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Tax Harmonization and Competition in the European Union

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Abstract
This paper presents a comprehensive review and analysis of tax harmonization and tax competition in the European Union. It is shown that while tax burdens in the European Union have increased substantially in the past 35 years, they did not converge. Also, there is no evidence of the 'race to the bottom' in taxing income from capital. However, small European Union country members tend to set lower effective tax rates than larger member countries. There is also a trend to abolish imputation systems in favour of a schedular tax on distributed profits.

I. INTRODUCTION

Economic integration in the European Union (EU) has progressed to a considerable extent culminating in the launch of Economic and Monetary Union (EMU) in 1999. Tax integration, however, has been relatively limited. Tax competition has attracted increasingly international attention, also within the EU. In itself, tax competition is generally welcome as a means of benefiting citizens and of imposing downward pressure on public spending. Unrestrained tax competition for mobile factors, however, can be harmful, for example by biasing tax systems against employment. In 1998, the Organisation for Economic Co-operation and Development (OECD) published a report on this subject presenting recommendations and guidelines (OECD, 1998). This report foresaw that OECD member countries would complete a self-review of their preferential tax regimes by April 2000 and recommended that they eliminate any harmful features of such regimes by April 2003.

Under the 1998 Report, a tax haven is a jurisdiction that:

- imposes no or only nominal taxes (generally or in special circumstances),
- offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape taxation in their country of residence, and
- possesses confirming criteria.

These confirming criteria are:

- lack of effective exchange of information;
- lack of transparency; and
- attracting business with no substantial activities.

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These criteria are consistent with the nature of the tax poaching schemes that are the object of the OECD's work: schemes that impede the ability of home countries to enforce their own tax laws.

Tax havens are often, but not always, somewhat peripherally located countries with extremely favorable tax regimes for certain groups of taxpayers. Examples are the Netherlands Antilles, the Bahamas, and the Cayman Islands. Examples in Europe are Andorra, Monaco, and the Channel Islands. Private investors who shelter their wealth in these tax havens do not pay income tax, wealth tax, or legacy duties provided that they are prepared to practice fraud by hiding their wealth and its returns for the tax man in their own country. The OECD does not confine itself to classic tax havens, but also targets harmful tax practices in industrialized countries. Virtually every industrialized country has certain favorable tax facilities to divert savings, financial activities, or investments from other countries. The OECD aims at phasing out a large number of these harmful facilities by 2006 by means of consultation and exerting pressure.

The EU also favors a coordinated approach to harmful tax competition. The EU (European Commission, 1997) recognizes the need for action at the European level in order to:

- reduce distortions to the single market;
- prevent significant losses of tax revenue; and
- reverse the trend of an increasing tax burden on labor as compared to more mobile tax bases.

Therefore, the EU aims at developing a tax policy that:

- serves the interests of citizens and businesses wishing to avail themselves of the four freedoms[1] of the internal market;
- contributes to a higher efficiency in the functioning of the goods, services and capital markets as well as to a properly functioning labor market; and
- facilitates efforts to cut nominal rates while broadening the tax base, thus reducing the economic distortions associated with national tax systems.

There are two routes to integration: through harmonization and through competition (Kay, 1993). In the first of these approaches the creation of free trade requires prior alignment of the policies and practices of the states involved. Under the second the favored mechanism is to promote integration as rapidly as possible, and let the consequences for rules follow from that. Generally, the EU's role in taxation has been relatively minor, so far. The EU favors tax harmonization, but it has mainly confined itself to harmonization of indirect taxes. Insofar the EU has been involved in direct taxation, it mainly pertains to corporate taxes.

Kirchgässner and Pommerehne (1996) point out that the European Commission first aimed to maximize rather than optimize tax harmonization, which was later followed by a strategy allowing more leeway to the individual member states with respect to their tax policies. Frey and Eichenberger (1996) state that tax harmonization is

[1] These freedoms are the free movement of persons, goods and capital, and the freedom to provide services.

normally advocated because it reduces *economic* distortions and tax competition because it reduces *political* distortions. Politicians pursue their own goals, which may deviate from the preferences of the citizens. One mechanism to ensure that politicians respect citizens' preferences is the exit possibility (voting by feet). Harmonization narrows the exit option by reducing tax differences. Therefore, Frey and Eichenberger (1996) consider harmonization an effective instrument to raise the tax level.

Tax burdens in the EU increased in the past 35 years, but they did not converge.[2] Table 1 shows that the average tax/GDP ratio in EU countries amounted to 27.9% in 1965 and 41.6% in 2000.[3] In 1965, tax burdens ranged from 14.7% of GDP in Spain to 35% in Sweden implying a range of 20.3 percentage points. In 2000, the range had broadened to 23.1 percentage points. Ireland had the lowest tax burden (31.1%) and Sweden the highest (54.2%). The widening of the range is a result of the EU's enlargement. Total tax burdens in the six founding countries (Germany, France, Italy and the three Benelux countries) ranged from 25.5% in Italy to 34.5% in France in 1965 and from 37.9% in Germany to 45.6% in Belgium in 2000. Thus, the range among the founding countries narrowed from 9.0 percentage points in 1965 to 7.7 points in 2000.[4]

