absconding or deposed dictators. Most recently, the events in the United States of 11 September have prompted a major effort to uncover and block the financing of terrorist groups.

The extent to which such action against criminal activities should extend into the field of taxation is nevertheless controversial. The dividing lines between tax evasion (illegal), tax avoidance (legal, but subject to the continuing efforts of tax authorities to close loopholes), and prudent tax planning are by no means clear-cut. In addition, a tax offence in one country may not be illegal in another. The US has recently shown itself less keen than the EU to act in this field.

Finally, discussions continue within international bodies like the IMF on whether the global financial system in general should be subject to greater regulation; and, if so, how. One proposal which refuses to die, despite frequent rejection, is that first made in 1972 by Professor James Tobin[3] for a tax on currency operations to "*throw some sand in the wheels of speculation*". The Commission has now been asked by EU Finance Ministers to carry out an evaluation of such a tax by the end of 2001.

[3] *The New Economics, One Decade Older*, Princeton University Press, 1972. The idea was more fully developed six years later in "A proposal for international monetary reform", *Eastern Economic Journal 4*, 1978. For an outline of the issue, see *The Feasibility of an International "Tobin Tax"*, European Parliament DGIV, March 1999.

I. Historical background

The Single Market

The White Paper on *Completing the Internal Market* (Commission 1985) was divided into three sections, the third of which was "The Removal of Fiscal Barriers". It contained a list of proposals aimed at ending all tax checks at internal national frontiers, both on goods being commercially traded and on the purchases of individual travellers.

By the time the Single Market came into existence in 1993, this objective had been secured by a number of measures. In the field of **Value Added Tax**, the Community already had a more or less common system. Under the First VAT Directive (Council 1967), all Member States had introduced the tax by the early 1970s; and the Sixth VAT Directive (Council 1977a) had ensured, at least for the most part, that each Member State had an identical "VAT base": i.e. levied tax on the same transactions.

In 1993, the Cockfield proposals having proved unacceptable to Member States, a mixed "transitional" system came into force. Purchases by final consumers were considered in free circulation throughout the Community once tax had been paid in any one Member State (i.e. the origin principle). In the case of commercial movements, the tax point was for most transactions moved from internal frontiers to the point of delivery (the destination principle).

In the case of **excise duties**, it was agreed that commercial movements across internal frontiers would take place under a system of duty-suspension, with tax becoming due only when the products were released for consumption. Individual travellers became entitled, in principle, to take unlimited quantities of duty-paid products across frontiers – but only when these were for personal consumption. **Duty- and tax-free** allowances for intra-Community travel continued under a vendor-control scheme until 2000, when they were abolished.

The New Approach

The Single Market more or less completed, attention turned to other tax issues. A "reflection document", *Taxation in the European Union* (Commission 1996a), 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 the then 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 published *Taxation in the European Union: report on the development of tax systems* (Commission 1996b), which summarised the views up to that point of the High Level Group. The report echoed a much earlier Commission paper, *The Scope for Convergence of Tax Systems in the Community* (Commission 1980), which had observed that *"tax sovereignty is one of the fundamental components of national sovereignty"*, and pointed to differing ideas about the functions of taxation. The High Level Group accordingly reported 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 "co-ordination" rather than "harmonisation".

The "Monti Package"

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* (Commission 1997a) – was nevertheless quite wide in scope. It took up a number of "blocked dossiers", formal proposals which had already been, or were in due course, published. The initial package, however, proved too extensive, and was reduced to three measures in a revised proposal, *A package to tackle harmful tax competition in the European Union* (Commission 1997b):

- 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 continued to pursue them in the normal way).

The Code of Conduct

The central proposal of the slimmed-down Monti package was the Code of Conduct. This represented a new strategy. Instead of legally binding instruments, the Code took the form of a political agreement, under which the EU Member States agreed to respect principles of fair competition and to refrain from tax measures harmful to others. The Code covered

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

In November 1997, the European Commission adopted the final version of the "Monti package". The Code was finally agreed at the ECOFIN Council meeting of December 1997 (Council 1998c).

The tax measures covered by the Code included both laws or regulations and administrative practices. Those particularly highlighted were:

- benefits given only to non-residents of the country in question; or given only in respect of transactions carried out with non-residents;
- benefits otherwise ring-fenced from the domestic economy so that they did not affect the national tax base;
- benefits available without there being any real economic activity;
- profit determination within a multinational group of companies departing from internationally accepted rules; and
- measures lacking transparency: for example, benefits given by relaxing statutory rules at an administrative level and not making this public.

In adopting the Code, the Council envisaged a number of practical steps:

1. **"Standstill"**. Member States undertook not to introduce new harmful tax measures.

2. **"Rollback"**. Member States agreed to a re-examination of existing laws and practices, and to amend those found to be harmful.
3. **Information exchange**. Member States would inform each other of existing and proposed tax measures which might fall within the scope of the Code.
4. **Co-operation** in the "*fight against tax evasion and avoidance*".
5. **State aids**. It was noted that some of the tax measures covered by the Code might fall within the scope of the provisions on State aid in Articles 92 to 94 of the EC Treaty (now re-numbered 87-89). The Code provided for an assessment to be made as to whether the measures were in proportion to, and targeted at, the aims sought; and the Commission was charged with examining existing tax arrangements and proposed new legislation.
6. **Dependent or associated territories.** Member States with, or having special responsibilities in respect of, other territories undertook to ensure that these principles were applied in those territories.

The "Primarolo Group"

The Council agreement on the Code envisaged the establishment of a "follow-up" group. This was established by ECOFIN on 9 March 1998, and met for the first time on 8 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 was to examine a list, compiled by the Commission largely on the basis of information supplied by Member States, of national tax provisions which appeared to lie within the scope of the Code.

The Group's first interim report was published at the end of November 1998 (Primarolo 1998). It identified 85 tax measures which were *prima facie* of a harmful nature. A further list of tax measures, based on direct submissions by Member States, was added at the end of January 1999.

A second interim report appeared in May 1999 (Primarolo 1999a); and a final report was submitted to the ECOFIN Council in November 1999 (Primarolo 1999b). At its session of 28 February 2000

> *"the Council decided to make this report accessible to the public without taking any position on its contents".*

The report showed that the Group had examined 271 tax measures within the Member States themselves, in "*European territories for whose external relations a Member State is responsible under Article 299.4 of the EC Treaty*" (i.e. Gibraltar) and in "*Dependent or Associated Territories*". Of these, 66 were given a "positive evaluation", on the grounds that they *did* affect *"in a significant way the location of business activity in the Community*". The remainder were evaluated negatively, because they did not. The bulk of the report consisted of detailed comments on each of the tax measures examined.

The reasons for the Group's positive evaluations were summarised. In the case of eight tax measures connected to "*the provision of financial services to third parties, intra-group financing and the provision or licensing of intangible property in return for royalty payments*", for example, the Group took account of whether "some or all of the following features" were present:

- they provided for a reduced nominal rate of tax;

- they provided fixed margins for pass-though financing without a regular review of those margins against normal commercial criteria;
- they allowed the creation of substantial reserves in excess of the real underlying risks and which reduced taxable profits;
- they permitted the profits to be allocated between a Head Office and a branch in a formulaic way contrary to the arm's length principle, so leading to a reduced effective rate of tax on the company as a whole.

Table 2. Tax Measures examined by the Primarolo Group: Member States

Country	Examined	Harmful
Austria	6	2
Belgium	13	5
Denmark	4	1
Finland	3	1
France	48	4
Germany	13	1
Greece	11	1
Ireland	14	5 (4 being ended)
Italy	14	1 (but not operational)
Luxembourg	12	5 (2 being phased out)
Netherlands	14	10
Portugal	13	1 (being phased out)
Spain	17	3
Sweden	3	0
UK	9	0

Source: Final Report of Primarolo Group

Table 3. Tax Measures examined by the Primarolo Group: Associated and Dependent Territories

Territory	Examined	Harmful
UK (Gibraltar)	6	3
Aruba (Netherlands)	7	4
British Virgin Islands	5	1
Guernsey (incl. Alderney)	7	5
Isle of Man	11	6
Jersey	4	4
Netherlands Antilles	7	3
Other territories	38	0

Source: Final Report of Primarolo Group

Similar considerations applied in the case of insurance, intra-group services, exempt and offshore companies, holding companies and other miscellaneous tax measures.

The work of the Primarolo Group also gave rise to a number of other studies and papers, among them a cross-country review of the tax treatment of holding companies, carried out by the Commission; and a comparative study of Member States' administrative practices in taxation, carried out by consultants on behalf of the Commission.

Following the publication of this "final" report, the Primarolo Group was given a further mandate. Member States have until 2003 to rescind those tax measures identified as harmful,

and the Group was charged with monitoring this "roll-back". The Group was also given the task of monitoring the "stand-still".

This indicates that the work of the Group will in practice "*never be finalised*", as Mrs. Primarolo herself told Parliament's Economic and Monetary Affairs Committee at its meeting on 10 October 2000.

The taxation of interest and royalty payments

At the beginning of 1990, the Commission published a proposal covering a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States (Commission 1990a). The purpose of the proposal was to abolish double taxation. However, despite being revised two years later (Commission 1993a) and receiving a favourable opinion from the European Parliament, it was withdrawn as a result of failure to agree in Council.

A new version was presented in 1998 (Commission 1998d) as part of the "Monti package", and on which there has been a measure of agreement in Council. Nevertheless, a decision was taken by the Council meeting of 25 May 1998 that the measure formed part of the package as a whole, and could not be adopted separately.

The taxation of personal savings

By far the most controversial element of the "Monti package", as it has turned out, was that *to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community*. The proposal published in 1998 (Commission 1998f) was based on a "coexistence model": Member States would either levy a 20% withholding tax on savings income paid to residents of another Member State; or they would provide information on payments to the tax authorities of the other Member State[4].

This was not, however, the first attempt by the Commission to tackle the issue. In 1989 the Commission had published a draft Directive for *a common system of withholding tax on interest income* (Commission 1989a), to be levied at the rate of 15%. The proposal was eventually withdrawn when it failed to make any progress in Council.

The new Commission proposal involved finding solutions to a number of technical problems. Some financial products, for example, combine interest income (expressed as a percentage rate on the capital invested and covered by the Directive) and dividend income from equity (expressed as a return per share from profits, and not covered). The Luxembourg Government, in particular, argued that such "mixed" investment funds should be excluded altogether.

The rough-and-ready solution proposed by the Commission was that the income from such funds would incur tax where they invested

> *"directly or indirectly more than 50% of their assets in debt-claims or corresponding securities[5]".*

One alternative, which emerged during the discussions in Council, was the "look-through" approach: only that proportion of the income from a fund which derived from interest would

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[4] Actually, the Draft Directive contained *three* systems: Withholding Tax**;** Provision of Information; and Certificate of Notification, under which a taxpayer could prevent withholding tax being levied by proving that the interest had been declared to the appropriate tax authorities.

[5] Article 5(c).

be subject to the Directive. This approach would apply to all mixed funds, or be combined with an overall threshold of the kind proposed by the Commission.

The main objections to the Directive in Council, however, were of a broader nature. The earlier draft Directive of 1989 (the so-called "Scrivener" proposal after the then tax Commissioner) had excluded the international market in "Eurobonds", worth some €4 000 billion in outstanding issues and largely based in the City of London. The latter, however, were included in the Monti proposal. As a result, the UK Government issued a paper in September 1999 (UK Government 1999) arguing for their renewed exclusion, and pointing to the danger of the whole market moving outside Europe. Disentangling the holdings by residents of EU Member States (about 50% of the total), which would be subject to the tax, from holdings by non-EU residents, which would not, could present unacceptable administrative and legal problems (e.g. triggering options to "call" at par).

The other most outspoken critic of the proposal was Luxembourg, where financial services provide an important and dynamic sector of the economy. Opposition, as in the case of the UK, was based on the fear that implementation of the Commission proposals would drive investment outside the EU, notably to alternative financial European centres like Zürich, Liechtenstein, the Isle of Man, etc. or even further.

In one important respect, however, the interests of the UK and Luxembourg diverged sharply. The European Council meeting in Helsinki on 10-11 December 1999 reached an agreement to continue discussions on the draft Directive, based on the principle that

> *"all citizens resident in a Member State of the European Union should pay the tax due on all their savings income".*

The UK Treasury then published a second paper (UK Government 2000) arguing, incontrovertibly, that this could not be achieved by a withholding tax, since there was no guarantee that the rate levied would actually correspond to the "tax due". Only an exchange of information between tax authorities, the paper argued, could achieve this. The real problem was the tradition of banking secrecy in some countries.

> *"A competent authority is not required to look for, or to transmit to the competent authority of another Member State, information which it would be prevented by its laws or administrative practices from collecting or using for its own purposes".*

The broad thrust of the UK's arguments obtained majority support in Council. Luxembourg and a number of other Member States pointed out, however, that ending banking secrecy within the EU would also drive investment outside the EU unless similar reforms took place in countries like Switzerland. In addition, certain other problems came to the fore, notably whether, and through what mechanism, the sums collected in withholding tax in one Member State would be transferred to the countries in which the taxpayers were resident.

After lengthy negotiations, a compromise was agreed at the **Santa Maria de Feira European Council** on 20 June 2000, under which the exchange of information model would be the ultimate objective, to be introduced within seven years after the adoption of the Directive. Meanwhile, Austria and Luxembourg – which maintain banking secrecy for non-residents – and possibly other Member States, would introduce a withholding tax on interest paid to non-residents, at a rate to be decided. An "appropriate share of their revenue" would be transferred to the investor's state of residence.

Introduction of the legislation would, however, be conditional on agreement being reached on similar measures with key third countries. (The Commission had, in fact, already begun talks

in early 1999 with Switzerland, Liechtenstein, Andorra, Monaco and San Marino). A decision, by unanimity, would be taken on the matter by the end of 2002.

On 26/27 November 2000 ECOFIN reached agreement on a number of principles.

- Austria, Belgium and Luxembourg would introduce a withholding tax at a rate not below 15% for three years following the entry into force of the Directive. This would rise to not less than 20% for another four years. The tax would be *libérateur* – that is, no further tax would be payable on the income.
- All other Member States would adopt the exchange of information system following the entry into force of the Directive, and Austria, Belgium and Luxembourg after seven years.
- The collecting country would retain 25% of withholding tax revenues, the rest would be cleared to the countries where the tax-payer was resident.
- Mixed investment funds would be covered, on the "look-through" principle, when 40% of the holdings were interest-bearing.
- Bonds issued before 1 March 2001 would not be subject to the Directive until the end of the projected transitional period (the "grandfathering" provision to limit the effect on existing securities;)

These conclusions were incorporated in a revised proposal (Commission 2001h), presented in July 2001 (see "The Taxation of Savings" in the next chapter).

The OECD: "Harmful Tax Practices"

Meanwhile, parallel negotiations were taking place within the broader context of the Organisation for Economic Co-operation and Development (OECD). In April 1998 a report (OECD 1998) was adopted by the OECD Council – with Luxembourg and Switzerland abstaining – authorising further work on nineteen recommendations for action against "harmful tax practices", including a timetable for their identification and elimination. A Forum on Harmful Tax Practices was established to carry out the work.

The Forum presented a progress report (OECD 2000a) to the OECD Council in June 2000. It observed that

> *"harmful tax competition is by its very nature a global phenomenon and therefore its solution requires a global endorsement and global participation".*

"Harmful" was defined as any tax practice which effectively eroded the tax base of other countries, in particular by facilitating tax avoidance. Where these were identified, the 29 OECD Member States undertook (as under the EU Code of Conduct) to refrain from extending them or from introducing new schemes ("standstill"), and to eliminate them within five years ("roll-back").

The main focus of the report's attention, however, was on non-OECD-members, and in particular on "tax havens". The main criteria for identifying these were:

- no, or only nominal effective tax rates;
- lack of effective exchange of information;
- lack of transparency; and
- absence of a requirement of substantial activities.

The Forum initially identified 47 possible havens. In advance of its report, however, six of these – Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino – issued "advance commitment" letters, undertaking to eliminate the offending practices by 2005.

Following its investigations, the Forum eventually listed 35 jurisdictions "found to meet the tax haven criteria of the 1998 Report" (see Table 4). These included most of the EU associated and dependent territories listed in the Primarolo Report, as well as, within Europe, Andorra, Liechtenstein and Monaco.

Table 4. Jurisdictions meeting the OECD "tax haven" criteria in 2000

Andorra	Guernsey/Sark/Alderney*	Niue (New Zealand)
Anguilla (UK)	Isle of Man*	Panama
Antigua and Barbuda	Jersey*	Samoa
Aruba (Netherlands)	Liberia	Seychelles
Bahamas	Liechtenstein	St. Lucia
Barbados	Maldives	St. Christopher & Nevis
Belize	Marshall Islands	St. Vincent & the Grenadines
British Virgin Islands (UK)	Monaco	Tonga
Cook Islands (New Zealand)	Monserrat (UK)	Turks & Cacos (UK)
Dominica	Nauru	Virgin Islands (US)
Gibraltar (UK)	Netherlands Antilles	Vanuatu
Grenada		

**Neither the Channel Islands nor the Isle of Man are part of the United Kingdom, but are direct dependencies of the Crown (e.g. the Queen holds the title of "Lord of Man").*

The Report also outlined the "defensive measures" which could be taken by OECD members against tax havens. The jurisdictions listed would be encouraged to co-operate with the OECD in eliminating their harmful tax practices. But those that had failed to make such a commitment by 31 July 2001, or which failed to carry out a commitment already made, would be included on a "List of Uncooperative Tax Havens". A range of more direct defensive measures might also back up this "naming and shaming" procedure, including the imposition of withholding taxes on certain payments to residents of Uncooperative Tax Havens, and of charges or levies on transactions involving them.