EU member states participating in EMU have given up the possibility of an independent monetary policy. Therefore, they have fewer policy options, so they might have incentives to use taxes to achieve competitive advantages. This may intensify tax competition, create additional economic distortions and cause an erosion of tax revenues. Since the introduction of the Euro taxation is higher on the EU agenda than it has been before. The launch of the Euro has strengthened the need for more tax coordination in the field of direct taxes (Monti, 1998). Capital, especially financial capital, is very mobile. Labor is much less mobile, not only because of language and cultural barriers, but also because of differences between EU member states in social benefit systems and taxation of pensions and annuities[5], labor regulations, etc. As a result, part of the tax burden has shifted to labor. Effective tax rates on labor steadily increased in the period 1970-1998 and are considerably higher than effective tax rates on capital, which hardly rose in the same period (European Commission, 2000, p. 78). However, the shift of the tax burden towards labor is not wholly attributable to tax competition. It is partly the result of ageing of the population, the evolution of tax rates and the fact that employment income is a relatively stable and easily taxable base (European Commission, 1997, p. 4).

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[2] Though I use tax/GDP ratios, it should be noted that this measure does not capture government's influence on the economy through regulation, state-owned enterprises, etc. Moreover, governments can easily manipulate this measure, for example by transforming direct expenditures into tax expenditures or vice versa.

[3] In 1965, the EU comprised six member countries. Denmark, Ireland and the UK joined in 1973, followed by Greece in 1981, Portugal and Spain in 1986, and Austria, Finland and Sweden in 1995. Moreover, the former German Democratic Republic (Eastern Germany) joined the EU as a result of the reunion with the Federal Republic of Germany in 1991. For reasons of comparison I have listed all current EU member states from 1965.

[4] The years used are crucial. For example, the range among EU countries had narrowed to 17.7 percentage points in 1995 from 20.3 in 1965.

[5] Although member states have regulated the taxation of pensions and annuities by bilateral treaties, double taxation and double non-taxation of benefits still occur resulting in problems for the free movement of workers.

TABLE 1 TOTAL TAX REVENUE AS PERCENTAGE OF GDP

	1965	1970	1975	1980	1985	1990	1995	2000
Austria	33.9	34.6	37.4	39.8	41.9	40.4	41.6	43.7
Belgium	31.1	34.5	40.1	42.4	45.6	43.2	44.6	45.6
Denmark	29.9	39.2	40.0	43.9	47.4	47.1	49.4	48.8
Finland	30.4	31.9	36.8	36.2	40.1	44.8	45.0	46.9
France	34.5	34.1	35.9	40.6	43.8	43.0	44.0	45.3
Germany	31.6	32.3	35.3	37.5	37.2	35.7	38.2	37.9
Greece	20.0	22.4	21.8	24.2	28.6	29.3	31.7	37.8
Ireland	24.9	28.8	29.1	31.4	35.0	33.5	32.7	31.1
Italy	25.5	26.1	26.1	30.4	34.4	38.9	41.2	42.0
Luxembourg	27.7	24.9	37.3	40.2	44.8	40.8	42.0	41.7
Netherlands	32.8	35.8	41.6	43.6	42.6	43.0	41.9	41.4
Portugal	15.8	19.4	20.8	24.1	26.6	29.2	32.5	34.5
Spain	14.7	16.3	18.8	23.1	27.8	33.2	32.8	35.2
Sweden	35.0	38.7	42.3	47.5	48.5	53.6	47.6	54.2
UK	30.4	37.0	35.3	35.2	37.7	36.8	34.8	37.4
EU-15	27.9	30.4	33.2	36.0	38.8	39.5	40.0	41.6
Australia	21.9	22.5	26.6	27.4	29.1	29.3	29.7	31.5
Japan	18.3	20.0	21.2	25.1	27.2	30.1	27.7	27.1
USA	24.7	27.7	26.9	27.0	26.1	26.7	27.6	29.6

Source: OECD (2002).

The remainder of this paper is organized as follows. Section 2 deals with tax competition by reviewing arguments for and against and putting them in perspective of the development of tax structures in the period 1965-2000. Section 3 discusses tax harmonization in the EU, while section 4 reviews the legal framework. Section 5 looks at what has been achieved in the EU. Finally, section 6 summarizes the main conclusions.

II. TAX COMPETITION AND TAX STRUCTURE

A major argument against tax competition between countries to attract investment and capital is that it may lead to an inefficient allocation of resources. Tax competition may force governments to decrease taxes and, consequently, public services to a sub-optimal level, i.e., a level lower than the median voter prefers. However, the assumption that voters can fully express their preferences about size and composition of the public sector seems questionable. Modern public finance theory, in particular the public choice school, doubts that political structures within a closed governmental system are able to achieve an efficient allocation of resources and an optimal supply of public services. Tax competition that leads to a lower tax level can even bring a gain in total welfare if a substantial share of public spending is wasteful or unproductive and lower tax rates would lead to a reduction of this share (Tanzi and Zee, 1998).

If capital moves from countries with higher taxes to countries with lower taxes total tax revenue might decrease. Reducing tax rates may be in the domestic interests of a country gaining tax revenues by attracting capital. However, it may be inefficient from

an international point of view. If the revenue losses in high-tax countries are not offset by revenue gains in low-tax countries, the overall tax revenue will decrease. Also, it may be unfair from the viewpoint of international equity because one country gains at the expense of other countries losing part of their tax bases. Fairness becomes a problem if some distribution of tax revenue resulting from the greater mobility of factors of production and tax bases is politically unacceptable to certain EU member states (Devereux and Pearson, 1989).

Sinn (1990) points out that though tax harmonization is needed to avoid distortions, it does not necessarily require centrally coordinated actions by European governments. Via a process of iterative adjustment tax competition might bring about the required harmonization. The losers of tax competition will be those unable to escape high taxation (including immobile workers and landowners) and those benefiting from a large government sector. The poor will also lose because governments will no longer be able to maintain their current scales of redistribution. Thus, unmitigated tax competition will be the death of Europe's welfare states.

Klaver and Timmermans (1999), however, question that tax competition will hurt the European welfare states. They argue that the rising tax burden on labor in a number of countries has more to do with their failure to make structural adjustments in the public sector and their traditionally low tax burden on capital than with excessive tax competition. Tax competition tends to keep tax/GDP ratios low, while low tax burdens encourage wage cost moderation and foster a more attractive business climate. In addition, if low labor mobility causes over-taxation of labor and high unemployment, the solution might be the implementation of policies increasing labor mobility.

Table 2 shows major changes in the share of personal income taxes in total tax revenues in individual EU member states.[6] For example, it almost doubled in Greece and Ireland, whereas it nearly halved in the Netherlands. In six EU countries (Finland, Germany, Luxembourg, the Netherlands, Sweden and the UK) the share of personal income taxes in total taxation was lower in 2000 than in 1965. In the other EU member states this share increased. On average, however, the EU's reliance on personal income taxes did not change very much. The development in Australia was more or less similar as in the EU though more pronounced. In the 1970s and 1980s, Australia increased its reliance on personal income taxes, but reduced it in the 1990s. In 2000 it was almost back at its 1965 level. The development in Japan was not fundamentally different. Initially, the share of personal income taxes rose somewhat, but in the 1990s it decreased again. In contrast, the USA's reliance on personal income taxes as a source of tax revenues was considerably higher in 2000 compared to 1965. This is the more remarkable since it is commonly assumed that labor is more mobile in the USA than in Europe and Japan.

Tax competition may force countries to adopt other tax structures than they would have preferred in the absence of tax competition. Competition for mobile tax bases may lead to a "race to the bottom", which could even result in the abolition of taxes on capital. As a result, the tax burden may shift to less mobile factors of production, which are easier to tax. Thus, tax competition may lead to inequality in tax treatment between mobile and less mobile factors. Also, the fairness and acceptability of EU

[6] Note that table 1 focuses on the tax *level* (relative to GDP), whereas tables 2-5 focus on the tax *structure* by showing the share of a particular tax in total taxation.

member states' tax laws could be jeopardized because their capacity to tax income from capital on the basis of recipients' ability to pay is undermined (Ruding Committee, 1992, p. 38). Table 2, however, does not show a strong trend towards a rising share of personal income taxes in total revenues with the exception of the USA.

TABLE 2 TAXES ON PERSONAL INCOME AS PERCENTAGE OF TOTAL TAXATION

	1965	1970	1975	1980	1985	1990	1995	2000
Austria	20.0	20.7	21.6	23.2	22.9	21.0	20.9	22.1
Belgium	20.5	24.9	32.6	36.3	35.6	32.1	32.0	31.0
Denmark	41.4	48.6	55.9	52.0	50.5	52.7	54.1	52.6
Finland	33.3	39.2	44.1	38.8	41.6	38.5	36.2	30.8
France	10.6	10.7	10.6	11.6	11.5	11.8	11.3	18.0
Germany	26.0	26.7	30.0	29.6	28.7	27.6	27.5	25.3
Greece	6.8	9.7	8.9	14.9	13.9	14.1	12.3	13.5
Ireland	16.7	18.3	25.2	32.0	31.3	31.9	30.7	30.8
Italy	10.9	10.9	15.2	23.1	26.7	26.3	26.0	25.7
Luxembourg	24.9	25.9	27.7	27.3	25.6	23.4	21.4	18.3
Netherlands	27.7	26.8	27.1	26.3	19.4	24.7	18.9	14.9
Portugal						15.9	18.0	17.5
Spain	14.3	11.5	14.5	20.4	19.7	21.7	23.6	18.7
Sweden	48.7	49.8	46.1	41.0	38.7	38.5	35.3	35.6
UK	33.1	31.5	40.0	29.4	26.0	27.1	27.1	29.2
EU-15	23.9	25.4	28.5	29.0	28.0	27.2	26.3	25.6
Australia	34.4	37.3	43.6	44.0	45.2	43.0	40.6	36.7
Japan	21.7	21.5	23.9	24.3	24.7	26.8	21.4	20.6
USA	31.7	36.6	34.6	39.1	37.8	37.7	36.3	42.4

Source: OECD (2002).