Corporate Taxation

The first proposals in the field of corporate tax were contained in a report prepared in 1962 by the **Neumark Committee** (Neumark 1962). This recommended that corporation tax systems should be harmonised along the lines of a split-rate system, with a lower rate of tax on distributed (i.e. dividends) than on retained profits. There followed the **Van den Tempel Report** (van den Tempel 1970), which advocated a classical corporation tax system throughout the Community.

In 1975 the European Commission tabled a proposal on the harmonisation of systems of company taxation and withholding tax on dividends (Commission 1975). The draft proposed a common partial imputation system of company taxation, with rates within a band of 45-55%, and a tax credit for dividend recipients, irrespective of the Member States in which they resided. At the same time, all Member States would levy a 25% withholding tax on dividends distributed by their resident companies. This draft, however, failed to include common rules for computing the tax base. Partly for this reason, and partly as a result of the "new approach" of co-ordination rather than harmonisation, the proposal was withdrawn by the Commission in April 1990.

The Commission, however, had already begun work on harmonised rules for the determining the corporate tax base. The initial draft contained guidelines about depreciation allowances,

capital gains, inventory valuation, reserve provisions, valuation adjustments, and overhead costs. The scope for indirect subsidies through the tax base would be limited, and tax incentives would have 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 1990 three proposals concerning company taxation were adopted:

- The **Parent-Subsidiary Directive** (Council 1990a) 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.
- The **Merger Directive** (Council 1990b) aimed at the deferral of capital gains taxation in cases of certain cross-border transactions related to the restructuring of groups of companies.
- The **Convention on the elimination of double taxation** (Council 1990c) with the adjustment of profits of associated enterprises.

In addition, an earlier Directive for **mutual assistance in direct tax matters** (Council 1977b) provided 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 monitor the activities of multinational corporations. The European Commission also published a draft Directive on the **set-off of losses sustained by branches and subsidiaries** (Commission 1984).

The Ruding Report

In March 1992 a Committee of experts chaired by Onno Ruding published a report (Ruding 1992) on what changes to company taxation would be necessary to ensure the proper functioning of the Single Market. The main priorities of the report were:

- removing discriminatory and distorting features of tax arrangements that impeded 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; and
- encouraging maximum transparency of any tax incentives granted by Member States.

Among the specific measures advocated by the report were

- a minimum **corporation tax rate** of 30% and a maximum of 40%;
- the complete elimination of **withholding taxes** levied by source countries on dividends paid by subsidiaries to parent companies;
- a uniform 30% **withholding tax on dividend distributions** by resident European companies, subject to waiver where appropriate tax identification was provided;
- 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;
- full Community-wide **loss offsetting** within groups of enterprises;
- a common policy on **double tax agreements** both between Member States and with respect to third countries;
- harmonisation of **the dates** on which taxes of common application were payable.

Although the Commission accepted many of these detailed recommendations, there was considerable resistance by Member States to the central proposal for a minimum rate of Corporation Tax. In any case, the legislative action advocated by the report was put in abeyance as the focus of attention moved to the Code of Conduct and its implementation. The most recent Commission study on company taxation (Commission 2001j), published in October 2001, observed of the Ruding Report that

> *"little progress has been achieved in the field of company taxation as a result of its findings and recommendations."*

The Bolkestein Priorities

At the beginning of 2000 Frits Bolkestein replaced Mario Monti as Taxation Commissioner. His approach towards taxation issues proved to be one of great caution, with a strong emphasis on co-ordination rather than legislation. In February 2001 he circulated a paper within the Commission which stated clearly that

> *"the complete harmonisation of the Member States' tax systems….is neither necessary nor desirable".*

Such an approach had, in any case, become virtually inevitable. The passage of controversial tax legislation is impossible as long as unanimity is required in Council; and all proposals to change this situation in the Nice Treaty – for example, by introducing weighted majority voting for some aspects of tax *systems*, while leaving unanimity on tax *rates* – were comprehensively rejected.

The first result of this modified approach was a shift of emphasis in the Commission's approach to Value Added Tax. While adoption of a "definitive" system based on the origin principle was not ruled out as an ultimate goal, the emphasis in the Communication of June 2000 on a **Strategy to Improve the Operation of the VAT System within the Context of the Internal Market** (Commission 2000b) was on measures to improve the present "transitional" arrangements.

In May 2001 the Commission published a much more comprehensive Communication on **Tax policy in the European Union - Priorities for the years ahead** (Commission 2001f). In the Introduction to this document the Commission contrasted the volume of legislation on VAT and excise duties of the early 1990s with

> "*the absence of a coherent policy on direct taxation*." In the past, it added, "*tax proposals were too often discussed in isolation rather than in the context of wider EU policy*."

This wider context, the paper went on to outline, included:

- The strategic goal, agreed at **the Lisbon Summit** in 2000, for the EU to become "*the most competitive and dynamic knowledge-based economy in the world*". One element was the role of tax policy in increasing Research and Development (R&D) and innovation.
- The impending **enlargement** of the EU. It was vital that the body of Community tax law should be consolidated and stabilised to the largest extent possible before enlargement.
- The **challenges for fiscal policy** posed by the Stability and Growth Pact and Broad Economic Policy Guidelines procedures.
- The programme of reforms to make tax systems more **employment-friendly**. "*Tax cuts should be focused on areas where they have beneficial supply side effects.."*
- The objective of promoting common **environmentally-friendly** tax policies.

Within this context, the paper went on to propose a number of general objectives.

- Tax systems should be *simpler and more transparent.*
- Inefficiencies in the functioning of markets, *linked to the operation of 15 different tax systems within the EU,* should be removed.
- *More efficient tax collection* should offset revenue losses caused by ending tax obstacles.
- Efforts to *cut nominal rates while broadening the tax base* should be continued.

As far as methods to achieve such objectives were concerned, the paper observed that "*a high degree of harmonisation is essential in the **indirect tax** field*". In the case of **personal incomes**, on the other hand, "*the view is that such taxes may be left to Member States*" subject to their respecting "*the fundamental Treaty principles on non-discrimination and the free movement of workers*".

Finally, in the case of **corporate taxation**, a balance had to be found between tackling direct obstacles to the Internal Market and the sovereignty of the Member States.

Indirect Taxation

The current "transitional" **VAT system**, the Commission paper stated baldly, "*is complicated, susceptible to fraud and out of date*". Nevertheless, Member States' fears of losing revenue continued to make a "definitive" system, based on the origin principle, unacceptable to them. The strategy of concentrating on improving the current system was therefore re-affirmed.

One "unhelpful" feature in both the VAT and excise duty fields was the continued existence of a variety of derogations. Future proposals in the VAT field would therefore include

> *"a review and rationalisation of the rules and derogations applying to the definition of reduced VAT rates...but not before the end of 2002."*

In the case **of energy and environment taxes**, it was essential to break the four-year stalemate in Council on the 1997 proposal on the taxation of Energy Products (Commission 1997d) "*even if unanimity cannot be obtained*". Taxation in the energy and environmental field had developed in an uncoordinated way; and the

> *"multiplication of national taxes that differ in their scope, methods of calculation, rates, etc. jeopardises the unity of the Internal Market and might negatively affect the functioning of the liberalised gas and electricity markets."*

In the case of duties on **tobacco and alcohol**, efforts would continue to reduce disparities between the rates in different counties.

Finally, the paper drew especial attention to the **taxation of vehicles**.

> *"In eleven Member States, a person who purchases a car will be required to pay a registration tax. If that person then moves to live and work in another Member State, it is necessary to re-register the car on local number plates and, in at least eleven of the Member States, to pay a further registration tax there, with no system of refunds or reliefs for registration taxes paid in the first country."*

All this was in addition to the "highly differentiated" system of taxes on the purchase of the vehicles themselves. The Commission would examine whether these problems constituted breaches of the Treaty, and would present a Communication on vehicle taxation "*towards the end of this year*".

Company Taxation

The paper observed that the

> *"cross-border activities of companies give rise to numerous cases of discrimination, double taxation, excessive administrative costs owing to complicated administrative procedures and delays in tax refunds."*

There were three broad options for reform:

- *piecemeal solutions*, leaving the 15 different corporate tax systems to coexist;
- general acceptance of the *Home State Taxation approach*, combined with mutual recognition of tax rules;
- *new common rules* at EU level.

The issue of how European-based companies were taxed would in any case have to be addressed following agreement on the European Company Statute.

Personal income taxation

The Commission was emphatic that "*personal income taxes fall in their entirety under the sole responsibility of Member States*". Action at EU level might nevertheless be necessary to:

- prevent cross-border discrimination or obstacles to free movement;
- eliminate double-taxation; and
- avoid "*unintentional non-taxation*" and "*cross-border tax evasion*".

Particular problems had arisen in the case of "persons having their **fiscal residence in one Member State but carrying out their activities in another**", which had been substantially alleviated by action following publication of a Recommendation in 1993 (Commission 1994). There remained, nevertheless,

> *"numerous other problems of non-residents in the field of taxation or the inter-relation between taxation and social security"*

of which the growing number of cases before the European Court of Justice was evidence.

A particular issue of recent concern was the practice of some high-tax Member States of taxing **expatriate staff** at special low rates "*as a means to attract specific categories of skilled workers and experts*". Finally, there were a number of issues arising from differing systems for **taxing occupational pensions**, which had been the subject of a recent Communication (Commission 2001c).

Legal and other Instruments

The final section of the Commission paper dealt with the mechanisms which might be used to achieve the objectives outlined earlier.

Its starting point was the "disappointingly slow" progress in adopting the traditional legislative instruments of Directives and Regulations.

> *"There are currently 16 Commission proposals for Directives in the taxation domain on the Council's table. Some of these have been on the table since the early nineties."*

The Commission therefore outlined a number of alternative mechanisms.

1. **Legal action**. As the "guardian of the Treaties", the Commission is empowered to take infringement proceedings against Member States whose tax rules appear to contravene either the Treaty itself, or existing legislation. However, the paper observed, most of the

"*rapid development of EC case law in the direct tax field over the last few years*" had been as a result of cases brought by individual litigants. The Commission's own role had been generally limited to submitting its "observations" to the European Court of Justice.

Leaving matters to the Court in this way, however, had certain disadvantages. Not only was litigation expensive for both taxpayers and administrations, but in many cases

> *"the general application of a specific case in an individual Member State is not entirely clear."*

In consequence, the Court ruling might result in "vastly differing" new tax rules in the various Member States affected.

The Commission therefore intended to "*adopt a more pro-active strategy generally in the field of tax infringement..*" It would

- be more ready to initiate action where it believed that Community law was being broken; and
- would ensure the correct application of the European Court of Justice's judgements.

In particular, the Commission would pay close attention to the observance of State Aid rules where these applied to tax measures.

2. **"Soft legislation".** A number of instruments are at the disposal of the Commission which, unlike regulations or directives, do not directly create Community law.

   - Article 249 of the Treaty (ex-Article 189) provides for the Commission to "*make **recommendations***" or "*deliver **opinions***", which "*shall have no binding force*". The Commission document observed that recommendations had been successfully used in the past in the tax field, as in the case of the 1993 Recommendation on the taxation of non-residents.
   - The Commission might also consider the use of **guidelines** and **interpretative notices**. These could be particularly useful in clarifying the legal situation following a Court judgement.
   - Finally, Commission **Communications** provided another method of promoting the development of new tax rules, as in the recent case of occupational pensions.

3. **Enhanced co-operation.** Much recent progress in the tax field – notably the Code of Conduct on business taxation and the work of the Primarolo Group (see earlier) – has taken the form of non-legislative **agreements in Council**, with enforcement relying mainly on peer pressure. In addition, most existing arrangements between Member States in the field of direct taxation do not take the form of Community law, but of **bilateral tax treaties** governed by normal international law.

   The Amsterdam Treaty, however, introduced the possibility of building on such arrangements by enabling sub-groups of Member States to conclude cooperation agreements within a Community framework. In the tax field, this might prove particularly useful: where unanimity is not achieved in Council, the supporting States might in any case proceed (as in the case of the third stage of Economic and Monetary Union). The Commission document suggested that this might prove a way forward in the area of environmental and energy taxation, where "*a majority of Member States have indicated their strong desire to make progress*".

II. Current issues

The Taxation of Savings: latest

The revised draft Directive on the *effective taxation of savings income in the form of interest payments within the Community*, presented by the Commission in July 2001 (Commission 2001h), is still under active consideration in the Council, although its main lines were already agreed in June 2000 (see earlier section on "The taxation of personal savings").

In principle, there should be no need for such a Directive. A taxpayer in one Member State who receives interest from an asset in another Member States is required to declare such income when making normal tax returns in his or her home country. But in practice

> *"the free movement of capital... together with the existence of bank secrecy... increase[s] the potential for tax evasion by individuals*[6]."

Only Greece and Portugal levy withholding tax on interest paid to non-residents. But most Member States levy a tax on interest paid to their own citizens (see Table 5). However, when in 1989 Germany introduced such a tax at the modest rate of 10%, there was massive movement of funds into Luxembourg. The German tax had temporarily to be abolished. This experience became an argument both for and against the Commission proposal. For those in favour, it demonstrated the need, in conditions of free capital mobility, for common tax measures. For those against, it illustrated the danger of a capital flight to outside the Community if any such measure was introduced.

The fate of the most recent proposal now rests, in effect, on the success of negotiations with third countries and on developments within the context of the OECD. Luxembourg and Austria have made it a condition of adopting the Directive that “equivalent” measures will be introduced in the countries with which negotiations are to take place.

Contacts between the Commission and tax authorities in the main third countries involved had, in fact, already been established at an early stage. However, a further unanticipated problem arose during 2001 concerning the Commission's mandate to negotiate. A number of countries, notably the UK, maintained that negotiations on taxation with third countries was primarily the responsibility of the Member States rather than the Commission.

A compromise formula was eventually agreed on 16 October 2001 to enable the opening of formal negotiations with the US, Switzerland, Liechtenstein, Monaco, Andorra and San Marino. The Commission will act "jointly" with the Council Presidency, on the basis of a mandate, and "in close and regular consultation" with the inter-governmental High-Level Group on Tax. The aim of the negotiations – which it is hoped will be concluded by June 2002 – is to sign permanent agreements, but with provision for later amendment.

It is nevertheless by no means certain as yet that the Directive will be adopted and implemented as planned. It remains part of the “Monti package”; and Austria and Luxembourg specifically inserted a statement into the minutes of the 26/27 November 2000 ECOFIN meeting that they would agree to the Directive on the taxation of savings

> *"only when there has been a binding decision on the roll-back of the sixty-six measures within the Code of Conduct."*

Discussions also continue on the application of the Directive to the associated and dependent territories of Member States.

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[6] Quotation from the Ruding Report (Ruding 1992).

Table 5. Withholding tax on residents' interest income from government bonds (%)

Country	% tax rate	Notes
Austria	25	Tax is final if taxpayer so opts. Otherwise aggregated into total taxable income.
Belgium	15	Tax is final if taxpayer so opts. Otherwise aggregated into total taxable income. First BEF 56 000 tax-free.
Denmark		All interest income incorporated into total taxable income.
Finland	29	Tax is final.
France	15	Tax is final if taxpayer so opts. Otherwise aggregated into total taxable income.
Germany	31.65	Withholding tax is credited against tax on total taxable income.
Greece	15	
Ireland	24	Withholding tax is credited against tax on total taxable income. Rebated for pensioners, etc.
Italy	12.5	Tax is final.
Luxembourg		All interest income incorporated into total taxable income, with first LUF 60 000 exempt.
Netherlands		All interest income incorporated into total taxable income, with first DFL 1 000 (double for married couples) exempt.
Portugal	20	Final, with option for payment on account against total tax.
Spain	18	Withholding tax is credited against tax on total taxable income.
Sweden	30	
United Kingdom	20	Withholding tax is credited against tax on total taxable income. Interest may be received gross in certain circumstances.

Source: *Tax systems in European Union Countries*, (OECD 2001a).

One critical point in the negotiations with third countries will be whether all participants can reach a common definition of "equivalent". The Swiss government has on a number of occasions stated that its bank secrecy laws are "non-negotiable". Lukas Mühleman, chairman of Credit Suisse, declared on 22 January 2001[7] that a withholding tax would be

> *"effective to fight tax evasion and is compatible with our view of the state. A mandatory exchange of information between banks and governments is not."*

The Swiss negotiating position would appear to be as follows[8]:

- Any discussion of the taxation of savings income should take place within the framework of wider EU-Switzerland bilateral negotiations. Following the agreements of 1999, six major subjects are still under discussion (including the free movement of persons and the right of asylum), to which the tax issue could be added.

[7] Reported in the *Financial Times* of 23 January 2001.

[8] This was outlined to the European Parliament's Economic and Monetary Affairs Committee on 3 December, 2001 by Swiss representatives.

- A draft negotiating mandate has been agreed at the level of the Swiss Federal Council, but must also be agreed by the separate cantons. Any outcome of the negotiations will have to follow the same constitutional path, and may also need to be the subject of a referendum.
- A withholding tax might be acceptable, but not the exchange of information.
- Any agreement would be subject to other third countries also adopting "equivalent measures"; and also to the adoption of such measures by the associated and dependent territories of EU Member States.