Table 3 displays the development of the share of property taxes in total tax revenues. Since property is a typical immobile factor, tax competition may induce countries to rely more on this tax base. This assumption does not find strong support in empirical data. In only four EU countries (France, Luxembourg, the Netherlands, and Sweden) the 2000 share of property taxes in total tax revenues exceeded the 1965 share. In the EU as a whole and in Australia, however, the share of property taxes in total tax taxation was somewhat lower in 2000 than in 1965. Compared to 1975 the share of property taxes in total tax revenues in the EU and Australia was approximately the same in 2000. In Japan, the share of property taxes in total taxation slightly increased. It clearly declined in the USA, however, which occurred in particular in the late 1970s.[7] Another base that is relatively easy to tax is consumption. Empirical data shows, however, that the share of taxes on goods and services in total revenues declined rather than increased (table 4). This occurred in the EU-15, Australia, Japan

[7] Most likely, this reflects the impact of the so-called tax revolt in the USA. This started in 1978, when Californian voters adopted proposition 13 that was aimed at reducing the property tax. It seems that the high visibility of property taxes prevents governments from considerably increasing the burden on this immobile tax base, not only in the USA, but also in other countries.

and the USA. Luxembourg and the Netherlands are the only EU member states where the share of taxes on goods and services in creased somewhat in the period 1965-2000.

TABLE 3 TAXES ON PROPERTY AS PERCENTAGE OF TOTAL TAXATION

	1965	1970	1975	1980	1985	1990	1995	2000
Austria	4.0	3.7	3.1	2.9	2.4	2.7	1.5	1.3
Belgium	3.7	3.1	2.3	2.4	1.8	2.7	2.5	3.3
Denmark	8.0	6.0	5.9	5.5	4.2	4.2	3.5	3.3
Finland	4.0	2.2	1.9	1.9	2.7	2.4	2.3	2.5
France	4.3	4.8	5.1	4.8	5.8	5.1	7.4	6.8
Germany	5.8	4.9	3.9	3.3	3.0	3.4	2.8	2.3
Greece	9.7	9.3	9.7	4.6	2.7	4.6	3.4	5.1
Ireland	15.1	12.2	9.7	9.7	4.0	4.7	4.5	5.6
Italy	7.2	6.0	3.3	3.3	2.5	2.3	5.6	4.3
Luxembourg	6.2	7.1	5.1	5.1	5.5	8.4	7.2	10.6
Netherlands	4.4	3.3	2.4	2.4	3.5	3.7	4.1	5.4
Portugal	5.1	4.2	2.5	2.5	1.9	2.7	2.5	3.2
Spain	6.4	6.5	6.3	6.3	3.5	5.5	5.5	6.4
Sweden	1.8	1.5	1.1	1.1	2.3	3.5	2.9	3.4
UK	14.5	12.5	12.7	12.7	12.0	10.3	10.4	11.9
EU-15	6.7	5.8	5.0	5.0	3.9	4.4	4.4	5.0
Australia	11.4	11.0	8.8	7.8	7.8	9.0	8.8	8.9
Japan	8.1	7.6	9.1	8.2	9.7	9.1	11.7	10.3
USA	15.9	14.2	13.9	10.7	10.7	11.4	11.3	10.1

Source: OECD (2002).

Theoretical economic models predict that tax competition between governments will result in diminution of source-based corporation taxes towards zero (Ruding Committee, 1992, pp. 143-151). Gordon (1986) shows that a small country would not find it attractive to impose a corporate income tax. Razin and Sadka (1995) foresee that capital income taxes will vanish in small open economies faced with perfect capital mobility because residence countries cannot enforce taxes on foreign source capital income, whereas they are able to tax immobile factors. Frenkel, Razin and Sadka (1991) show that zero taxation of capital is optimal if two small countries can coordinate their tax policies, while capital can flow without costs to tax havens in the rest of the world and escape residence taxation. However, empirical evidence shows that EU countries did not reduce their reliance on corporate taxation. Table 5 displays that the share of taxes on corporate income in total taxation was fairly stable in the period 1965-1995 and slightly increased in the late 1990s. In Japan it decreased considerably in the 1990s, whereas in the USA it declined particularly in the period 1965-1985. Australia shows a mixed picture with a decrease of the share of corporate income taxes in total taxation in the period 1965-1985 followed by a considerable increase both in the late 1980s and in the late 1990s.

TABLE 4 TAXES ON GOODS AND SERVICES AS PERCENTAGE OF TOTAL TAXATION

	1965	1970	1975	1980	1985	1990	1995	2000
Austria	37.4	37.4	34.5	31.5	32.6	31.5	27.7	28.4
Belgium	37.2	36.5	27.4	27.2	25.3	26.4	25.7	25.4
Denmark	40.6	38.8	33.6	37.4	34.2	33.5	32.2	32.5
Finland	42.5	39.6	32.4	35.7	33.9	32.6	29.6	29.1
France	38.4	38.1	33.3	30.4	29.7	28.4	27.4	25.8
Germany	33.0	31.8	26.9	27.1	25.7	26.7	28.0	28.1
Greece	48.8	48.2	46.8	41.2	42.7	44.5	42.1	36.1
Ireland	52.6	52.4	46.5	43.7	44.4	42.3	40.7	37.2
Italy	39.8	38.7	29.4	26.5	25.4	28.0	27.3	28.4
Luxembourg	24.7	14.3	21.1	20.9	24.1	24.8	26.7	27.3
Netherlands	28.6	27.8	24.2	25.2	25.6	26.4	27.2	29.0
Portugal	44.2	44.6	40.7	44.9	42.8	43.8	43.5	39.9
Spain	40.8	35.9	24.2	20.7	28.7	28.4	28.6	29.8
Sweden	31.2	28.2	24.3	24.0	26.6	25.0	24.2	20.7
UK	33.1	28.8	25.0	29.2	31.5	30.5	35.4	32.3
EU-15	38.2	36.1	31.4	31.0	31.5	31.5	31.1	30.0
Australia	34.7	32.0	29.3	31.1	32.8	27.8	29.0	27.5
Japan	26.2	22.4	17.3	16.3	14.0	13.2	15.2	18.9
USA	22.8	20.0	19.5	17.6	18.8	17.3	17.9	15.7

Source: OECD (2002).