A seminar of the Swiss Bankers Association in Bern in June 2001indicated that the banks would be prepared to accept an agreement with the EU on the taxation of savings, but only on condition "equivalent measures" were also applied by Asian countries such as Japan, Singapore and Hong Kong. This is one more indication that the fate of the draft Directive may ultimately rest on developments at the international level (see under "The OECD: 'Harmful Tax Practices'" earlier, and next Chapter).

A number of technical points are also still under discussion: for example, whether the scope of the information-exchange system might be extended from private individuals to other legal persons; and the exact information that must be provided to tax authorities.

Reform of the VAT System

One of the most serious defects of the current "transitional" VAT system is its complexity: the scope it allows for varying national interpretations of VAT law (and also for fraud and tax evasion). The basic system established under the Sixth VAT Directive is riddled with derogations, exemptions, options and special regimes. Further problems have been caused by the application of the three "special regimes": distance sales[9]; tax-exempt legal persons (i.e. hospitals, banks, public authorities, etc.); and new means of transport (see later section on "The taxation of vehicles").

The Commission has envisaged meeting these problems, in part, by allowing decisions on detail to be taken without the full application of Article 93. 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 (Commission 1997e). So far, however, Member States have been reluctant to take even this step, and the European Parliament itself has been wary of allowing decisions to be taken by a body over which it cannot exert democratic scrutiny.

As already noted, the Commission's Communication of June 2000 (Commission 2000b) gave priority to improving the present “transitional” system rather than to creating a “definitive” one based on origin. A new three-phase, two-year Action Programme listed (or re-listed) nine proposed legislative measures (see Table 6).

In addition to the measures announced in the 2000 programme, the Commission has also stated its intention to publish proposals on **the place of supply of goods,** on **travel agents** (which is expected before the end of 2001) and on the **"recasting" of the Sixth Directive**. It has also listed a number of "potential future priorities" (see Table 10)

[9] Mail-order or similar companies having sales over a certain threshold to any Member State were obliged to levy VAT at the rate applied in that country (i.e. where the goods were delivered); and if necessary, to appoint "fiscal agents" to account for the tax. Consumers, meanwhile, had no way of knowing whether the correct rate of tax had been charged. In 1998 the Commission tabled a proposal to abolish the need for tax representatives, which was adopted by Council in October 2000 (Council 2000b).

Table 6. The VAT "Action Programme" of June 2000

Proposals already tabled	Target Date for Adoption	Actual date
VAT Committee (COM(1997)325)	2000/2001	Still pending
Mutual assistance on recovery (COM(1998) 364)	2000/2001	June 2001
Right of deduction (COM(1998)377)	2000/2001	Still pending
Persons liable for VAT (COM(1998)660)	2000/2001	17 October 2000
New Proposals	**Target Date for Publication**	**Actual date**
Taxation of postal services	June/July 2000	Still awaited
Taxation of e-commerce	June/July 2000	June 2000
Electronic Invoicing	Autumn 2000	November 2000
Administrative cooperation and mutual assistance	December 2000	June 2001
Minimum standard rate of VAT (revision)	July 2000	September 2000

The Commission's original proposals on **VAT rates** (Commission 1987b) were for "approximation" within two tax bands: a 14-20% standard rate; and a 5-9%reduced rate. However, the main provisions of the system eventually adopted (Council 1992b) were:

- a minimum standard rate of 15%, subject to review every two years;
- the option for Member States to apply either a single or two reduced rates over 5% to any of the goods and services listed in Annex H of the amended 6th. VAT Directive;
- derogations for certain Member States to apply a zero rate, a "super-reduced" rate or a "parking" (i.e. transitional) rate, pending the introduction of a definitive VAT system
- abolition of "luxury" or higher rates.

Even with a "floor" to standard rate, it was feared at the time that the remaining differences would result in widespread distortions of competition. In the event, successive subsequent Commission reports have found that the abolition of tax checks at internal Community frontiers 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.

No proposals have subsequently been made, therefore, to alter the 15% minimum. On the other hand, the Commission has on several occasions attempted to introduce a **maximum rate of 25%.** The first attempt (Commission 1995b) was rejected by Council, which only agreed to make "every effort" not to widen the current 10% span. Parliament also rejected the maximum rate, its major reason being incompatibility with the then proposed Stability Pact limiting the ability of Member States to run budget deficits. Upper limits on tax rates, it was argued, would unduly restrict room for manoeuvre.

In 1998, the Commission made another attempt to introduce a maximum rates by proposing a 15% to 25% standard band (Commission 1998a). This was also rejected by Council. The only initiative on rates since has been to confirm the 15% minimum until 2005 (Council 2001a). The Commission has, however, announced its intention to make further proposals in the field of the **reduced rates of VAT**. The widely differing applications of Annex H are a particular source of complexity and distortions in the system (see Table 8 and next section). Current legislation also permits the continued existence, until the implementation of a "definitive" system, of "super-reduced" and zero rates, as well as temporary "parking" rates (see Table 7).

Table 7. VAT Rates applied in Member States (as of May 2001)

Member State	Super-reduced rate	Reduced Rate	Standard Rate	"Parking" Rate
Belgium	-	6	21	12
Denmark	-	-	25	-
Germany	-	7	16	-
Greece	4	8	18	-
Spain	4	7	16	-
France	2.1	5.5	19.6	-
Ireland	(0)/4.2	12.5	20	12.5
Italy	4	10	20	-
Luxembourg	3	6	15	12
Netherlands	-	6	19	-
Austria	-	10/12	20	-
Portugal	-	5/12	17	-
Finland	-	8/17	22	-
Sweden	-	6/12	25	-
UK	(0)	5	17.5	-

Source: Commission (DOC/2905/2001)

The reduced rates of VAT

The Commission is required under Community legislation[10] to publish regular reports on the reduced rates of VAT. The most recent appeared in October 2001 (Commission 2001i).

Reduced or "super-reduced" VAT rates can exists in a number of ways.

- On the goods and services specified in **Annex H** of the Sixth Directive.
- On supplies of **electricity and natural gas** under Article 12(3)(b) of the Directive.
- On goods and services not listed in Annex H under various **exemptions and derogations** governed by Article 28(2) of the Directive. These can be maintained as long as the "definitive" VAT system has not been introduced. Austria and Portugal also have special transitional derogations.
- On **labour-intensive services** under Article 28(6), introduced as a result of a special Directive (Council 1999a). Member States have an option to levy, on an experimental basis until the end of 2002, reduced rates on any three of the services listed in new Annex K. Nine have chosen to do so (see Table 9).

Moreover, the report noted, there were regular requests to extend Annex H to new goods and services – often by those who objected to the distorting effects of the existing provisions.

These objections concerned a number of features, among them:

- The discretionary and piecemeal way in which the rates were applied. Member States were not obliged to apply the rates to all goods and services in the category chosen.
- The difference between reduced rates (having a 5-14% range) and super-reduced rates.
- The lack of common definitions of the goods and services in Annex H, and defects in the wording and application of derogations.
- Added complexity because some derogations were permanent, other transitional.

[10] Under Article 12(4) of the Sixth Directive, 77/388/EEC.

Table 8. Reduced VAT rates on the categories of goods and services contained in Annex H of the 6th. VAT Directive

0 = zero rate (exemption with refund of tax paid at preceding stage); [ex] = exemption

Category	B	DK	D	EL	E	F	IRL	I	L	NL	A	PT	FIN	S	UK
1 Foodstuffs	6 12 21	25	7 16	8	4 7	5.5 19.6	0 12.5 20	4 10	3	6	10	5 12 17	17	12	0
2 Water Supplies	6	25	7	8	7	5.5	[ex]	10	3	6 19	10	5	22	25	0
3 Pharmaceutical Products	6 21	25	16	8 18	4	5.5 19.6	0	10 20	3 15	19					0 17.5
4 Medical equipment for disabled persons	6 21	25	7	8 18	4 16	5.5 19.6	0	10 20	3 15	6 19	20	5 17	8	25 0	0 5 17.5
5 Transport of Passengers (+see n° VI)	6 0 [ex]	[ex] 0	7 16	8	7	5.5	[ex]	[ex] 10	[ex] 3	19	20	17	22 [ex]	25 [ex]	0
6 Books, newspapers, Periodicals	6 0/6 0/6	25 0/25 25	7 7 7	4 4 4	7	5.5/19.6 2.1/19.6 2.1/19.6	0 12.5 12.5	4 4 4	3 3 3	[ex] 6	10	5	8	6 0	0
7 Shows, ... Radio and TV	[ex] 6 21	25	[ex] 7 16	[ex] 4 8 18	[ex][1] 7 16	2.1 5.5 19.6	[ex] 12.5 20	4 10 20	3 15 [ex]	6 6 6	10 10 10	5 5 5	8 0/22 0/22	25 6 [ex]/25	0 0 0
8 Writers, composers, ...	6 21 [ex]	[ex]	7	8	7	5.5	20	[ex] 20	3	19 [ex]	20 10	17 [ex]	[ex]	6	17.5
9 Social housing	6	25	16 7	8	4	5.5 19.6	12.5	4 10	3 15	19	20	[ex] 5	22	25 [ex]	17.5 0
10 Agricultural inputs	6 12 21	25	7	8	7	5.5	12.5	4 10 20	3	6	20 10	5	22 17	25	17.5
11 Hotel accomodation	6 [ex]	25	16	8	7	5.5	12.5	10	3	6	10	5	8	12	17.5
12 Sporting events	6 [ex]	[ex] 25	16	8	7 16	19.6	[ex]	10 20	3 [ex]	6	20	5	8 [ex]	[ex] 6	17.5
13 Use of sporting facilities	6 [ex]	[ex] 25	[ex]	8	[ex] 16	19.6	12.5	20	3	19 6 [ex]	20 [ex]	5	8	6 [ex]	[ex] 17.5
14 Social services,	6 21 [ex]	25	7	8	7	19.6	[ex]	[ex] 4 10 20	3 15 [ex]	19	0 10	17 [ex]	[ex]	[ex] 25	[ex]
15 Cremation services	6	[ex]	16	8	7 16	19.6	20 [ex]	20	3	[ex]	20	[ex]	[ex]	[ex]	[ex]
16 Medical and dental care	6 21 [ex]	[ex]	7 [ex]	8	7	19.6 5.5	[ex] 20	[ex]	3 [ex]	[ex] 19	10 [ex]	[ex] 5	[ex]	[ex]	[ex]
17 Collection of domestic waste and street cleaning...	21	25	[ex] 16	8	7	19.6 5.5	[ex] 20	10	3	19 [ex]	10	[ex] 5	22	25	0 17.5

(1) supplied by bodies governed by public law or by other organisations recognised as charitable by the Member State concerned.

Table 9. Rates application by Member States to the categories of labour-intensive services contained in Annex K to the Sixth VAT Directive

Supplies of services referred to in Article 28(6)	B	DK	D	EL	E	F	IRL	I	L	NL	A	PT	FIN	S	UK
1 Small repair services:															
a) Bicycles	6	25	16	18	16	19.6	12.5	20	6	6	20	17	22	25	17.5
b) Shoes	6	25	16	18	16	19.6	12.5	20	6	6	20	17	22	25	17.5
c) Clothing and household linen (including mending and alteration)	6	25	16	8	16	19.6	12.5	20	6	6	20	17	22	25	17.5
2 Renovation and repair of private dwellings (excluding materials which form a significant part of the value of the supply)	6[1]	25	16	18	7[2]	5.5[3]	12.5	10	15	6[4]	20	5	22	25	5[5]
3 Window cleaning and cleaning in private households	21	25	16	18	16	5.5	12.5	20	6	19	20	17	22	25	17.5
4 Domestic care services (e.g. home help and care of the young, elderly, sick or disabled).	21	25	16	8	16	5.5	[ex]	10	15	19	20	5	22	25	17.5
5 Hairdressing	21	25	16	18	7	19.6	12.5	20	6	6	20	17	22	25 [ex]	17.5

1 Renovation and repair of private dwellings more than five years' old.
2 Masonry work to repair private dwellings.
3 Renovation and repairs to private dwellings completed more than two years earlier.
4 Painting and plastering for the renovation and repair of private dwellings more than 15 years' old
5 Only on the Isle of Man.

The Commission stated that it did *not* intend to review Annex H before the end of the labour-intensive services experiment (i.e. the end of 2002). It would, however

> *"draw up a viable strategy geared to four main objectives: the simplification and modernisation of existing rules, more uniform application of current arrangements and a new system of administrative cooperation*".

It hoped to "*launch a debate in business circles and the Member States*" on the issue of reduced VAT rates. One option, however, might be to establish a new structure based on two reduced rate bands, each applicable to a list of goods and services.

- A rate near the current 5% minimum applying to basic necessities or to fulfil a social objective. This might be *mandatory*.
- A higher reduced rate applicable to other goods and services "for historical reasons or for reasons of economic expediency".

Telecommunications and e-commerce

Under the normal provisions of Article 9 of the 6th VAT Directive, services are taxed at the place of establishment of the service provider. A supplier within the EU must therefore charge VAT; one established outside need not. As long as the purchaser of the service is VAT-registered, this situation will cause only minimal distortion of competition, since input taxes can be deducted. But when the purchaser is not registered, there is a strong incentive to avoid VAT altogether by purchasing from a non-EU supplier.

Until recently, the scope for large-scale tax avoidance was limited. Rapid advances in technology, however, made the purchase of telecommunications services from non-EU suppliers increasingly economic. The problem for national revenues has come not so much from individual phone-users as from large VAT-exempt organisations, notably those involved in financial services. As important has been the distortion of competition between EU-based suppliers, and those based outside.

In March 1997, forestalling Commission proposals for a Directive on the matter, the fifteen Member States simultaneously applied for and granted each other a derogation from the normal provisions of Article 9. The place of taxation for telecommunications services was switched from the supplier's location to that of the purchaser, and the purchaser became liable for the tax – the so-called "reverse charge" procedure. This system was eventually made permanent in preference to the Commission's original alternative (Commission 1997c) – to switch the place of taxation, but retain the collection of tax by the supplier and oblige non-EU suppliers to register for VAT in a single Member State.

Telecommunications services, however, turned out to be only the tip of an iceberg. The expansion of the Internet and the arrival of e-commerce led the Commission to publish a Communication on **Electronic Commerce and Indirect Taxation** in (Commission 1998e). This was followed up by a draft Regulation and a draft Directive (Commission 2000a).

Advances in information technology have made it possible for customers to download certain products from sources which can be, effectively, anywhere in the world. In addition, the distinction between "goods" and "services" has become blurred: software or electronic documents, for example, are "goods" without physical form. It has been agreed that all such products shall in principle be taxed as "services".

This has only partially solved the problem, however. Certain products – for example, books and journals – can take either a physical or an electronic form; and if the former are taxed as

goods, the latter as services, there can be distortions of competition (in the UK the VAT rates would be 0% and 17.5%).

The most serious problem, however, is the tax advantage which such an arrangement gives non-EU based suppliers. Electronic goods downloaded from inside the EU are subject to VAT. Those supplied from outside are not. This gives US or Japanese firms an estimated average tax-related price advantage of between 15 and 20%. At the same time, EU-based suppliers to third countries have to charge VAT.

Four alternative solutions have been proposed.

1. **The Commission's initial draft**. This proposed, as in the case of telecommunications, that non-EU suppliers should register in a single Member State only. This would then have become the place of supply from which VAT could be charged if sales were over €100 000. At the same time, EU-based suppliers would no longer have to charge VAT to non-EU customers. This solution, however, ran into strong opposition in Council, where it was pointed out that non-EU suppliers would be likely to invoice all final consumers from the Member State with the lowest VAT rate, i.e. Luxembourg.
2. **The French proposal**. One alternative consequently proposed by the then French Presidency (Council 2000a) was that non-EU suppliers should register in *all* Member States where they had sales of over €5 000 a year. However, the objection was then raised that such multiple-registration requirements would reverse the current situation, and place non-EU suppliers at a competitive disadvantage compared to EU suppliers. This might have repercussions under international trade agreements, and lead to a complaint against the EU in the World Trade Organisation (WTO).
3. **The Council compromise.** Negotiations within the Council eventually produced a compromise solution, similar to that reached in the case of telecommunications.
   - Non-EU suppliers would be required to register, as under the Commission's original draft, in one Member State only.
   - The rate of VAT chargeable, however, would that in force in the *country of the customer*.
   - The revenues would then be remitted to the country of consumption by the country of registration through a "clearing" mechanism. This is, in fact, a solution which had already been suggested by the European Parliament's Economic and Monetary Affairs Committee.

   One objection to this solution is that he proposed system rests heavily on the ability of suppliers to identify their customers correctly: whether they are businesses or private individuals; and where they live. In the case of Internet commerce, this could prove virtually impossible.
4. **The UK proposal.** This compromise has not therefore been supported by the UK, which instead has proposed the solution implemented in the United States: i.e. that all supplies of this kind of service should be untaxed, at least during the next two or three years. This would place EU-based and non-EU-base suppliers on an even footing. It would also, in the UK at least, place the suppliers of electronic books and printed books on an even footing – though this would not be so in other Member States

Discussions on the problem continue in Council.

The right of deduction

Even before the coming of the transitional system, the most common complaint about the European Community's VAT system concerned the delays experienced by firms established in one Member State in obtaining re-payment of input tax from the authorities of another. The legal framework for transfers of this kind is contained in two VAT Directives: the Eighth (Council 1979a), which covers such refunds in general; and the Thirteenth (Council 1986), which covers refunds to firms not established in the Community.

The refund mechanism established by the Eighth Directive requires claimants to submit an application, attaching originals of invoices or import documents; produce evidence of being a taxable person; and satisfy complex time-scale criteria[11]. In principle, the claimant should be reimbursed after six months. In fact, traders are frequently compelled to pre-finance the tax rebate over lengthy periods. Adding insult to injury, the Directive also states that bank charges for a transfer are payable by the applicant.

The obvious solution is to allow the trader to deduct input tax in the normal way in the country of establishment. However, this would result in the money ending up in the "wrong" national Treasury – the vendor's Member State would be gaining revenue, the purchaser's would be losing. The Commission most recent proposal (Commission 1998b) would remedy this situation by an administrative mechanism to "clear" the revenue from the country in which it was paid to the country where the deduction was made.

Both the Commission and the European Parliament have emphasised that the adoption of this Directive is of the highest priority.

Tax-exemption thresholds for SMEs

Accounting for VAT has always constituted a considerable burden for smaller businesses. As a proportion of tax paid, compliance costs tend to run in inverse proportion to size of enterprise. Moreover, under the current transitional regime the burdens have been potentially even greater for those involved in intra-Community transactions. VAT has also created especial problems for tax administrations in its dealings with smaller firms. They are numerous, but pay relatively small sums in revenue. There is no way of verifying the VAT returns of retailers through claims for input tax deduction.

Both to reduce costs for the businesses themselves and to avoid levying a tax that costs more to administer than it raises in revenue, most countries apply special schemes to SMEs. Article 24 of the Sixth VAT Directive enables Member States to exempt firms whose turnover is below a particular threshold, and to apply simplified procedures to others. However, thresholds, criteria and systems vary widely. Most, but not all, Member States exempt SMEs below a certain annual turnover, with an option for taxation. In some countries there is minimum registration period; and sometimes exemption is combined with a special "equalisation tax" to reduce potential distortions of competition.

Apart from exemption, all Member States then apply various simplification schemes, often applying up to relatively high thresholds. An OECD study of the subject (OECD 1994) gave details of the most common: reductions in net tax payable; longer return and payment periods; accounting for tax on the basis of payments received and made; and simplified calculation of liability and simplified records. Special schemes often apply to retailers. The study noted that in countries with straightforward VAT systems (i.e. one rate with a broad

[11] see Articles 2 and 7 of the Directive.

Table 10. Pending or proposed measures in the VAT field

Measure	Situation
Tax-exemption thresholds for SMEs	Tabled 1987 (COM(87)525), but withdrawn 21/11/96 (see final item in list).
Powers of the VAT Committee	Tabled 1997 (COM(1997)325). Priority of action programme.
Right of deduction	Tabled 1998 (COM(1998)377). Priority of action programme.
Taxation of e-commerce	Tabled 2000 (COM(2000)349). In action programme.
Electronic Invoicing	Tabled 2000 (COM(2000)650. In action programme.
Administrative cooperation and mutual assistance.	Tabled 2001 (COM(2001)294. In action programme.
Taxation of postal services	Promised in action programme for 2000, but not published.
"Recasting" of the 6th Directive.	Promised in tax policy communication.
Place of supply of goods.	Promised in tax policy communication.
Taxation of travel agents.	Promised in tax policy communication. Publication 2001.
Report on the reduced rate(s).	Promised in action programme.
Treatment of public services and subsidies	Listed as "potential future priority" in action programme.
Treatment of financial and insurance services	Listed as "potential future priority" in action programme.
Sales promotion, discount vouchers, etc.	Listed as "potential future priority" in action programme.
Supply of goods: assembly, distribution networks, distance selling.	Listed as "potential future priority" in action programme.
Coordination of customs and taxation.	Listed as "potential future priority" in action programme.
Place of taxation of services: general revision.	Listed as "potential future priority" in action programme.
Rationalisation of Article 27 derogations.	Listed as "potential future priority" in action programme.
Rationalisation of options, rights and derogations	Listed as "potential future priority" in action programme.
Rationalisation of reduced VAT rates	Listed as "potential future priority" in action programme.
Schemes applying to small businesses.	Listed as "potential future priority" in action programme. But see above.

- "action programme": see *Communication from the Commission to the Council and the European Parliament: a Strategy to Improve the Operation of the VAT System within the Context of the Internal Market*, COM(2000)348 of 07.06.2000.
- "tax policy communication": *Communication from the Commission to the Council and the European Parliament: Tax Policy in the European Union - Priorities for the years ahead,* COM(2001) 260.

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base), there tended to be fewer concessions than in countries with multiple rates and/or a wide range of exemptions or zero rates. In other words, simplified schemes tend to be a "second best" offset for complexity in the general VAT system.

In 1987, the Commission's proposed common thresholds (Commission 1987c):

- a 10 000 ECU threshold below which exemption would be *mandatory*;

- a 10 000-35 000 ECU band within which exemption would be *optional*; and
- a threshold of 150 000 ECU below which there would be *mandatory* simplified schemes.

Despite a favourable opinion from the European Parliament, given almost immediately (European Parliament 1987) – and also "*repeated calls for a thorough overhaul of the special schemes applying to small businesses*[12]" – the proposal has remained on Council's table until 1996, when it was withdrawn. The issue now features as a "potential future priority" in the Commission's VAT action programme (see Table 8).

Excise duties

Although, at one time, excise duties were charged on a wide variety of products in different Member States, they are now legally confined to three categories of product: alcoholic beverages; cigarettes and other manufactured tobacco products; and hydrocarbon oils. A certain minimum harmonisation has taken place (for example, in reaching common definitions of tax categories). But decisions on the *rates* of excise duty have always been complicated by continuing disagreements about the *structure* of the duties.

Alcoholic beverages

In the case of alcoholic beverages, for example, all attempts to introduce a simple system based on alcoholic strength have foundered on the firm resistance of the seven Member States which charge no excise on still wines (mainly producer countries) to introduce such a tax. Instead, products are roughly divided into the separate tax categories of:

- wine;
- beer;
- spirits; and
- "intermediate" products.

The Commission's initial proposals within the Single Market programme (Commission 1987d) were that for each alcoholic beverage there would be a single Community rate, fixed as the average of existing national rates. Unlike VAT, however, few national alcohol excises are close to the average rate. No Member State therefore found the proposals acceptable.

A revised proposal (Commission 1989b) then suggested *minimum* rates, together with *target* rates, on which there would be long-term convergence. In the end, only the minimum rates were retained in Directive (Council 1992c). Under the terms of this, the Council should have reviewed the rates by the end of 1994, and adopted any necessary changes. But no Commission proposals were tabled. Instead a *Report on the rates of excise duties* was published (Commission 1995a) proposing that the whole issue should be examined in the course of consultations with national administrations and with trade and other interest groups.

A new report and possibly a new legislative proposal is expected before the end of 2001.

One key issue is **the extent to which different alcoholic drinks are in competition with each other**. In 1983 the European Court of Justice ruled on the levels of duty in the UK on wine and beer (Case 170/78 ECR (1985)). The Court's view was that the products could be considered substitutes since "*the two beverages are capable of meeting identical needs*". The Commission has also traditionally taken the view that "*all alcoholic drinks are more or less in competition*" (Commission 1979).

[12] Commission (2000b), final page.

Recent research (Commission 2001a), however, has reached a less clear-cut conclusion.

> "*From our analysis it is possible to conclude that there is no systematic pattern of whether certain types of beverages are complements or substitutes for each other…..[T]he estimated cross price elasticities between drinks indicate a lack of price sensitiveness between alcoholic drinks."*

Broadly, the consumption of beer, wine and cider was relatively insensitive to excise duty changes. That of sparkling wine, spirits and intermediate products was.

The study also examined **the utility of the existing minimum rates**. Since these had not changed since 1992, it found, they are "*becoming less relevant each year due to inflation*". Had the minima been indexed to at the EU inflation rate, four Member States would have had to raise certain duties. As it was, however,

> *"the Directive had some effect in 1993, but without updating would appear to be generally ineffective in its current form."*

The effects of possible alternatives were therefore examined. All countries, for example, might apply the *indexed minimum rates*. The main effect would be a switch from wine and beer consumption to spirits, particularly in Northern Europe.

Alternatively, there might be a return to the original proposals for *target or median rates*. Here, the effects would depend significantly on the cross elasticities. The consumption of spirits would again rise in Northern Europe, as would the consumption of beer; but that of wine might rise or fall. In most of Southern Europe the consumption of spirits would fall, with that of still wine either falling or remaining roughly constant.

Finally, the study looked at **the effect of rate differences on the cross-border movement of products.** Substantial rate differences existed between the UK and France; between Sweden and Denmark; and between Denmark and Germany. These resulted in revenue losses by the higher-taxed country. The main conclusions were that:

- Revenue losses through legitimate cross-border shopping were modest, with the UK losing the most (€400 million a year).
- Losses through illegal cross-border smuggling, however, presented "a very different picture" (see next section).
- In absolute terms, the UK was losing most revenue. In terms of market share, however,

  > "*the problem is more acute in Denmark and Sweden, where about a quarter of spirits consumed are bought outside the consumers' own member state*".

Tobacco products

The basic structure of tobacco excises within the Community was established in 1972, but with a large number of amending Directives being passed in the year that followed. These were eventually amalgamated into a single consolidated text (Council 1995).

The categories of tobacco subject to taxation are defined as cigarettes; cigars and cigarillos; smoking tobacco (fine-cut for the rolling of cigarettes); and smoking tobacco (other). **Cigarettes** are subject to

- A proportional (*ad valorem*) excise duty, calculated as a percentage of the maximum retail-selling price[13] by reference to the most popular price category (MPPC); and to

[13] In the United Kingdom the retail price of cigarettes is identified as

- A specific excise duty calculated as a fixed sum per thousand cigarettes. The amount of the specific excise duty may not be lower than 5% of the aggregate amount of the proportional and the specific tax, and it may not be lower than 5% nor higher than 55% of the total tax burden (i. e. proportional, specific and VAT together).
- The rate of the duties must be the same for all cigarettes, whatever their selling price.
- VAT is charged at the standard rate on the whole excise duty-inclusive price.
- The overall minimum excise duty on cigarettes (proportional and specific excise duty, but excluding VAT) must be at least equal to 57% of the retail-selling price for cigarettes of the MPPC, according to data established on 1 January of each year (the "57% rule").

As far as **tax rates** are concerned, the Commission's original proposals (Commission 1987e and 1987f) were for the absolute harmonisation of rates. For tobacco products, the proposed rate was the arithmetic average; in the case of cigarettes the average specific rate (ECU 19.5 per thousand at that time) plus the average proportional rate (53% including VAT at that time). In the end, the Directives on cigarettes, 92/79/EEC, and other tobacco products, 92/80/EEC, set only bare minimum rates:

- Cigarettes: 57% of the tax-included retail price;
- Hand-rolled tobacco: 30% of t-i. retail price, or ECU 20 per kilo;
- Cigars & cigarillos: 5% of t-i. retail price, or ECU 7 per 1000 or per kilo;
- Pipe tobacco: 20% of t-i. retail-price, or ECU 15 per kilo.

This minimum level of rate harmonisation at EU level is compatible with very large differences in overall tax rates and in prices. In the United Kingdom the excise burden, in terms of €, is over 400% higher than in Spain. The excise yield from cigarettes, expressed in terms of € per 1000, is over €100 for UK, Ireland, Denmark, Finland and Sweden, while it is well below €70 for Spain, Italy, Portugal, Greece and Luxembourg. These differences can lead to widespread cross-border movements of tax-paid cigarettes, both legal (for personal consumption) and illegal (for resale).

However, the difficulty of reaching more harmonised rates reflects the structure of the Community tobacco industry. A specific tax on cigarettes benefits the more expensive products of the private companies by narrowing price differences. A proportional tax, particularly when combined with VAT, has the opposite effect, multiplying up price differences. Some Member States have accordingly chosen a minimum specific element, others have chosen a maximum, so contributing to variations in retail prices.

The rates and structure of excise duty are subject to review every three years. The last Commission report (Commission 2001b) was the result of an in-depth analysis of the rates and structures of excise duties on tobacco products and was accompanied by a proposal for a directive amending the existing tobacco legislation. In addition, the Commission proposed an amendment to the current Directives[14] in order to extend to four years the review period.

"(a) the higher of-

(i) the recommended price for the sale by retail at that time in the United Kingdom of cigarettes of that description, and

(ii) any (or, if more than one, the highest) retail price shown at that time on the packaging of the cigarettes in question; or

(b) if there is no such price recommended or shown, the highest price at which cigarettes of that description are normally sold by retail at that time in the United Kingdom".

(Finance Act 2000, Chapter 17, Section 13, amending Section 5 of Tobacco Products Duty Act 1979).

[14] Article 4 of Directive 92/79/EEC and Article 4 of Directive 92/80/EEC.

One of the problems with the present system is the "57% rule" itself. If the level of overall excise duty is already at or close to the 57% minimum, a rise in base price can lead to the overall excise falling below 57%, requiring an increase in excise duty. This will be the case even if the level of final price is comparatively high; and the increase may therefore result in a *widening* of the disparities in final price. Sweden, for example, despite its extremely high cigarette price and excise yield, has great difficulties in complying with the minimum rate. Sweden's overall minimum excise duty is given by the sum of the specific element (11.27%) and the proportional one (39.20%); and reaches only 50.47%. It is for this reason that Sweden has had a temporary derogation from the overall minimum excise rate of 57% up to and including 31 December 2002 (Council 1999b).

The Commission draft Directive proposed to remedy this situation through a *minimum specific excise* as an alternative to the 57% rule. Member States would have had to apply:

- *either* the minimum excise incidence (specific and *ad valorem* together) of 57% of the tax-inclusive retail-selling price of the most popular price category; *or*
- a minimum excise (specific and *ad valorem* together) of €100 per 1000 cigarettes for the category most in demand.

However, in order to produce a faster convergence of duty rates, the Commission also proposed a minimum specific excise *in conjunction with* the 57% rule. Member States would have had to apply:

- the minimum excise incidence (specific and *ad valorem* together) of 57% of the tax-inclusive retail-selling price of the most popular price category; *and*
- a minimum excise (specific and *ad valorem* together) of €70 per 1000 cigarettes.

The minimum specific excise proposed is lower than the average specific excise of about €90 per 1000 cigarettes. The new requirement would, as a result, have affected only those Member States which meet the 57% rule but, because of their relatively low prices, are able to levy a low real amount of excises. In particular, five Member States (Spain, Italy, Greece, Portugal and Luxembourg) would have had to increase their excise duties (see Table 11).

Table 11. Estimated increase in cigarette prices as result of Commission proposals
(assuming no change in specific/ad valorem balance)

Country	% increase *(most popular brand)*
Spain	27
Greece	18
Italy	18
Portugal	16
Luxembourg	11

Source: Commission internal memorandum

The Commission proposals therefore proved highly controversial. Opponents argued not only that the rises in cigarette prices would increase inflation rates (particularly if applied in the currently low-tax candidate countries) and damage tobacco producers, but that they are unnecessary. Since 1993 there has, in fact, been a convergence of cigarette taxes within the EU. The ratio of the standard divergence to the mean has fallen from about 6.5% to just under 6%, though since 1998 the divergence has marginally increased again.

In November 2001, a compromise was arrived at in Council. The €100 per 1000 *alternative* threshold was reduced to €95; and the €70 *additional* threshold to €60 per 1000 from July 2002, rising to €64 from July 2006. Spain and Greece will also be given derogations: until 2005 for the €60 minimum and 2008 for the €64 minimum.

Meanwhile, however, Parliament rejected the entire proposal at its sitting of November 2001; and declined to give an opinion by referring the matter back to committee. The Committee has given its *rapporteur*, Prof. Katiforis, a mandate to negotiate with Council and Commission.

Mineral oils

The basic structure of mineral oil excises within the Community was established by Directive (Council 1992d). Every Member State was required to apply an excise duty to mineral oils used as motor fuels or heating fuels, subject to certain exemptions, which were to be reviewed by no later than the end of 1997. The duties are specific: i.e. calculated per 1000 litres or per 1000 kilogram. For the purposes of excise. Mineral oils are defined as covering: leaded petrol; unleaded petrol; gas oil; heavy fuel oil; liquid petroleum gas (LPG); methane; and kerosene.

The Commission's original proposals for the rates of excise duties, within the context of the Single Market programme (Commission 1987g), were for absolute harmonisation, based on average rates (for petrol and LPG the arithmetic average, for fuel oil a weighted average). Even in the revised approach document of June 1989 (Commission 1987h) the Commission argued that single rates or rate bands should be applied to mineral oils because "*the risks of competitive distortion...are greater in this area than for alcohol and tobacco*".

Nevertheless – and as in the case of alcohol and tobacco – only minimum rates were eventually fixed by (Council 1992e). These were:

- leaded petrol: ECU 337 per 1000 litres;
- unleaded petrol: ECU 287 per 1000 litres on the understanding that "*in every case the rate of duty shall be below that charged on leaded petrol*";
- gas oil: ECU 245 per 1000 litres with reduced rates for heating oil;
- heavy fuel oil (diesel): ECU 13 per 1000 kg.;
- LPG and methane used as a propellant: ECU 100 per 1000 kg.; in other cases ECU 36 per kg. or ECU 0 per kg.
- kerosene used as a propellant: ECU 245 per 1000 litres; otherwise ECU 18 per 1000 litres, or ECU 0.

Every two years, "*and for the first time not later than 31 December 1994*", these rates were to be reviewed "*on the basis of a report and where appropriate a proposal from the Commission*". The Commission's first report, however, was not formally published until September 1995 (Commission 1995a). Though earlier drafts had proposed various changes to the minimum rates; making unleaded rather than leaded petrol the basis for the standard minimum; and a narrowing of the gap between petrol and diesel rates, the final report made no formal proposals.