Tax competition may lead to resource allocation on the basis of tax minimization rather than comparative economic advantages, which will lead to welfare losses. Tax differences between countries may cause allocative distortions in the capital market because capital will move to the country with the lowest effective tax rate rather than the most efficient use. In addition, differing tax rates may lead to trade diversion, which in turn also may result in welfare losses. However, this has been challenged by Bracewell-Milnes (1999, p. 87). He draws an analogy with a supermarket competing with its rivals on price or otherwise, trying to attract geographically mobile customers and to affect the location of their activities. The promotional activities of this store may also be accompanied by a dead-weight loss, which is considered normal part of its business.

Tax competition theory suggests that small countries set lower tax rates than large countries. The reason is that small countries attract more capital relative to their own size by reducing their tax rate (Kanbur and Keen, 1993). There is, indeed, some empirical evidence that small countries set relatively low effective tax rates compared to large countries. More specifically, the five largest EU members, Germany, France, Italy, UK and Spain, have an effective tax rate that is, on average in the period 1990-1999, 11.2% higher than in the smaller member states. The mean effective tax rate of small EU countries was 24.6%, whereas the mean effective tax rate of large member states was no less than 35.8%. The difference between small and large countries declined, however, from 10.8% in 1990 to 8.5% in 1999 (Gorter and de Mooij, 2001, p. 61).

Tax competition may serve as a disciplinary mechanism to prevent governments from growing bigger than the electorate prefers. Moreover, competition by other tax jurisdictions may put pressure on governments to increase their efficiency. A counter argument, however, is that tax competition will not lead to a lower tax level, but only to a shift of the tax burden from mobile factors to less mobile factors that are easier to tax (labor, consumption, real estate). If tax competition in the EU occurs, there is no evidence that it has led to lower overall tax burdens. Table 1 shows that the average tax burden in the EU-15 rose to 41.6% of GDP in 2000 from 27.9% in 1965, an increase of nearly 50%. This relative increase is comparable to that in Australia and Japan, though the overall tax levels in these countries are still considerably lower than in the EU. In the USA, the tax level has risen to 29.6% in 2000 from 24.7% in 1965, which is an increase of only 20%. Notably, though statutory corporate income tax rates in EU countries declined in the 1990s, effective tax rates on corporations did not decline irrespective of the measure of the effective tax rate (Gorter and de Mooij, 2001, p. 59). The share of corporate income taxes in total taxation increased by one third in the EU in the late 1990s.

TABLE 5 TAXES ON CORPORATE INCOME AS PERCENTAGE OF TOTAL TAXATION

	1965	1970	1975	1980	1985	1990	1995	2000
Austria	5.4	4.4	4.3	3.5	3.5	3.6	3.7	4.7
Belgium	6.2	6.9	7.4	5.1	5.6	5.5	6.7	8.1
Denmark	4.5	2.6	3.1	3.2	4.8	3.2	4.0	4.9
Finland	8.1	5.3	4.0	4.0	3.7	4.7	4.1	11.8
France	5.3	6.3	5.2	5.1	4.5	5.3	4.8	7.0
Germany	7.8	5.7	4.4	5.5	6.1	4.8	2.8	4.8
Greece	1.8	1.6	3.4	3.8	2.7	5.5	6.5	11.6
Ireland	9.1	8.8	4.8	4.5	3.2	5.0	8.5	12.1
Italy	6.9	6.5	6.3	7.8	9.2	10.0	8.7	7.5
Luxembourg	11.0	20.8	15.6	16.4	17.7	15.8	17.5	17.7
Netherlands	8.1	6.7	7.7	6.6	7.0	7.5	7.5	10.1
Portugal						8.0	8.0	12.2
Spain	9.2	8.2	6.9	5.1	5.2	8.8	5.4	8.6
Sweden	6.1	4.4	4.3	2.5	3.5	3.1	6.1	7.5
UK	4.4	8.7	6.2	8.4	12.6	11.2	9.4	9.8
EU-15	6.7	6.9	6.0	5.8	6.4	6.8	6.9	9.2
Australia	16.3	17.0	12.4	12.2	9.4	14.1	14.8	20.6
Japan	22.2	26.3	20.6	21.8	21.0	21.6	15.3	13.5
USA	16.4	13.2	11.4	10.8	7.5	7.7	9.4	8.5

Source: OECD (2002).

III. TAX HARMONIZATION IN THE EU

The 1987 proposal of the European Commission with regard to indirect taxes was based on a rather ambitious goal of tax harmonization. Though tax harmonization ensures an efficient international resource allocation within the private sector by equalizing relative prices across borders, it does not ensure an efficient resource

allocation between the private and the public sectors since it does not respect cross-country differences in the preference for income redistribution (Hagen et al., 1998).