It likewise observed that, though there were strong arguments for increasing the minimum rates of excise on heating fuels, this depended on extending the scope of the duty to cover competing fuels (e.g. natural gas and coal). The Commission undertook detailed consultations

with national administrations and with trade and other interest groups, including a conference on excise duties in Lisbon on 13-15 November 1995.

In 1997, the Commission duly made a new proposal (Commission 1997d). This sought to build on the existing system for the taxation by extending it to all energy products, and in particular to products which are directly or indirectly substitutable for mineral oils: coal, coke, lignite, bitumens and products derived from them; natural gas; and electricity.

In the case of electricity, the tax would be on the electricity itself rather than the fuel inputs, although a rebate would be possible where "environmentally preferable" fuels were used for generation. Various rebates, etc. would be made available to certain industries with high energy costs. The legislation would introduce *minimum excise* duties (see Table 12).

Table 12. Commission proposal of 1997 on energy taxation

Energy products used as motor fuels	
Petrol (€ per 1000 l)	417
Kerosene (€ per 1000 l)	310
Natural gas (€ per gigajoule)	2.9
Gas oil (€ per 1000 l)	310
LPG (€ per 1000 kg)	141
Energy products used as motor fuels for certain industrial and commercial purposes	
Gas oil (€ per 1000 l)	32
LPG (€ per 1000 kg)	41
Kerosene (€ per 1000 l)	30
Natural Gas (€ per gigajoule)	0.3
Energy products used as heating fuels	
Heating gas oil (€ per 1000 l)	21
Kerosene (€ per 1000 l)	7
Natural Gas (€ per gigajoule)	0.2
Solid energy products (€ per gigajoule)	0.2
Heavy fuel oil (€ per 1000 kg.)	18 or 22
LPG (€ per 1000 kg)	10
Electricity (€ per Mwh)	1

So far the Council has not accepted these proposals.

The Commission's most recent suggestions for the taxation of aircraft fuel (Commission 2000d), has run into a problem of a different kind (but similar to that in the case of withholding tax). A duty could only be effectively imposed upon domestic flights, or on flights originating within the EU, with damaging competitive consequences for EU-based operators.

Tackling tax fraud

The Commission Communication of May 2001 observed that

> *"both in the area of direct and indirect taxation tax fraud is a phenomenon of growing concern to EU Member States, but also globally."*

The Commission's third report on administrative co-operation in the field of **Value Added Tax** (Commission 2000c), for example, began with the trenchant observation:

> *"The transitional VAT arrangements have been in place for more than 6 years. During this period, one would have expected that the implementing problems should have been solved and that the system should be running smoothly. However, this does not appear to be the case. The 6 years appear to have given the fraudsters time to appreciate the possibilities offered by the transitional VAT arrangements to make money, while, generally speaking, Member States have not met the challenge posed by fraud."*

An earlier report from the EU's Court of Auditors estimated that the gap between the amount of VAT theoretically payable, based on GDP figures, and the amount actually collected amounted to €70,000 million, or 21% of Member States' revenues.

The fact that, under the transitional system, goods generally travel between Member States untaxed is at the root of much VAT fraud. Under the pre-1993 system, exports from one Member State to another were also zero-rated; but VAT was levied at the frontiers when the goods entered the importing country. From the end of 1992 frontier controls were abolished, and VAT became liable only at the point of delivery. Opportunities for fraud also arise from complexities in documentation – e.g. claiming deduction of input tax on forged invoices.

The Commission's report of January 2000 outlined the findings of its research into the fraud problem. Examination of a thousand reported VAT frauds revealed €1 300 million of real VAT losses, which it believed were "the tip of the iceberg". A relatively small number of VAT officers had to police 24 million VAT traders making intra-Community transactions worth €930 000 000 000 a year. There was "*very low activity in the field of administrative co-operation",* and *"extreme slowness of response to requests for information*". In addition, the computerised VAT Information Exchange System (VIES) was not being optimally used.

In the case of **excise duties**, the illegal component of the movements such as that into the UK of alcoholic beverages and tobacco generally arises from abuse of provisions contained in the 1992 Directive on the movement of products subject to excise duty (Council 1992a). Individual final consumers can take duty-paid goods from one country to another, without paying further duty, provided that the products are for their own personal consumption. "Indicative allowances" have been set, below which there is a presumption that this is the case. "Personal consumption", however, is a flexible term; and, from the start, white vans have been sent from the UK to France by ferry or tunnel to pick up stocks for weddings, parties, football matches and so on[15]. More recently, however, there has been evidence of very large-scale movements by organised gangs, particularly of cigarettes, for illegal resale.

Cigarettes have also featured in much more widespread and expensive frauds throughout the EU. Abuse of transit procedures has enabled smugglers to bring products into one Member State for delivery, under the tax suspension regime, to another. In theory, duty becomes

[15] There have recently been complaints that the UK customs authorities, in an attempt to limit the influx of alcoholic and tobacco products, have been acting against anyone bringing in more than the "indicative allowances". Since, in principle, all EU citizens have the right to bring in unlimited quantities for personal use, the Commission launched an infringement proceeding against the UK in October 2001.

payable when the products are released for consumption in the country of final delivery. In practice, the goods have often vanished *en route*.

As in the case of legitimate movements resulting from large differences in tax rates, the consequences of fraud are both revenue losses and damage to legitimate traders (i.e. "harmful tax competition"). It has been estimated, for example, that some 1 million pints of beer are being brought across the Channel to England *every day*[16], about half of which is being illegally resold. The cost to the UK Exchequer has been put at some £1.5 billion a year. Similarly, in 1999, some 18% of the UK cigarette market was estimated to be contraband. Even in lower-taxed Italy the percentage was between 12% to 15%. The loss to the United Kingdom national budget, for example, was put at £2.5 million in 1999.

Unlike legitimate movements, however – where at least some revenue accrues to the lower-tax country of supply – fraudulent movements generally escape tax altogether. This, in turn, can have consequences not only for national Budgets, but also for the "own resources" of the European Community. In addition, fraudulent movements are frequently carried out by organised groups which are linked to other criminal activities like the supply of illegal drugs, the evasion of immigration controls and money-laundering.

When the transitional VAT system and the "duty suspension" system for excisable goods were adopted, it was hoped that the scope for fraud would be limited by very close co-operation between national tax authorities. The proposal for an autonomous EU customs service was rejected; but initiatives were adopted for improving co-operation between national authorities through integrated systems, exchanges and training programmes for national customs officers – for example, the MATTHAEUS programme, and its successor, FISCALIS (Council 1998a); and measures to improve mutual assistance on the recovery of unpaid tax (Council 1998b).

It has since become clear that cooperation between tax authorities has been insufficient. In 1999 the Council established an *ad hoc* working party, which reported in 2000, and outlined a number of measures to be taken by the Commission and by the Member States themselves.

The most recent proposals in the VAT field (Commission 2001g) are designed to strengthen cooperation between Member State tax authorities by removing outstanding obstacles to the exchange of information. The three main objectives are:

- to lay down clearer and binding rules governing the exchange of information,
- to provide for more direct contact between national anti-fraud agencies, and
- to facilitate more intensive exchange of information.

In the field of excise duties, the Commission has proposed the creation of a computerised Excise Movement and Control System (EMCS) (Commission 2001m). The Commission is also proposing that Member States can exchange information concerning certain taxes levied on insurance premiums.

Finally, the Annual Report for 2000 on *Protection of the Communities' Financial Interests and the Fight Against Fraud* (Commission 2001d) was accompanies by an *Action Plan for 2001-2003* (Commission 2001e). This included the fostering of a "culture of prevention" (for example, the "fraud-proofing" of legislation); strengthening the legal instruments for detection and sanctions; and greater cooperation with third countries, in particular the candidate countries.

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

The taxation of occupational pensions[17]

In June 1997 the Commission published a "Green" consultation paper on "*Supplementary Pensions in the Single Market*" (Commission 1997f). This drew attention to a number of specific problems affecting the development of such schemes within the EU as a whole, and especially across national frontiers. In particular, Chapter V covered "*The Importance of Taxation for Supplementary Pensions*". It noted that

> *"the tax rules which have been developed over many years are extremely complex and specific to each Member State",*

creating obstacles both to the free movement of workers and to a single market in financial services. A report on the results of the consultation (Commission 1999a), observed that

> *"these tax distortions are regarded by the industry and by the financial sector as the main obstacles to the establishment of a genuine single market in supplementary pensions."*

"The elimination of tax obstacles to the cross-border provision of occupational pensions" (Commission 2001c) appeared in April 2001, taking the form of a Communication rather than draft legislation. The Commission distinguished three levels of possible taxation:

1. The contributions. The main issue is whether these are paid out of pre- or post-tax income: i.e. whether they are exempt from normal income tax. In all Member States there is some exemption; but there are variations between Member States as regards:

- the amount of exemption permissible; and
- the definition of schemes into which payments from tax-exempt income can be made.

2. The investment returns. Where supplementary pension schemes are organised on the basis of a fund invested in assets, the issue arises as to whether tax should be levied on:

- the income from the assets; and
- any appreciation in the capital value of the fund.

The Commission paper notes that some tax is levied in Denmark, Italy and Sweden.

3. The pension payments themselves. The Commission notes that most Member States tax pension benefits; but that the rates of tax and of tax-free allowances vary considerably. It also notes the distinction made, in some cases, between:

- regular payments made as income; and
- lump sum payments.

The latter are sometimes un-taxed or taxed at a lower level; and sometimes banned entirely.

Systems of taxation: the TEE, ETT, EET issue

The systems of taxing pensions can therefore be classified as follows:

1. **Taxed, Exempt, Exempt (TEE),** where contributions must paid out of taxed income, but neither investment returns nor benefits are in principle subject to tax. Only Germany and Luxembourg fall into this category.
2. **Exempt, Taxed, Taxed (ETT),** where contributions can be paid out of untaxed income, but where both investment returns and benefits are subject to tax. Denmark, Italy and Sweden fall into this category.

[17] For a fuller treatment of this subject, see "The Taxation of Occupational Pensions", Briefing ECON 517, European Parliament Directorate-General for Research, July 2001.

3. **Exempt, Exempt, Taxed (EET),** where neither contributions nor investment returns are subject to tax, but where benefits are. All other Member States fall into this category.

Under provisions of the OECD Model Tax Convention[18], a pensioner is normally taxable in the country of actual residence. This applies even if contributions to the relevant pension fund have been made in another country; and irrespective of whether they have been paid out of taxed or untaxed income.

This situation has a number of consequences.

- Where contributions are made out of untaxed income, but the pension is paid in a country where no tax is levied on benefits (EET/ETT ►TEE), tax may be avoided altogether.
- Where contributions have been made out of taxed income, and the pension is paid in a country where benefits are taxed (TEE ►EET/ETT), the result can be double taxation.
- Where contributions are made out of untaxed income, and the pension is paid in a country where tax *is* levied (EET/ETT ► EET/ETT), there will be a transfer of fiscal capital from the country of employment to the country of retirement.
- In contrast, where contributions are taxed, and the pension is paid in a country where no tax is levied (TEE ►TEE), there will be no such fiscal transfer.

The Commission's preferred solution is to "*strive for alignment of Member States' pension taxation systems on the basis of the EET principle*" – in effect, a switch of systems by Germany and Luxembourg. It does not, however, propose legislation. It recognises, however, Commission the different systems are likely to coexist for some time to come, and therefore suggests practical solutions other than harmonisation.

- Double-taxation problems could be avoided through the conclusion of double-taxation treaties such as those between Denmark and Sweden, or the US and Canada.
- Tax avoidance problems could similarly be solved through agreed exceptions to the principle of taxing pensions on the basis of residence, as provided for in the tax treaty between the Netherlands and Portugal.

Other issues

- **Should contributions paid into a pension scheme in another Member State qualify for tax relief on the same basis as those into a domestic scheme?**

  The Commission argues, in effect, that Community law already requires this to be the case, and declares that it will monitor Member States' rules and

  > *"take the necessary steps to ensure effective compliance with the fundamental freedoms of the EC Treaty, including bringing the matter before the Court on Justice on the basis of Article 226…"*

- **Should contributions to a pension scheme in another Member State be tax-deductible if it conforms to the "tax-approved" rules of its own country, but not to those of contributors' country?**

  The principle of "mutual recognition" would imply: yes. The Commission's answer, however, is that

  > *"Member States are entitled to require that such schemes meet the conditions applied to similar domestic schemes.."*

[18] This Convention has no legal force, but most bi-lateral tax treaties follow it closely.

- **When an employee moves from one company to another, what should happen to his or her accrued rights in any occupational pension fund?**

  The main alternatives are to "freeze" the accrued rights until retirement; or to transfer the capital sum into an occupational scheme with the new employer. A problem with the first alternative is that a pensioner who has frequently changed jobs may be drawing benefit from many different funds; and total payments may turn out to be less than if there had been membership of a single fund (for example, because of the relationship to final salary). The second alternative, as the Commission puts it, is often "*difficult or even impossible*". In addition, where the employee has moved from one Member State to another, there can be an added tax problem – the Member State from which the capital sum is being moved may require tax to be paid equal to the amount of exemptions on the original contributions. The Commission believes such situations may contravene the Treaty, notably where pension capital is taxed on cross-border, but not domestic transfers.

- Benefits paid from a pension fund based in one Member State to a pensioner resident in another are normally taxable in the country of residence. **But how can the country of residence be sure that pension payments from a fund in another country are properly declared for tax purposes?** The perceived danger to revenues does not principally arise in the case of those who have worked in one country, but retired to another. Rather, it is the possibility that those who *both work and reside* in one Member State will nevertheless participate in a pension scheme based in another. Such a situation can arise simply because an employee works for a firm based in another Member State.

  In the case of payments within the *same* Member State, the Commission notes that national tax laws usually

  > *"impose an obligation on domestic pension institutions to inform national tax authorities of any payment of pension benefits, and in some cases to deduct tax at source."*

  One solution would therefore be for a similar obligation to exist in relation to cross-frontier payments. This could be organised on an "exchange of information" basis, similar to that now proposed in the case of bank and other interest paid to non-residents. The Commission notes that the necessary legislation is already in place in the form of the Mutual Assistance Directive (Council 1977b); and proposes consultations in the Committee provided for in the Directive's Article 9(1) to agree detailed arrangements for information-exchange on occupational pensions.

- **Why shouldn't companies operating in more than one Member State be able to set up a "pan-European pension fund", to which employees working anywhere in the EU could belong?** Such a fund could be based in one Member State only; but have different sections, corresponding to the Member States in which the company had employees. It could be managed in such a way that each section would comply with the tax regulations of the Member State in question. Where tax was due – on investment yield under an ETT system, or on benefit payments under an EET or ETT system – the fund could collect the tax and pay it to the appropriate tax authority. The Commission

  > *"invites Member States to explore with it how the proposal…could be made operational."*

In October 2001 the Council discussed a number of these issues, and resolved to examine instances of double- or non-taxation.

The taxation of vehicles

In 1997 the Commission published a background paper on *Vehicle Taxation in the European Union* (Commission 1997h). All Member States, this noted,

> "*rely heavily on a range of tax instruments to ensure significant budgetary receipts from both private and commercial road users*".

But various pressures had resulted in "*large differences in the overall strategies followed.*." The result was that "*we are a long way from a true single market*".

Tax instruments

The study listed vehicle taxation under three broad categories:

1. **Taxes on the acquisition, purchase or registration of a vehicle.** All Member States levy **Value Added Tax** on the purchase of new vehicles. Under the special regime introduced under the transitional VAT system, this is levied in the country of destination, even if the purchaser is the final consumer. For this purpose, "new" vehicles are defined as those which have travelled less than 6 000 kilometres, or which have been in service for less than six months. VAT is usually deductible as input tax in the case of commercial vehicles. Passenger cars are in some Member States fully deductible; in others partially deductible; and in others not deductible at all.

   Before 1993, a number of Member States applied "luxury" VAT rates (or special excise duties) on motor vehicles, which were abolished under the transitional system. In most cases, however, these were replaced by **registration taxes**, usually related to the characteristics of the vehicle, and payable on the issue of registration plates and documentation[19]. Sometimes a **registration fee** is added to cover administrative costs.

2. **Taxes on the possession or ownership of a vehicle.** In all Member States, vehicles are not permitted to circulate on the public highway without the payment of an **annual road tax** – usually through the purchase of a *vignette* to be displayed on the windscreen. These can be at a flat rate, or, like registration taxes, be related to the power, age or other characteristics of the vehicle. In addition, all vehicle users are required to carry at least third-party **insurance**, the premiums on which can incur tax.
3. **Taxes on the use of vehicles.** The **fuel** used by motor vehicles is subject in all Member States to both **VAT** and **excise duties**. Under Community law, the excise on leaded petrol must be higher than that on unleaded petrol; and the tax on the diesel used by commercial vehicles is usually lower than that on petrol. A number of Member States also charge **tolls** for the use of some motorways. Six Member States operate a *Eurovignette* system, the purchase of which allows access to their motorways.

The diversity between national systems has created problems for the Single Market.

Competition and car prices

Successive surveys have revealed that the pre-tax price of identical models of car can vary by more than 20% between different Member States. This has given rise to a running dispute between the car manufacturers and their distributors on the one hand, and car purchasers, independent distributors and "parallel traders" on the other.

[19] The UK is the only Member State not levying registration taxes.