A less ambitious strategy is to fix some minimum rates leaving more latitude for member states.[8] Nonetheless, low-tax countries would suffer welfare losses because they are forced to raise their tax rates to the minimum. The European Commission abandoned its original plan for harmonization of indirect taxes. Instead, the EU agreed on low minimum tax rates representing a binding constraint only for very few member states. This is not surprising given the extent of diversity among EU member states. Diversity does not only result from different national preferences with regard to income redistribution, but also from differences in factor productivities, population size and composition, capital composition, and mobility of various types of capital. The extent of diversity between EU member states will further increase as a result of the eastern enlargement of the EU in 2004.

It can be expected that the welfare effects of tax harmonization will be unequally distributed, both over countries and over interest groups within countries. Large countries tend to benefit more from tax harmonization than small countries. Since large countries have certain advantages over small countries, they can impose higher taxes and yet remain competitive. Enterprises in small countries more often need to cross borders if they want to expand their activities than companies in large countries. Moreover, companies in a small country have fewer opportunities for loss compensation and depreciation relief than enterprises in a large country.

EU decision-making on taxation requires unanimity reflecting that taxation is in the heart of national sovereignty. Given the differences between and different interests of large and small countries it seems very difficult to agree on a tax level that is in the best interest of all EU member states. This seems a prisoner's dilemma. Harmonization can lead to a sub-optimal allocation of resources and welfare losses, if it is accomplished at too high a level. Therefore, tax harmonization can most likely only be achieved if the winners from harmonization compensate the losers. This not only requires that the efficiency gains exceed the efficiency losses, but also that winners are willing to compensate losers. Tax harmonization in the EU might thus lead to higher tax levels, may protect inefficient governments, and may lead to reduced competitiveness relative to other trading blocks.

IV. THE LEGAL FRAMEWORK OF HARMONIZATION

The general harmonization provisions (articles 94 and 95 of the EC Treaty) form the main legal basis for harmonizing taxes. Article 94 pertains to "directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market." So far, however, only three directives have been issued,[9] though the European Commission has proposed several corporate tax directives. The Single European Act amending the EC Treaty introduced article 95 stipulating that the Council will adopt

[8] Janeba and Smart (2003) show that under specific conditions a minimum tax rate is superior to a restriction of tax preferences.

[9] The first aims at mutual assistance by tax administrations of member states and was issued in 1977. The second directive (Parent-Subsidiary Directive) aims at elimination of double taxation of dividends of parent companies and subsidiaries of different member states and was issued in 1990. The third directive (Merger Directive) was also issued in 1990 and stipulates that capital gains arising from a merger or a similar operation will only be taxed upon realization.

the measures for the approximation of the provisions aiming at the establishment and functioning of the internal market. By way of derogation from article 94 it allows for qualified majority decision-making, but according to paragraph 2 this does not apply to fiscal provisions. In addition, some non-binding instruments have been applied.[10]

Obviously, EU member states have retained their national fiscal competence, although they will have to observe the limits imposed by EU legislation and policies. In particular the common objective of an internal market without borders restricts national governments' autonomy to design their own tax policies. The most significant progress in harmonizing member states' tax systems, however, has been achieved by decisions taken by the European Court of Justice (ECJ). These decisions are not based on provisions on taxation in the EC Treaty, but rather on the provisions on non-discrimination and the four freedoms of the internal market. The four freedoms imply the right of cross-border movements (market access and exit) and the prohibition of discrimination by reason of nationality of persons or origin of goods. The ECJ has ruled that national legislation must avoid any overt or covert discrimination by reason of nationality to be consistent with EU legislation.

Generally, EU legislation only affects European citizens and companies engaged in intra-community cross-border economic activities. They can claim protection under the EC Treaty if they encounter discriminatory or restrictive measures while making use of one of the four freedoms. The ECJ interprets the free movement provisions broadly by prohibiting not only distinctions based on nationality or origin (direct or overt discrimination), but also distinctions based on other criteria if they result in disadvantages for foreign products or factors (indirect or covert discrimination). Obviously, this concept of discrimination goes beyond that of international tax law. The OECD Model Tax Convention, for example, assumes that non-residents are in a different position and may be subject to different tax treatment. Therefore, it only prohibits direct discrimination.

The ECJ has ruled that residents and non-residents from other member states must be treated equally. For example, different treatment on the basis of residency may imply covert discrimination if it results in a different tax treatment of a group mainly comprising foreign nationals. Another example is that the ECJ interprets the four freedoms as prohibiting the enactment of national legislation impeding or rendering unattractive the exercise of any such freedoms, even if this legislation does not consider nationality. However, different treatment may be justified either because the EC Treaty allows for an exception or because it is necessary in the overriding public interest and is proportional.[11]

Though discriminatory tax measures are prohibited, the ECJ has held that they are compatible with EU law if they can be justified by acceptable reasons. Restrictions on the four freedoms can only be justified if they:

- pursue a legitimate aim compatible with the EC Treaty;

[10] The European Commission has adopted recommendations on taxation of frontier workers and on taxation of small and medium-sized enterprises. Moreover, the Council has adopted a code of conduct on harmful tax competition and the Arbitration Convention aiming at a solution of double taxation issues in connection with adjustments to transfer prices.