- The latter have argued that the ability of motor manufacturers to sell cars through tied dealer networks (the result of a "block exemption" from normal competition policy, which is currently under review) has enabled them to segment the Single Market, and maintain higher prices and profit margins in some parts of the Market than in others. Despite efforts by the Commission to ensure that any model of car must be purchasable in one Member State for delivery in another ("full-line availability"), the manufacturers are accused of making this, in practice, as difficult as possible.
- The manufacturers have replied that the segmentation of the market largely results from differences in national taxation systems. The level of tax may depend on definitions of vehicle category, which can vary widely. As a result, the same model may have to be produced to different specifications in different countries. More significantly, the very large differences in tax rates – particularly of registration taxes, which can vary between 0% of the pre-tax price in the UK and 180% in Denmark – have meant that broadly similar *post-tax* prices are divided in different proportions between *pre-tax* price and taxation. The lowest pre-tax prices are found in those countries with the highest taxes.

The 1997 study observes, pointedly, that

> *"Member States with a large car production tend to have relatively low registration taxes or no taxes at all."*

The taxation of vehicles in use

The application of VAT to commercial transactions in used vehicles is governed by the 7th.VAT Directive (Council 1994) and has worked relatively smoothly. Application of the destination principle to vehicles owned and in use by final consumers, however, has given rise to substantial problems.

The Commission paper observed, for example, that

> *"the treatment of individuals moving, either temporarily or permanently from one Member State to another with their cars can, in some cases, be more restrictive now than prior to 1993."*

Under current Community law, **a vehicle used in a country other than that in which the user is normally resident** does not become liable to tax in the country of use provided it is not there for more than six months in the year. Numerous problems arise, however, in applying this rule: establishing and proving residence; the question of who can drive a vehicle which is taxed in another country, etc.

The situation when a vehicle moves between countries on **transfer of residence** is theoretically covered by a Directive on "*tax exemptions applicable to permanent imports...of the personal property of individuals*" (Council 1983). The study observed, however, that this Directive has in effect become obsolete, since import taxes are prohibited within the Single Market, and other taxes are not covered.

The study also drew attention to the special problems in the **car rental sector**.

> *"At present, a vehicle registered in one Member State cannot be hired for use in another Member State by a resident of that latter Member State."*

There was, in effect, no free movement of rental cars. But if there were to be, the study added, most car rental firms would probably operate from the countries with the lowest taxes.

In 1998 the Commission tabled a comprehensive proposal, covering both temporary and permanent movements of vehicles (Commission 1998c). Following the passage of

amendments by the European Parliament, a revised proposal was made (Commission 1999b). Under this, the levying of new registration taxes on transfer of residence would have been prohibited. In the case of temporary use, the six months rule would have been made more flexible. Where there were "professional ties", for example, the period would have been nine months; and provisions would have existed permitting use by persons other than the owner; on hire cars; and for special circumstances like scrapping following irretrievable damage.

The Council, however, has held only limited discussions on the text, and is now unlikely to adopt it. In its Communication of 2001, the Commission therefore promised a further examination of the whole area of vehicle taxation (see earlier), with the aim of remedying some of the defects in the current system through cooperation rather than legislation.

The taxation of passenger transport

It is also worth recalling, in the context of transport policy, that the issue of VAT on passenger transport is still largely unresolved. Article 9.2(b) of the Sixth VAT Directive states that

> "*the place where transport services are supplied shall be the place where transport takes place, having regard to the distance covered*".

If fully applied, this would mean that any journey across two or more Member States would be taxed in "slices", corresponding to the distance covered in each territory. Each slice might be taxed at a different rate; and the revenue from each slice would need to be paid into a different Treasury, with transport operators registering separately for VAT in each country.

However, the abolition of frontier controls in 1993 made monitoring these rules practically impossible. The Commission's 1994 report on the operation of the transitional VAT system (Commission 1994b) indeed observed that it was *"a moot point whether these rules are effectively applied*".

As it happens, Article 28.5 of the Sixth Directive states that, once the "definitive" VAT system in place, "*passenger transport shall be taxed in the country of departure for that part of the journey taking place within the Community…"*. The Commission tried to bring this change forward by publishing a draft Directive (Commission 1992). This provoked considerable dissent – the alternatives proposed included taxation at the place where a transport operator is established, or the exemption of all passenger transport – and was eventually withdrawn.

The Reform of Corporate Taxation

At the end of 1998, the Commission was asked by Member State governments to prepare "*an analytical study of company taxation in the European Community*", a request which became a formal mandate in mid-1999. The Commission accordingly established two panels of experts, one academic and one from the business community and trade unions. The study – some 700 pages long, including Annexes – was published in October 2001 (Commission 2001j). There followed a Commission Communication "supplementing and building" on the study (Commission 2001k).

Tax obstacles to cross-border activities

Picking up from the Ruding Report of 1992 (see last Chapter), the study observed that the underlying analysis of that report was still topical, but that "*the overall economic framework has changed significantly since the early nineties*". In particular, there had been two major

developments impacting on the functioning of the tax system: the Single Market (from 1993); and Economic and Monetary Union (from 1999). European business was now

> *"confronted with a single economic zone in which 15 different company tax systems apply".*

This reduced overall economic efficiency and transparency, and produced extra costs for European companies, which increasingly

> *"no longer define one Member State but rather the whole EU as their 'home market'".*

The situation created a number of obstacles to cross-border activities; for example:

- Companies were obliged to allocate profits to each jurisdiction on an "arm's length" basis by separate accounting, i.e. on a transaction by transaction basis.
- Member States were reluctant to allow relief for losses incurred by associated companies whose profits fell outside the scope of their tax jurisdiction.
- Cross-border reorganisations entailing a loss of taxing rights for a particular Member State could give rise to capital gains taxation and other changes.
- Double taxation could arise when Member States' taxing rights conflicted.
- Above all, the need to comply with a multiplicity of different tax rules in different countries represented a substantial barrier, more especially for Small and Medium-sized Enterprises (SMEs).

Effective tax rates

Differences in effective tax rates within the Single Market also affected the behaviour of companies. If two different companies competing in the same market faced two different tax rates, there was an impact on their relative competitivity. This, in turn, influenced the location choice of activities. But

> *"from the point of view of economic efficiency, tax systems should ideally be 'neutral' in terms of economic choices….[T]he choice of investment, its financing or its location should in principle not be driven by tax considerations".*

Such an analysis, the study conceded, had to be modified by other considerations.

- Taxation was only one of the determinants of investment decisions. Moreover
  > *"taxation ultimately involves a political choice and may entail a trade-off between pure economic efficiency and other legitimate national policy goals and preferences".*
- Within the EU context, it was also necessary to bear in mind the subsidiarity principle.
- Finally, "*weaknesses of existing methodologies*" and lack of data did not make it possible to "*provide empirical evidence of the impact of taxation on actual economic decisions*".

Effective corporate tax rates nevertheless varied considerably between Member States (see Table 13). The range of differences in domestic corporation tax rates was around 37 percentage points in the case of marginal investment, and around 30 percentage points in the case of more profitable investment. In addition, there were variations in the way that each country treated investments in or from another country, so that

> *"the effective tax burden on a subsidiary of a parent company…depends crucially on where that subsidiary is located….[T]he range of variations of the effective tax burdens of subsidiaries located in different host countries can rise above 30 points, regardless of the method of financing the subsidiary".*

The data also showed that:

- On average, outbound and inbound investment were more heavily taxed than otherwise identical domestic investment; but that
- The working of the international tax system meant that foreign multinationals operating in a host country were likely to face a lower effective tax burden than domestic companies.

Table 13. Effective Average Corporation Tax rate by Country, 2001
(by asset, source of finance and overall)

Country	Overall 1999	Overall 2001	Intangibles Buildings	Industrial Buildings	Machinery	Financial Assets	Inventories	Retained Earnings	New Equity	Debt
Austria	29.8	27.9	26.4	28.2	26.2	30.9	27.6	30.7	30.7	22.6
Belgium	34.5	34.5	30.7	36.1	31.0	39.2	35.3	39.1	39.1	25.8
Denmark	28.8	27.3	19.9	33.3	24.7	29.3	29.3	30.7	30.7	21.0
Finland	25.5	26.6	25.7	26.6	23.9	28.3	28.3	30.0	30.0	20.8
France	37.5	34.7	27.8	38.2	38.4	35.6	33.8	39.0	39.0	26.8
Germany	39.1	34.9	30.8	36.0	33.0	39.2	35.4	38.7	38.7	27.7
Greece	29.6	28.0	33.3	28.5	31.3	11.9	34.8	32.4	32.4	19.7
Ireland	105	10.5	8.9	15.8	8.2	9.8	9.8	11.7	11.7	8.2
Italy	29.8	27.6	22.5	27.1	24.9	35.1	28.4	28.7	28.7	25.5
Luxembourg	32.2	32.2	28.6	33.7	29.2	36.6	32.9	36.6	36.6	24.0
Netherlands	31.0	31.0	26.7	32.6	29.2	34.2	32.5	35.2	35.2	23.3
Portugal	32.6	30.7	31.3	30.1	26.9	34.4	30.9	34.8	34.8	23.0
Spain	31.0	31.0	31.1	31.8	27.4	34.2	30.7	35.2	35.2	23.3
Sweden	22.9	22.9	19.6	23.4	19.7	25.7	25.7	26.0	26.0	17.1
UK	28.2	28.3	24.2	34.0	24.7	29.3	29.3	31.8	31.8	21.7

Source: SEC(2001)1618

Tax base or tax rate?

A crucial finding of the study concerned the extent to which such variations in effective taxation resulted from *differences in tax rates*, as opposed to *differences in the tax base*.

A previous study (Baker & McKenzie, 1999 & 2001) had found that

> *"the composition of the tax base does not have a great impact on the effective tax burden and that the level of the tax rate is the truly important factor for the difference in the tax burden."*

The simulations carried out for the Commission study achieved much the same results, from which two main conclusions could be drawn:

- By far the most effective way of decreasing the dispersion of effective taxation, and of reducing locational inefficiencies, would be **introducing a statutory common tax rate in the EU.**
- Introducing **a common tax base**, or applying the **home country tax base** to EU-wide profits, would not achieve such an objective. Worse – it could **increase the dispersion in effective tax rates** if nominal tax rates were not also harmonised.

These findings have clearly created some problems for the Commission. The Communication notes that the conclusions were the result of "static analysis", and did not assess the possible dynamic effects if particular features of the tax system were harmonised in isolation. So

> *"at this point in time, there is no convincing evidence for the Commission to recommend specific actions on the approximation of the national corporate tax rates or the fixing of a minimum corporate tax rate."*

Instead, the Commission would monitor trends "*in order to understand the dynamic effects of the reforms in progress*".

The framework for possible remedies

The study identified two possible approaches to company tax obstacles in the Single Market:

- "targeted" solutions to remedy individual obstacles; and
- comprehensive solutions addressing the underlying causes.

Part IV of the study (covering *Remedies to the Company Tax Obstacles in the Internal Market*) made it clear that there was a "*case for studying both targeted and comprehensive remedial measures".*

First, "*some of the targeted measures appear to be important, regardless of whether or not comprehensive solutions are introduced*".

On the other hand, "*even if all the targeted measures were implemented, the EU corporate tax system would still suffer from several basic shortcomings*".

Accordingly, the Commission Communication opts for a "twin-track strategy", both targeted and comprehensive.

Targeted measures

In considering remedies for particular tax obstacles, the study made the preliminary observation that

> *"in the absence of political solutions, taxpayers have been compelled to have recourse to the legal process to overcome discriminatory rules and other obstacles. In consequence, the European Court of Justice (ECJ) has developed a large body of case law on the compatibility of national tax rules with the Treaty."*

However, the implementation of ECJ rulings was left to the Member States, "*who often fail to draw the more general consequences which flow from them*".

The first Commission proposal for action listed in the Communication is therefore to **develop guidance on important ECJ rulings and to co-ordinate…the implementation of these.** Other specific targeted measures include:

- **Extending the existing Merger and the Parent-Subsidiary Directives**. Proposals for amendments to these had already been made by the Commission in 1993 (Commission 1993b). The Communication undertakes to table revised amendments in 2003, following consultations with Member States.
- **New proposals on the cross-border offsetting of losses**. The study observed that a proposal to allow parent companies to take into account losses made by subsidiaries in another Member State had been made by the Commission in 1990 (Commission 1990b), but "*the Council failed to adopt the proposal and has ceased discussion of it.*" One option was to present an amended version of this Directive. Another was to adopt the Danish

system of joint taxation, under which the whole group was taxed on a consolidated basis. The Commission Communication undertakes to withdraw its 1990 proposal; to study the options; and to "*report on its legislative intentions*" by the end of 2003.

- **Action on transfer pricing rules**. These, the study observed, gave rise to a variety of problems. The Commission has therefore undertaken to convene a standing "Joint Forum on Transfer Pricing" in 2002, which will examine, among other measures:
  - the development and exchange of best practice on Advance Pricing Agreements;
  - the scope for more uniform methodologies within OECD guidelines; and
  - the Arbitration Convention, with a view to proposing a draft Directive in 2003.
- **Double taxation**. The study observed that "*the filling of the few remaining gaps in the existing network of double taxation treaties within the EU would be helpful*". But the most complete solution would be "*the conclusion under Article 293 of the Treaty of a multilateral tax treaty between Member States, conferring interpretative jurisdiction on the Court"*. Alternatively, an EU version of the OECD model convention could be elaborated. The Commission opts for this last solution as a first step towards an EU model tax treaty, and promises a Communication on the subject in 2004.

Comprehensive solutions

The essential element of all comprehensive approaches, the study and the Communication state, is that **companies should have a consolidated corporate tax base, under one set of rules, for all their activities within the EU**. Purely internal transactions within a group should no longer have tax effects; and it should be possible to offset losses in one part of a group against profits in another. The study analysed a number of alternative mechanisms for achieving this consolidated tax base objective.

1. Home State Taxation (mutual recognition).

Enterprises with operations in a number of Member States would compute their consolidated tax base according to the rules of the country in which the parent company was established. The group would therefore only have to deal with one tax code and one tax administration. Member States, for their part, would have to recognise the validity of each others' tax codes as a basis for calculation.

This approach would have a number of advantages. There would be no need to devise a common or harmonised tax code, so that it could be adopted relatively quickly. It would be particularly appropriate, the study notes, to meet the problems faced by SMEs. On the other hand, the current substantial differences between national systems would mean that there would still be no "level playing field". Different groups, for example, would be subject to different conditions for loss relief depending on their home state.

The study therefore suggests that there would either have to be some prior alignment of Member States' tax systems; or the solution could be adopted "*as an optional scheme for companies in Member States with a sufficiently similar tax base*".

2. A Common Tax Base

This approach has been advocated by representatives of business (UNICE 2000). It would involve the creation of a new, common tax code, which would exist as an option, alongside the fifteen national codes. As in the case of the Home State solution, the tax rules would be administered by the Member State in which the parent company of a group was located.

Such an approach would have the advantage over the Home State solution that there would be a "level playing field" for all groups, irrespective of where the parent company was based. In addition,

> "*over time one might expect individual 'domestic' codes to evolve towards the common code…*"

One drawback, however, would be that Member States' tax authorities would be obliged to administer two tax codes in parallel: their own and the common code. This would be in addition to the problems of arriving at the common code itself – though the already agreed European Accounting Standards would be a good starting point. Since use of the code would be optional, there would still be differences in the way similar firms were treated (and the number of different systems would rise from 15 to 16!).

3. A harmonised tax base

Such problems would be eliminated if all 15 national tax codes were to be replaced by a single, harmonised code, to be applied uniformly across the EU. This would not mean a single *rate* of tax – only that every Member State would have to raise tax using the same basis of calculation.

This is the traditional approach of previous Commission proposals, and would provide the most complete solution to the consolidation and "level playing field" problems. Its main defect, as the study observes, is that it "*does not correspond to current levels of institutional development*". Member States would not only have to negotiate the common code itself, but agree to apply it to all companies, even those operating only domestically.

4. A European corporate income tax

The study also examined the suggestion of allowing firms, in particular large multinationals, to opt for taxation at an EU level.

> *"In its purest form [the tax] would be administered by a new single authority, with a single EU tax rate and the revenues would be used to fund the EU institutions…"*

It would "*certainly represent a major step towards the creation of a 'federal Europe'..*"

Unless taken to the ultimate extreme of replacing all national corporate taxes, however, it would have the same drawbacks as the Common Tax Base approach: a new tax code would have to be devised, which would be additional to the existing 15 codes.

The apportionment mechanism

Except in the case of the "pure" European Corporate Income Tax, these solutions would all mean that a single Member State would be responsible for levying tax on companies which operated in several Member States. It would therefore be necessary – the Commission Communication observes – to develop an **apportionment mechanism,** "*which can be agreed by all participants*", in order to allocate the revenue to the correct national Treasuries.

The precedent of the clearing system proposed for the "definitive" VAT system does not, on the face of it, give many grounds for optimism. On the other hand, the mechanism suggested for apportioning corporate taxes would be relatively simple.

Whether a company was operating under Home Country rules, or under common or harmonised rules, the tax base would be the same for all its activities within the EU. It would only be necessary, therefore, to allocate proportions of this single tax base between the appropriate Member States, which would then apply their own tax rates to it.

The European Company Statute (SE)

The Nice European Council of December 2000 finally reached agreement on the fifteen-year-old proposal for a European Company Statute (*Societas Europeae*). A Regulation and a Directive (Council 2001b) will come into effect in 2004.

How such companies are to be taxed, however, is as yet unresolved. In adopting the Statute in September 2001 the European Parliament required *that "approximating the fiscal rules applicable to SEs*" should be the subject of a Commission report and proposals "*three year at the latest*" after the entry into force of the Regulation (European Parliament 2001b).