[11] A national measure fails to meet the proportionality criterion if the overriding public interest can also be achieved by measures that are less restrictive on intra-community trade or if it is not in proportion to the goal pursued.

- are justified by pressing reasons of public interest;
- are of such a nature as to ensure achievement of the aim in question; or
- are proportional.

A measure restricting free movement may be justified on the basis of two categories of grounds:

- The measure falls within the scope of one of the derogations the EC Treaty explicitly provides for.
- The measure can be justified on grounds the EC Treaty does not provide for, but which the ECJ has recognized and accepted as overriding requirements in the general interest.

With regard to income taxation the ECJ has developed both a non-discrimination and a non-restriction approach. The *non-discrimination* principle prohibits treating non-residents from other member states less favorably for the income tax than residents. However, there is no violation of the EC Treaty if residents and non-residents are treated equally, but non-residents face a barrier while operating in another member state. The *non-restriction* principle is based on the free movement of goods and is more radical. It forbids national rules leading to a disadvantageous treatment of people, goods or investments from other member states.

In most EU member states tax treatment is distinct on the basis of residence. If a particular tax rule is discriminatory or restricts the free movement of factors in the internal market member states may try to justify this rule. The only justification the ECJ has accepted so far is the cohesion argument: the need to protect the integrity of national tax systems. However, member states can only refer to the need to preserve fiscal coherence if there is a direct link between any fiscal advantage and a corresponding disadvantage. The cohesion argument must be viewed in the light of European regulations, bilateral tax treaties, and the possibilities of mutual assistance in tax matters. Arguments that the ECJ has refused to accept include:

- the lack of harmonization of income tax legislation;
- the need to prevent a reduction of tax revenues;
- the presence of an offsetting advantage;
- the problem of obtaining necessary information from other member states;
- the fact that the disadvantageous effect of a tax measure can easily be avoided; and
- the need to protect consumers.

V. ACHIEVEMENTS

The achievements with regard to tax harmonization in the EU have been most pronounced in the field of indirect taxes. In particular the adoption of a common Value Added Tax (VAT) system has brought about uniformity, since it is the only system that member states are allowed to use. Notably, the current VAT system is still a transitional one. The move to a definitive system requires an agreement on approximation of VAT rates and rules as well as a compensation mechanism to ensure that revenues continue to accrue to the countries in which consumption occurs. However, the member states are unwilling to accept the changes that would be needed for a definitive system to be implemented (Bolkestein, 2000). Nonetheless, the rules

determining the tax base have been harmonized to a large extent. The same holds true with regard to the procedures for tax collection and administration (VAT Information Exchange System, VAT identification numbers, multiple registration of companies for VAT purposes, tax representatives of foreign traders not established in the EU, thresholds, etc.). Statutory minimum rates have been established (15% for the standard rate and 5% for the reduced rate), but there are no maximum rates. Thus, actual rates are subject to intra-community tax competition. They still vary, but they converged in the period 1987-2002 (see table 6).[12] In 1987, the standard VAT rates varied from 12% in Luxembourg and Spain to 25% in Ireland. In 2002, this range of 13 percentage points had narrowed to 10 points. Standard rates range from 15% in Luxembourg to 25% in Denmark and Sweden. Effective VAT rates differ from the statutory rates, however, since tax bases differ across member states as a result of derogations and exemptions.

Cnossen (2001, p. 35) observes that the coordination of excises in the EU is based on three sets of directives:

- three directives on the structures of the excises on manufactured tobacco, alcohol and alcoholic beverages and mineral oils;
- four directives on the approximation of the rates of duty applicable to these products; and
- a directive on the duty-free movement and monitoring of excisable products between member states.

TABLE 6 STANDARD VAT RATES

	1987	2003
Austria	20	20
Belgium	19	21
Denmark	22	25
Finland		22
France	18.6	19.6
Germany	14	16
Greece	18	18
Ireland	25	21
Italy	18	20
Luxembourg	12	15
Netherlands	20	19
Portugal	17	19
Spain	12	16
Sweden	23.46	25
UK	15	17.5

Source: European Commission (2003), p. 2 and 19-22.

[12] Table 6 only shows standard VAT rates and no other rates because these vary widely. Countries may have one or more reduced rates, while they may combine them with super reduced rates and/or a zero rate.

However, progress on harmonization of excise taxes has been very slow. Often, excise harmonization has been spontaneous. As borders were abolished and mobility grew, excises were reduced to their lowest common rate. Total excise revenues for the EU as a whole amounted to 3.8% of GDP, down from 4.4% in 1970, whereas in the same period the total tax/GDP ratio increased (see table 1). As a result, excise revenues decreased relative to total tax revenues. Table 7 shows that excise revenues still widely vary across EU member states. In 2001, the share of excises in total taxation ranged from 14.9% in Greece to 5.3% in Belgium, while the share in GDP ranged from 5.7% in Denmark to 2.4% in Belgium.

Cnossen (2001, p. 37) argues that harmonization of excises is more urgent than harmonization of VAT for four reasons. First, excises, particularly on drinking and smoking interfere less with production efficiency than VAT, let alone taxes on labor and capital. Harmonization would enable the member states to use the revenue to reduce more distortionary taxes on labor and capital. Second, harmonization would reduce the incentive for tax-base snatching and bootlegging. Cross-border shopping is mainly caused by differences in excises, not in VAT. Third, harmonization would improve the efficiency of exchange. Fourth, if fuel and motor vehicles are used in the production process, harmonization of the related excises reduces intercountry distortions from excise-induced differences in cost structures.