The Communication undertakes to "*make sure that the current body of EU company tax law will be fully applicable*" to SEs as from 2004. At the same time it will explore

> *"the particular potential of a comprehensive company tax regime and of a consolidated corporate tax base for the EU-wide activities of companies to be applied to SEs."*

A "broad debate"

Neither the study nor the Communication make a choice between the options for reaching a consolidated corporate tax base. Instead, the Communication advocates a "*structured debate involving all stakeholders*" as a first step. Accordingly, the Commission undertakes to organise a **European Company Tax Conference** in the first half of 2002, after which it will present its own policy conclusions "*by 2003*".

This "broad debate" will need to address a number of fundamental issues.

- **EU-wide or "enhanced cooperation"?** All the options – and especially those for Home State taxation or a common tax base – need not be applied at once by all EU Member States. Using the option introduced by the Amsterdam Treaty for groups of Member States to proceed in advance of others, corporate taxes might be levied on a common basis in one part of the EU, but not in the rest. Such a "two-speed" solution already operates in the cases of the € and of the Schengen agreement. It is nevertheless arguable that dividing the Single Market in this way might damage, rather than improve, overall economic efficiency.
- **Optional or compulsory solutions?** The common tax base approach, and less ambitious versions of the European Corporate Income Tax approach, would allow firms to choose between a new EU tax base and the existing 15 national tax bases. While introducing flexibility into the system, this would also add to its complexity, particularly for tax administrations. A more robust approach might be to insist that all companies operating in more than one Member State were taxed according to common criteria.
- A much more serious issue is **whether it is worth proceeding with measures to consolidate the tax base without some harmonisation of tax rates.** The findings of the Commission study, referred to earlier, suggest that differences in corporate tax bases to some extent offset differences in tax rates; and that aligning tax bases without aligning rates would therefore *increase* disparities. In effect, this was the conclusion of the Ruding Report, and of previous Commission proposals.
- Similarly, it is possible to question **whether action on corporate taxation, in isolation from other taxes and other economic parameters, will improve overall welfare**. The study itself noted that

"to the extent that there are pre-existing distortions and/or imperfections in the market economy (market failures), taxes may be used to internalise these externalities (e.g. pollution), thereby enhancing economic efficiency."

Differences in corporate tax bases between Member States may reflect such "second best" arrangements. Hence their elimination could be counter-productive. There is also the point of view – recently expressed in letter to the *Financial Times*[20] – that the present system *"whereby economic activity in any one state is taxed using that state's tax base and rates*" is simpler than, and therefore preferable to, consolidation.

- Finally, there is the fundamental political argument as to **how much Member States should be prepared to sacrifice tax sovereignty in pursuit of economic efficiency**. On the one hand, it cannot be argued that national sovereignty is still absolute in the tax field, since, as the study observed in its analysis of the legal issues,

  " national tax provisions may be incompatible with the requirements of the EC Treaty and thereby void".

  On the other hand, as noted earlier, the study is careful to point out that taxation policy involves trade-offs between pure economic efficiency on the one hand, and other legitimate goals on the other: for example, equity or the redistribution of wealth. Given that all EU Member States are democracies, it is hard to argue that electorates should not be able to opt for relatively low/high tax levels, or for particular tax structures – even if the results are less economic efficiency or an apparent competitive advantage/disadvantage.

A Community Tax?

In mid-2001 the Belgian Finance Minister, Didier Reynders – the incoming President-in-Office of ECOFIN – raised the idea of introducing a "European Tax" to help finance the EU Budget. The idea was opposed by a majority of national finance ministers[21]; but received support from a number, including the German minister, Hans Eichel.

Both Reynders and Eichel emphasised that the tax should *substitute for* existing taxes – i.e. should not lead to an increase in the total tax burden. Its main advantage would be to create a direct link between EU expenditure and the raising of taxes, a link which the current system of finance through national budgets makes it difficult to perceive. Bringing together decisions on expenditure and revenue generation, Hans Eichel also pointed out, "*could lead to more efficient and thrifty public administration*". The European Parliament, for example, would be able to vote not only to spend money (which it does already) but on how to raise the necessary revenue (which it does not).

A number of possible taxes might wholly or in part become "a Community Tax".

Value Added Tax.

It is widely believed already that a proportion of the VAT paid by consumers when they buy goods and services goes directly to the EU. In fact, this is not the case. Instead, the VAT element of "own resources" is the result of calculating the sum that *would* be raised by applying a particular percentage to the common VAT base in each Member State, irrespective

[20] *Financial Times*, October 24, 2001.

[21] The Dutch Finance Minister, Gerrit Zalm, was reported as having said that "the last time a European tax was introduced was at the time of the Duke of Alba - and we had eighty years of war".

of the actual VAT rates charged. In the UK, for example, food is included in this base, even though the rate of tax is zero. The money is then paid to the EU out of general revenue.

One possibility would therefore be to make a reality of the popular misconception. An "EU VAT" would be shown separately on invoices – in the same way that local and State sales taxes are shown separately on invoices in the US – and would be separately deductible. This would, of course, add new complexity to an already complex system. A simpler alternative, was proposed in 1962 by the Neumark Committee, which was set up by the EEC Commission in 1960 to examine the whole issue of indirect taxation within the common market (Neumark 1962). There would be a European VAT at the pre-retail stage, combined with a traditional retail Sales Taxes at national level.

A more ambitious alternative would be to pay *all* VAT, at uniform rates, directly into the EU Budget, with surplus revenue being rebated to Member States – a system similar to that operating in the Federal Republic of Germany. This would, at a stroke, remove the main obstacle to a "definitive" VAT system based on the origin principle. With all revenue going into the same Budget, there would be no need for a clearing system. As far as VAT was concerned, the EU would become a genuine "single fiscal area"[22].

Unfortunately, for any of these alternatives to be acceptable, there would need to be a fully harmonised VAT base throughout the EU; and, despite the best efforts of the 6th VAT Directive, this is still far from the case. The continuing defects in the system were implicit in the Community decision of 1992 to reduce the proportion of "own resources" provided by VAT, and to introduce the GNP-related "fourth resource" and the GNP ceiling.

Taxes on corporations

A second alternative would be to create an EU tax in conjunction with the proposed reform of Corporate Taxation, outlined in the previous section. Obvious candidates would be a European Corporate Income Tax, or the revenues raised from companies opting for taxation under a common tax code.

A major problem in both these cases, however, would be the optional element. If firms were able to choose between taxation under national rules (with revenues accruing to national governments), or under common rules (with revenues going directly to the EU), political tensions would probably be acute. In addition, neither national governments nor the EU would be able to rely on their tax bases remaining stable from year to year.

Companies could therefore be given no option. All businesses with operations in more than one Member State, for example, might be compulsorily taxed according to the common criteria, in which case the revenue could go directly to the EU.

Environmental and other taxes

Many other suggestions have been made for a European Tax, mostly in the field of customs or excise duties. Indeed, the tariffs and levies on imports from third countries may already be considered to constitute such a tax, though one largely unperceived by the general public. The logic of these taxes – that the goods on which they are charged are entering the EU Single Market as a whole, and not the Member State at the port, airport or frontier of which they happen to arrive – can be applied in other areas as well.

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[22] For more details, see "The Federal Option" in *Options for a Definitive VAT System*, European Parliament, Directorate-General for Research, Economic Affairs Series E-5, 1995.

There are, for example, good arguments for considering taxes designed to limit pollution to be in this category. Since emissions in one Member State can constitute an externality giving rise to costs in other Member States, remedies at EU level are an appropriate instrument. One credible European Tax might therefore have been the Community-wide tax on carbon dioxide emissions, originally proposed in 1992, and published in a revised version (Commission 1995d) three years later. Following the failure of the Council to agree the measure, further options were outlined in a Commission communication, *Environmental Taxes and Charges in the Single Market* (Commission 1997g).

Given the problems caused by diverging national system of vehicle taxation (see the earlier section on "The taxation of vehicles") another suitable candidate might be a European Vehicle Registration Tax. This might be supplemented by a European *vignette,* applying to the EU as a whole, and to all vehicles, the system already operated by six Member States.

Principles

The choice between these alternatives, even if the principle of an EU tax is accepted, will not be easy. The issue might be clarified, however, through the acceptance of two general rules.

1. Where a particular economic activity is regulated exclusively or mainly at EU level, the tax levied on it might be logically paid directly into the EU Budget. This might be the case, for example, for corporation tax paid by businesses established under the European Company Statute, or operating under a European Corporate Tax Code (see above); and to the revenues from taxation in the transport field such as the European *vignette.*
2. Where tax legislation requires revenues collected in one Member States to be remitted to another through some form of "clearing" system, administrative costs could be minimised by paying the tax into the EU Budget instead. This might apply, for example, in the cases of VAT on electronic commerce or under the reformed 8th. VAT Directive; and possibly even to revenues from a withholding tax on savings where this exists.

III. International developments

Tax havens

The publication of the OECD's 1998 and 2000 reports (see Chapter II) caused outrage in some of the listed "tax havens". The director-general of Jersey's Financial Services Commission[23] claimed that the OECD had "*culled the names from airline magazines*". A member of the Jersey senate asked for a vote to be held on total independence from the British Crown; and in the Isle of Man there were calls for a similar move.

The authorities in a number of the listed territories also disputed the OECD's basic arguments. A small country, they maintained, should in principle be able to enjoy the natural economic advantage provided by its ability to levy lower tax rates than a larger one, as a result of gaining more revenue from international business than of losing domestic revenue. Though the existence of "tax havens" might put pressure on large countries' tax take, the territories concerned were only acting rationally in the interests of their populations. For some small countries, indeed, the exploitation of this natural advantage might be the only way out of grinding poverty.

Since then, intensive negotiations have taken place and a significant number of the territories on the initial list have reached accommodation with the OECD. Most conceded that some reforms to their tax regimes were needed, and might even have advantages – an OECD "seal of approval" could help in establishing a reputation for sound financial management. Following the 2000 report, Aruba, Bahrain, the Isle of Man, the Netherlands Antilles and the Seychelles issued commitment letters, so removing themselves from the "black list". On 23 August 2001 the OECD announced that Tonga was also no longer on the list (see Table 4).

The 2001 Report

The latest progress report on harmful tax practices was published by OECD in November 2001 (OECD 2001d). As in the case of earlier reports, both Luxembourg and Switzerland abstained from its adoption, in which they were joined by Belgium and Portugal. The report observes that

> *"Globalisation of the economy has had the side effect of opening up new ways in which companies and individuals can avoid taxes that are legally due".*

Increasingly, therefore, domestic sources of information were no longer sufficient to endure compliance with tax laws. Only the exchange of information between tax authorities could deter and uncover non-compliance in cross-border transactions.

The report also observes, however, that the initial stance taken in the 1998 and 2000 reports has been modified as a result of bilateral and multilateral international discussions.

> *"The dialogue between the OECD Members and the tax haven jurisdictions has resulted in the OECD having a better understanding of the concerns of the jurisdictions…"*

This has led to some modifications to the four criteria for defining a tax haven described in the 1998 document.

- The report emphasises that the first of these – whether the jurisdiction imposes no or only nominal taxes – is

[23] Richard Pratt, quoted in the *Financial Times* of 4 August 2000.

"*not sufficient, by itself, to result in characterisation as a tax haven. The OECD recognises that every jurisdiction has a right to determine whether to impose direct taxes and, if so, to determine the appropriate tax rate."*

- The second criterion was lack of transparency. This was concerned with ensuring that:
  1. Laws were applied on an open and consistent basis among similarly situated taxpayers; and
  2. Information needed by tax authorities to determine a taxpayer's situation were in place.

  Examples of lack of transparency were "secret" rulings, negotiated tax rates and similar practices (for example, creating a special tax regime for a particular company in order to attract investment). Transparency required that financial accounts should be drawn up in accordance with accepted accounting standards and that the accounts should be audited or filed. The authorities should also be able to identify beneficial owners.
- The third criterion of effective information exchange should include a number of elements, among them that
  - a legal mechanism should be in place allowing information to be given to the tax authority of another country in response to a request relevant to a specific tax inquiry;
  - there should, however, also be safeguards that the information provided should only be used for the purposes for which it was sought;
  - taxpayers' rights and the confidentiality of their tax affairs should be protected;
  - in the case of information requested in connection with a criminal tax matter, the information should be provided without a requirement that the conduct being investigated would constitute a crime under the laws of the requested jurisdiction;
  - in the case of information requested in the context of civil tax matters, the requested jurisdiction should provide the information without regard to whether or not it had an interest itself in obtaining the information.
- The fourth criterion in the 1998 paper was a lack of substantial activities by a body being taxed in a haven. This had been included because it suggested that "*a jurisdiction may be attempting to attract investment and transactions that are purely tax driven*". However, it had in practice proved difficult to interpret exactly what was meant by "substantial". Accordingly, following discussions with the jurisdictions, this criterion for determining a tax haven had been dropped.

The report also takes into account a number of other concerns raised by the "tax haven" jurisdictions. The deadline for making commitments is being extended from the original July 2001 date to 28 February 2002. Jurisdictions would then have a year after making a commitment – rather than the original six months – to develop implementation plans. Help from OECD countries will be available for jurisdictions which face administrative difficulties in putting effective measures in place.

Finally, the report deals with the framework for the possible "coordinated defensive measures" against non-cooperating tax havens. These will, in any case, not be taken any earlier than measures against "*OECD Member countries with harmful preferential regimes".* A number of considerations will guide the design of the framework:

- measures should be proportionate and targeted at neutralising the deleterious effects of harmful tax practices;

- the adoption of measures would be at the discretion of individual countries; and
- each country should be free to choose defensive measures "*proportionate and prioritised to the degree of harm that a particular practice has the potential to inflict*".

Action against money laundering

Most attention in the last two years, however, has been focused on the activities of the FATF on Money Laundering (see Introduction), rather than on specific action against tax havens. Though quite a few jurisdictions have featured on both the tax haven and money laundering black lists, the FATF has aimed at a wider field of targets, and at some much larger countries.

In 1990, the FATF published a list of forty recommended practices (revised in 1996) to act as an international standard for anti-money-laundering measures. The most important are:

- Laundering the proceeds of serious crime should be a criminal offence, and laws should be enacted to seize and confiscate the proceeds of crime.
- Financial institutions should be able to identify all clients, including the beneficial owners of property, and to keep appropriate records.
- Financial institutions should implement a comprehensive range of internal control measures and report suspicious transactions to the competent national authorities.
- There should be adequate national control and supervision of financial institutions.
- Countries should provide prompt and effective international cooperation at all levels.

In February 2000, the FATF published an initial report, listing criteria to be used in identifying "*detrimental rules and practices which impede international cooperation in the fight against money laundering*"; and also possible counter-measures (see Table 14) In June 2000 a formal report was adopted (OECD 2000b), outlining the findings of four regional review groups (Americas; Asia/Pacific; Europe; and Africa and the Middle East). "Serious systematic problems" were identified in fifteen jurisdictions, including, in the European section, Liechtenstein. These were listed as "non-cooperative".

One year later, in June 2001, a second formal report was published (OECD 2001c). Four jurisdictions – the Bahamas, the Cayman Islands, Liechtenstein and Panama – were found to have addressed the deficiencies identified the previous year, and were removed from the non-cooperative list. However, six new jurisdictions were added: Egypt, Guatemala, Hungary, Indonesia, Myanmar and Nigeria. The FATF also recommended that countermeasures should be taken against Nauru, the Philippines and Russia from the end of September 2001 unless their governments enacted "*significant legislation that addresses FATF-identified money laundering concerns*". In September, two more countries were added – Grenada and the Ukraine – bringing the total list to nineteen (see Table 14).

Table 14. The FATF's list of non-cooperative jurisdictions, September 2001

Cook Islands (New Zealand)	Israel	Philippines
Dominica	Lebanon	Russia
Egypt	Marshall Islands	St. Kitts & Nevis
Grenada	Myanmar	St. Vincent & the Grenadines
Guatamala	Nauru	Ukraine
Hungary	Nigeria	
Indonesia	Niue (New Zealand)	

On 6 August 2001 Russia enacted a Federal Law on Combating the Legalisation of Income Obtained by Criminal Means, with the result that the threat of counter-measures was withdrawn. At the end of August Nauru also enacted an Anti-Money-Laundering Act, which was, however, considered inadequate, and a new deadline for counter-measures was fixed for the end of November. Both countries remain provisionally on the black-list.

The events of 11 September 2001 in New York and Washington, however, significantly changed the situation. Meeting in Washington on 6 October 2001, the finance ministers and central bank governors of the G7 proposed that the mission of the FATF should be specifically widened to combat the financing of terrorism. In a special meeting at the end of October, the FATF decided to focus on this new objective, adopting a number of Special Recommendations on Terrorist Financing. Members committed themselves to:

- ratify and implement UN Resolution 1373 (see below);
- criminalise the financing of terrorism, terrorist acts and terrorist organisations;
- freeze and confiscate terrorist assets;
- report suspicious transactions linked to terrorism;
- provide the widest possible range of assistance to other countries' law enforcement and regulatory authorities for terrorist financing investigations;
- impose anti-money-laundering requirements on alternative remittance systems[24];
- strengthen customer identification measures in international and domestic wire transfers;
- ensure that various bodies, in particular non-profit-making organisations, cannot be misused to finance terrorism.

All countries undertook to assess their compliance by the end of 2001, and to comply fully by June 2002. Non-FATF countries were also invited to comply, for which technical assistance would be made available.

One month earlier the United Nations had unanimously adopted Resolution 1373, requiring all member states to refer to a criminal court all cases of the supply or collection of funds on their territories intended to finance terrorist activities; to freeze terrorists' funds; and to refuse asylum to those which financed, planned, supported or carried out terrorist acts, and those who harboured them.

On 6 November 2001 the Economic and Finance Ministers of the EU and the EFTA countries (Switzerland, Norway, Iceland and Liechtenstein) gave their full support to the international action. At a press conference the Swiss Economics Minister, Pascal Couchepin, significantly emphasised that Switzerland had already, in 1998, adopted similar measures to those that will be applied in the EU under the Money Laundering Directive. Switzerland had already frozen 24 bank accounts, holding a total of 12 million Swiss francs, as part of its contribution to the war against terrorism.

Finally, a meeting of IMF Finance Ministers in mid November decided to take action under its Article Four annual surveillance of procedure. It set a goal of 1 February 2002 for member governments to tighten regulatory standards and plug existing loopholes in order to keep track of terrorist funding.

[24] For example, the *hawala* (trust) money transfer system used in the Middle East and Asia to bypass banks.

Table 15. The FATF criteria for defining non-cooperative countries or territories.

Main headings	Categories	Examples
Loopholes in financial regulations	No or inadequate regulations and supervision of financial institutions	
	Inadequate rules for the licensing and creation of financial institutions, including assessing the backgrounds of mangers and beneficial owners.	*Absence of measures to prevent criminals controlling or investing significantly in financial institutions.*
	Inadequate customer identification requirements for financial institutions.	*Anonymous accounts or accounts in obviously fictitious names.* *No obligation to verify the identity of the client and beneficial owner, or to renew identification when doubts appeared.* *No anti-money-laundering training programmes.* *No obligation to keep records on clients and transactions for a reasonable time (5 years).*
	Excessive secrecy provisions regarding financial institutions.	
	Lack of an efficient system for reporting suspicious transactions.	
Obstacles raised by other regulatory requirements	Inadequate commercial law requirements for the registration of business and legal entities.	
	Lack of identification of the beneficial owner(s) of legal and business entities.	
Obstacles to international co-operation.	Obstacles by administrative authorities.	*Laws preventing the exchange of information.* *Authorities prevented from conducting investigations on behalf of foreign counterparts.* *Obvious unwillingness to respond constructively to requests.* *Restrictive practices in investigating suspicious transactions, especially on the grounds that these might relate to tax matters.*
	Obstacles by judicial authorities.	*Failure to criminalise laundering the proceeds of serious crime.* *Laws preventing the exchange of information.* *Obvious reluctance to respond constructively to mutual legal assistance requests.* *Refusal to provide judicial co-operation in cases involving offences recognised as such by the requested jurisdiction, especially on the grounds that tax matters are involved.*
Inadequate resources to combat money laundering.	Lack of resources in public and private sectors.	*Failure to provided the administrative or judicial authorities with adequate financial, human or technical resources.* *Inadequate or corrupt staff.*
	Absence of a financial intelligence unit or of an equivalent mechanism.	

What is "unfair tax competition"?

The international measures against tax havens, and those against money laundering and the financing of terrorism, share certain features. Key factors in identifying "uncooperative" jurisdictions are a lack of transparency in financial activities; and a lack of effective exchange of information with international and third country authorities. In both cases an important requirement is application by financial institutions of the "know your client" principle.

Nevertheless, the fact that one of the FATF criteria for defining non-cooperative countries is a refusal to cooperate *"on the grounds that tax matters are involved"* indicates a fundamental problem. Is it certain that taxation issues can be considered to fall within the same definition of "international crime" as the laundering of drug money or international terrorism?

- First, tax laws differ from country to country: a tax crime in one jurisdiction is not necessarily illegal in another. For this reason administrative or judicial action – e.g. the lifting of banking secrecy – has often been refused when requested by a foreign tax authority. Pressure to eliminate such differences can conflict with the rights of independent countries to determine their own tax systems and rates.

- Secondly, a distinction needs to be drawn between **tax evasion**, in which tax legally due in not paid (e.g. failing to declare interest from a foreign bank account); and **tax avoidance**, in which financial affairs are so arranged that a minimum of tax becomes due. The first is generally illegal, the second is not. In the documents of both the EU and the OECD, however, the distinction is often blurred. The Secretary-General of the OECD[25], for example, has used the phrase "illegal tax avoidance", as well as explaining that "*by 'tax avoidance' OECD means 'unacceptable avoidance*'". In addition, few would deny companies and individuals the right to carry out **prudent tax planning** within the law, and for the providers of financial products to compete in attracting their custom.

- Finally, in considering the issue of tax competition, there is no common definition of what is meant by "harmful". For example, a comparison of the EU Code of Conduct and the Primarolo Report on the one hand, and the OECD reports on the other, reveals some important differences. The OECD documents show an almost exclusive concern with **erosion of the tax base and of revenues** as a result of tax competition. Those of the EU, however, indicate that the main concern is for the effects of tax competition on ***"the location of business activity in the Community***", on the **structure and incidence of taxation**, and on **employment.** In the case of the EU, there is also a significant link with the Community's **competition policy**, under which not only direct state aids, but also "tax breaks" can be illegal.

  > *"In applying the Community rules on State aid, it is irrelevant whether the measure is a tax measure, since Article 92 [that is now 87] applies to aid measures 'in any form whatsoever'."* (Commission 1998g).

  However, to come within the scope of these Articles, *"the measure must affect competition and trade between Member States."* Moreover, state aid rules do not apply to "*general measures*" which are "*open to all economic agents operating within a Member State",* and *"extend to the entire territory of the State."*

Such factors help to explain the differences in emphasis between the United States and the EU in the context of international action.

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[25] The Honourable Donald J. Johnston, speaking at a High-Level Symposium on Harmful Tax Competition on 29-30 June 2000.

Tax Competition and Tax Cooperation

Finally, there is the continuing debate on the

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

Competition

On the one hand, are the arguments in favour of competition between tax systems.

- First, competition is held to serve

  > *"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 rejected. To the extent that a proportion can be considered "wasteful", welfare improvements cannot fully compensate for rises in the tax burden.

- Secondly, tax competition is seen to be in accordance with the "decentralising presumption" of subsidiarity; and, in any case, to produce a maximisation of economic welfare. 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; and the desired mix of taxation/public expenditure is not necessarily the same in all places. Where the decisions are devolved, levels of taxation and of public services provision are therefore more likely to correspond to citizens' preferences.

- Measures to limit tax competition through "harmonisation" or "cooperation" are 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.). Areas of cartelisation, in any case, tend to become uncompetitive. Even if there are initial gains from limiting competition, these eventually dissipate as economic activity relocates to third countries.

- Fourthly, the gains from limiting competition are not necessarily shared equally between the participants, and can result in losses for those that would otherwise compete most effectively. It can be argued that, in this context, "small is competitive": i.e. that smaller economies gain from tax competition as opposed to larger ones, and that the larger economies thus gain from co-operation at the expense of the smaller.

  Tax competition, indeed, 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.

- Where wide discrepancies exist in taxation rates, convergence is seen as more likely to be achieved through market mechanisms – i.e. competition – than through political attempts at harmonisation or coordination. In conditions of open frontiers, for example, there is a

natural limit to the ability of a country to raise tax rates on tradable commodities higher than the rates in neighbouring countries: i.e. when a marginal rise in rates produces a marginal fall in revenue as a combined result of demand elasticity and an inflow of the product in question. This would almost certainly become a powerful factor within the EU in the case of alcohol and tobacco products were the remaining barriers to free movement to be abolished. In the case of competition, of course, the pressure is for lower tax rates, where the opposite is generally so in the case of coordination.

The OECD's 2001 progress report on harmful tax practices (OECD 2000d), indeed, opens with a summary of some recent benefits provided by tax competition.

> *"The more open and competitive environment of the last decade has had many positive effects on tax systems, including the reduction of tax rates and broadening of tax bases....In part these developments can be seen as a result of competitive forces which have encouraged countries to make their tax systems more attractive to investors. In addition to lowering overall tax rates, a competitive environment can promote greater efficiency in government expenditure programmes."*

- Finally, there is the complex question of political theory concerning the right of democracies to choose their own tax levels and their own tax structures. In particular, the principle of "no taxation without representation", on which the system of parliamentary democracy substantially rests, is difficult to reconcile with decision-taking on tax matters by the still imperfectly democratic institutions of the EU. It is largely for this reason that majority voting within Council in this field has been consistently rejected. In the context of taxation, the doctrine of parliamentary sovereignty underpins that of national sovereignty – competition within a framework of classical international law appears more logical than harmonisation or coordination under Community law.

Cooperation

On the other hand are the arguments for limiting tax competition in favour of harmonisation or coordination.

- First, there is the danger that countries will design their tax systems specifically to attract

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

  This is the main charge against the "tax havens" identified by the OECD. Though such a policy may be rational from the point of view of the territories concerned, and produce real welfare gains, it is considered that these are outweighed by the losses to the majority of countries. Practices have been introduced specifically "*to encourage non-compliance with the tax laws of other countries*"[26]. Moreover, since the havens themselves only receive a small fraction of the revenue flowing through their jurisdictions, the main beneficiaries are "*rich tax cheats*"[27].

- Secondly, even where there is no deliberate tailoring of tax systems, it is argued that tax competition will produce a "race to the bottom", particularly in the case of the taxation of capital in conditions of capital mobility. Moreover, though countries may have equal overall levels of public expenditure and tax, differences in systems may nevertheless

[26] OECD 2001d.

[27] See the letter to the *Financial Times* from the former head of the OECD Tax Competition Unit, Frances Horner, of 4 May 2001.

result in a downward pressure on revenues. For example, two countries may have identical general level of taxation. The first, however, may have chosen high rates of indirect taxation, and relatively low rates of corporate tax; the second, the reverse. Tax competition will exert a downward pressure on indirect tax rates in the first country, and on corporate rates in the second.

- Thirdly, where one factor is mobile (capital), but another (labour) is not, there will be distortions of the tax system: i.e. the tax burden will be shifted to the immobile factor. Over the ten-year period 1985-94 there was indeed a shift to taxes on labour from taxes on other production factors in the EU as a whole (though this was not the case in all Member States). The result was an increase in "non-wage" labour costs, which in turn was considered to have increased rates of unemployment. This has been the principal argument advanced by the EU Commission for greater tax cooperation, notably in the Delors White Paper of 1993 (Commission 1993c).
- Fourthly, even if it is conceded that countries should generally be free to determine their own taxation/public expenditure mix, there are often spill-over effects – for example, if a consequence of low public expenditure is pollution affecting a neighbour, or if inadequate educational provision leads to the "poaching" of skills through tax incentives. A number of economic models exist for handling such externalities within a national economy (internalisation through taxation or obligatory compensation; market solutions *via* contract, etc.). In a multi-nation context, however, optimum solutions are most likely to come through conventions, treaties or other agreements – i.e. through cooperation.
- Fifthly, as the volume of international trade has grown through "globalisation", the degree to which complex and incompatible tax systems create costs has become increasingly apparent. Within the EU itself, this has been a central finding of studies into corporate taxation (Ruding 1992, and Commission 2001j and 2001k). In addition, complex tax systems and large differences in rates encourage tax avoidance and evasion. Major companies have often found themselves subject to a multiplicity of tax jurisdictions, causing them to devote considerable resources to tax minimisation. In the case of Value Added Tax, complexity has likewise created both the incentive and opportunity for firms and labour to move into the “black” economy[28].
- Sixthly, the complexity of tax systems is also increased by the measures taken by governments to combat tax evasion, placing "*greater burdens and costs on tax administrations as well as on compliant tax payers*"[29].

  These factors argue for the coordination of tax systems, as well as for cooperation in preventing abuses.
- Finally, it is argued that unrestricted tax competition will result in systems which maximise economic efficiency to the detriment of all other factors: for example, any redistributive element. Such social objectives form an integral part of most national tax systems, and cooperation in their pursuit can be considered a political priority.

The conclusions to which the economic analysis leads are unsurprising: that some – but not all – tax competition can be harmful; and that some – but not ubiquitous – co-operation may

[28] 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.

[29] OECD 2001d.

therefore be beneficial. Put formally by Edwards and Keen, some degree of tax co-ordination is desirable if the welfare gains from eliminating "*the inefficiency of non-co-operative behaviour"* exceed "*Leviathan's tendency to waste*".

There is also, however, the wider issue of whether economic factors should be considered in isolation. As a recent study of EU Tax Policy has observed (Cnossen 2001),

> *"there are important trade-offs between tax neutrality and tax autonomy. The economist can highlight these trade-offs and estimate the costs of alternative courses of action, but the body politic has to decide on the exact nature and extent of the trade-offs."*

Within the EU context, this is essentially the institutional question of sovereignty and democratic accountability, now under discussion at the highest level. Questions such as the level at which tax systems and rates should be decided, and the perhaps even more contentious issue of where the revenues should go, are only likely to be answerable once the future constitutional structure of the Union has been determined.

The Tobin Tax

The first formal proposal for a tax on spot transactions involving the conversion of one currency into another was made by the US Nobel prize-winning economist, Professor James Tobin, in a lecture at Princeton University (Tobin 1972). He further developed the concept in his Presidential Address to the Eastern Economic Association (Tobin 1978). Since then, the introduction of what has become known as a "Tobin Tax" has at regular intervals figured on the political agenda. The idea of "*throwing some sand in the well-greased wheels of international finance*" has been appealing at times of turbulence on world financial markets.

A Tobin Tax would be levied on foreign exchange transactions at a uniform, but low, *ad valorem* rate. Prof. Tobin himself suggested rates of 0.2%, 0.5% and 1%. Current French Prime Minister Lionel Jospin suggested 0.1% in 1995, "*qui ne pénaliserait pas les investissements à dix ans mais les placements à dix jours*"[30]. Were the transaction the consequence of long-term investment, indeed, such a levy would constitute a negligible extra cost to the total project. However, were the transaction to be a short-term speculation, involving movements in and out of a particular currency in a matter of weeks, days or hours, it could constitute a significant charge.

A Tobin Tax of only 0.1% would raise, it has been calculated, something over $50 billion a year in revenue – even assuming that the number of current foreign exchange transactions fell by half, that 20% were exempt and that another 20% of the tax was evaded. This is over double the total now spent on stabilisation programmes, development and humanitarian aid, peace-keeping operations and other activities by the UN and its agencies.

Recent discussions

The most recent interest in the Tobin Tax can be linked to the rise of the anti-globalisation movement during 2000 and 2001. The objectives of the protesters have including limitations on the international free movement of capital, and a large increase in expenditure to alleviate world poverty. Both of these might be furthered by the Tax.

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[30] "which would not penalise ten-year investment, but would penalise ten-day transactions" (from "*1995-2000, Propositions pour la France*" by Lionel Jospin).

At the end of August 2001 the French finance ministry reversed its official opposition to the tax; and the issue was raised at an informal Franco-German economic and finance council in Berlin by French Finance Minister Laurent Fabius. The immediate response of his German counterpart, Hans Eichel, was unfavourable. However, a week later a decision was announced by German Chancellor Gerhard Schröder to establish a high-level Franco-German working group on the control of international capital flows (though he specifically drew attention to the problems associated with the Tobin Tax itself).

At the informal meeting of ECOFIN on 22 and 23 September, the reactions of other EU Finance Ministers were generally hostile to the tax. However, the President-in-Office of ECOFIN, Belgian Finance Minister Didier Reynders announced his intention to ask the Commission to carry out a feasibility study by the end of the year.

For and against the Tax[31]

A Tobin Tax would serve a number of objectives:

- In so far as short-term, speculative transactions have a *de*stabilising effect on currency markets, a fall in the volume of such transactions would reduce exchange-rate volatility. This, in turn, would improve the financial climate for "real" trade in goods and services.
- The tax would also serve to put a "fiscal buffer" between economies. A government whose exchange rate was under threat would need to raise short-term interest rates by less in order to defend a particular parity than would otherwise be the case. The potentially damaging effect on growth and employment would consequently be reduced.
- The tax would also, of course, raise revenue - perhaps some $360,000,000,000 a year world-wide, based on a 0.5% rate and $1 trillion foreign exchange market turnover during each of 240 trading days[32]. Prof. Tobin's suggestion was that this should be paid into a central fund controlled by the IMF or the World Bank, so providing considerable extra resources for international stability programmes.

The levying of a Tobin Tax would also, however, present some daunting problems.

- There would need to be agreement on its application in every financial centre in the world – otherwise foreign exchange markets would move to "tax-free" jurisdictions. However, the current international action against tax havens, money laundering and the financing of terrorism, outlined earlier, might now make this feasible.
- Levying the tax on an estimated $1 to 1.5 trillion turnover *a day* would be a massive administrative task, even if the effect of the tax was to reduce the total. Turnover in the foreign exchanges in a month is roughly equivalent to the value of world-wide trade in a year.
- There would also be considerable problems in defining:
  - *the tax base* (would market interventions by central banks, or transaction between other governmental or international bodies, be covered? Would it also cover "beneficial" trading by market makers, or financial intermediaries providing stabilising liquidity?); and

[31] A fuller discussion of the issues is contained in a European Parliament study (European Parliament 1999).

[32] Estimate by David Felix (Felix 1995).

- *taxable transactions* (a tax on foreign currency transactions alone could be avoided through the derivatives markets).

➢ It is not even certain that a Tobin Tax would increase exchange-rate stability. When a currency was under attack by speculators, the cost of the tax would almost certainly already have been discounted, possibly resulting in greater, rather than lower, volatility. A Tobin Tax would have had little effect in preventing the fall of the Mexican peso in early 1995, for example, nor that of the South East Asian currencies in 1997.

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