TABLE 7 EXCISES IN THE EU, 2001

	Excise revenue as percentage of	
	GDP	Total tax revenue
Denmark	5.7	11.5
Portugal	4.8	14.0
Luxembourg	4.8	11.5
Greece	4.7	14.9
Finland	4.7	10.2
Ireland	4.6	14.2
UK	4.1	10.9
Sweden	3.7	7.0
Italy	3.5	8.1
Netherlands	3.3	8.0
France	3.0	6.6
Spain	2.8	8.3
Austria	2.7	6.2
Germany	2.6	7.0
Belgium	2.4	5.3
EU-15	3.8	9.6

Source: Cnosse (2001), p. 36.

Major differences still exist between corporate tax systems in EU member states. Cnossen (2001, p. 53) points out that corporation taxes are commonly distinguished depending on whether and to what extent they reduce double taxation (corporation tax and personal income tax) on distributed profits. The classical system does not provide

any relief of double taxation, whereas imputation systems provide full or partial relief by granting shareholders a tax credit against their personal income tax for the corporation tax that can be imputed to the dividends they received. Subjecting dividend income to a separate or schedular personal income tax rate lower than the top rate can also mitigate double taxation.

Six member states (Austria, Belgium, Denmark, Germany, Luxembourg and Sweden) apply a schedular treatment system that provides dividend relief to shareholders by taxing distributed profits at a schedular personal income tax rate separate from other personal income. Six member states (Finland, France, Italy, Portugal, Spain and the UK) employ an imputation system providing full or partial relief by permitting shareholders a tax credit against their personal income tax for the corporation tax that can be imputed to the dividends (grossed up by the tax credit) they received. Usually, the gross-up and tax credit are expressed as a fraction of the net dividend. Finland and Italy are the only member states that permit a full tax credit against the personal income tax for the corporation tax attributable to the shareholder's dividend income. Two member states (Greece and the Netherlands) apply a dividend exemption system for shareholders. However, the Netherlands levies a net wealth tax, which is called a presumptive capital income tax. One member state (Ireland) employs the classical system and subjects dividend income fully to both the corporation tax and the personal income tax. There is a trend to abolish imputation systems in favor of schedular taxes on distributed profits as well as other capital income. Notably, member states providing shareholders relief for the corporation tax generally confine this to dividends received from domestic firms implying double taxation of foreign dividends.

VI. CONCLUSIONS

EU member states participating in EMU have given up the possibility of an independent monetary policy. Therefore, they have fewer policy options, so they might have incentives to use taxes to achieve competitive advantages, which may intensify tax competition. However, tax burdens in the EU increased on average by almost 50% in the past 35 years, while they did not converge. Since capital is much more mobile than labor it can be expected that the tax burden has partly shifted from capital to labor. Yet, there is no evidence for a “race to the bottom”. In the 1990s, effective tax rates on corporations did not decline in the EU. Unlike the USA there is no strong trend towards a rising share of personal income taxes in total taxation in the EU. Moreover, there is no evidence of a rising share of property taxes in total tax revenues. On the contrary, in the EU as a whole this share decreased in the period 1965-2000, while the same holds true for Australia and the USA.

Tax competition theory suggests that small countries set lower tax rates than large countries. It appears that the five largest EU members have indeed an effective tax rate that is on average higher than in the smaller member states. The mean effective tax rate of small EU countries was 24.6%, whereas the mean effective tax rate of large EU member states was no less than 35.8%. The difference between small and large countries declined, however, from 10.8% in 1990 to 8.5% in 1999.

EU decision-making on taxation still requires unanimity making progress in tax harmonization a difficult and cumbersome process. So far, the achievements with regard to tax harmonization in the EU have been most pronounced in the field of indirect taxes, in particular the VAT. Minimum rates have been set, but no maximum

rates. As a result, VAT rates differ across EU member states. Moreover, VAT tax bases differ between member states because of derogations and exemptions. Less progress has been achieved with regard to harmonization of excise taxes. Harmonization in this field has been very slow and often spontaneous.

Insofar the EU has been involved in direct taxation, it mainly pertains to corporate taxes. The most significant progress in this field has been achieved by decisions taken by the ECJ. These decisions are not based on provisions on taxation in the EC Treaty, but rather on the provisions on non-discrimination and the four freedoms of the internal market. The ECJ has ruled that national legislation must avoid any overt or covert discrimination by reason of nationality to be consistent with EU legislation. However, major differences still exist between corporate tax systems in EU member states. Six member states apply a schedular treatment system providing dividend relief to shareholders by taxing distributed profits at a schedular personal income tax rate separate from other personal income. Six member states employ an imputation system providing full or partial relief by permitting shareholders a tax credit against their personal income tax for the corporation tax that can be imputed to the dividends they received. Two member states apply a dividend exemption system for shareholders. One member state employs the classical system and subjects dividend income fully to both the corporation tax and the personal income tax. However, there is a trend to abolish imputation systems in favor of schedular taxes on distributed profits as well as other capital income.

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