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Richard Teather

The Politics of EU Tax Harmonisation

*Occasional*Paper **25**

Imprint:

Published by
The Liberal Institute of the
Friedrich Naumann Foundation
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D–14482 Potsdam

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Production
COMDOK GmbH
Office Berlin
Reinhardtstraße 16
D–10117 Berlin

Printed by
ESM Satz und Grafik GmbH
Wilhelminenhofstraße 83-85
D–12459 Berlin

First Edition 2006

The Politics of EU Tax Harmonisation

Richard Teather

Paper presented at the colloquium
"Perspectives on International Tax competition" organised
by the Liberal Institute of the Friedrich-Naumann-Stiftung,
Potsdam 3. December 2005.

„The Government will continue to reject tax harmonisation and favour fair tax competition, recognising that in a global economy such harmonisation would impede economic growth, and not promote it."

UK Government, April 2004[1]

„A more co-ordinated approach at the EU level and more effective administrative co-operation between Member States could significantly improve the performance of tax systems ... helping to ensure more revenue is collected."

European Commission, October 2005[2]

Introduction

The dispute about tax harmonisation is not a mere technical issue but goes to the heart of the structure and purpose of the European Union (EU).

Without entering into the debate about the precise constitutional position of the EU, in loose terms it is a collective of Member States. Each of the States is sovereign, with its own laws and constitutional arrangements, but they act together in a variety of ways through the EU. This gives rise to EU-level law, imposed on the Member States either in specific areas (through Directives or Regulations) or generally through the Treaties (which have a quasi-constitutional status).

In theory the EU could lead to a beneficial diversity; different Member States could follow different paths, which would enable them to cater for different citizen preferences and allow best practice to emerge from the variety. This would result in reasonably efficient inter-jurisdictional competition, because the Treaty-protected freedoms of movement[3] would remove many of the common barriers to cross-border relocation and so permit individuals and businesses to move to the State whose policy mix best suited them.

1 „Prospects for the EU in 2004", para 36, Foreign & Commonwealth Office White Paper, Cm6174, April 2004.

2 European values in the globalised world, Communication from the Commission, COM (2005) 525 (final), Brussels, 20th October 2005.

3 Of people, goods and capital.

Alternatively the EU could have an institutional bias towards harmonisation, with laws increasingly being adopted at the EU rather than national level, and imposed uniformly throughout the Union (either by directly effect or indirectly through compulsory implementation by Member States' institutions). Over time this would reduce the areas of national autonomy and so restrict diversity.

Without entering into the wider argument over which of these two alternatives is the dominant one in current law and practice, there is a political fiction that taxation is at least partially protected from the harmonising process. On tax matters the electorates of Member States are said to be free to choose their own fiscal priorities. As the UK government said in its commentary on the draft EU constitution:

> „the right of Member States to determine their own tax policies is a fundamental one"[4]

This is seen as being a generally agreed position, although recent pronouncements by the EU Commission perhaps do not accept the full implications of the UK government's case; as the Commission stated in its briefing to the Hampton Court summit in 2005:

> „Responsibility for determining most aspects of taxation policy and setting tax rates remains firmly with Member States."[5]

Note that it is now only *„most"* aspects of tax policy over which Member States retain control, not all; even this politically sensitive area, the bedrock of national sovereignty, is now explicitly said to be at least partially subject to the drive towards harmonisation.

Why is this pluralistic approach to tax matters being diluted? What has changed the tax debate at the EU level is the new fear that there is a serious threat to the socio-economic model adopted (to a greater or lesser degree) by all EU governments. Although there are differences between Member States, all have a large Welfare State, with significant redistribution and levelling of income and a high level of State-provided services. The EU governments do not see this similarity as accidental, but as a fundamental feature of European life. The Commission is being increasingly explicit in its defence of this ‚European Social Model', and increasingly dogmatic about its shape:

- „national economic and social policies are built on shared values such as solidarity and cohesion, ... adequate health and safety, ... universal education and healthcare ... a choice in favour of a social market economy"[6]
- „European citizens have greater expectations of the state than their equivalents in Asia or America. The public sector tends to play a big role, either through regulation or government spending"[7]

So fundamental is this ‚European Social Model' to the governing class's view of the EU that it was to have been set out in the European Constitution which in its draft (now rejected in two national referenda) defined not so much the process by which EU law was to be made and decisions taken but the end result.

However despite its perceived centrality to European life, this European Social Model is now seen to be failing significant groups of citizens, and is said to be endangered by globalisation. Creating a high-cost, high-regulation model with high welfare payments has driven jobs to more flexible economies, creating unacceptably high levels of unemployment (now up to 19 million across the EU[8]), and the strong employment laws, which protect those already in work, have pushed the burden of this onto the young.

It is therefore not certain that this consensus amongst the European political class in favour of the old social model extends to all of the citizens of the EU. Some of the current problems in Europe, not only the highly visible civil disorder in France but also matters such as low voter turnout and the admitted low levels of qualification amongst the young (and the exit of those who are qualified to the USA)[9] may be evidence of increasing rejection of the post-War consensus by the new generation.

4 „A Constitutional Treaty for the EU", para. 76, Foreign & Commonwealth Office White Paper, Cm5934, September 2003.

5 European values in the globalised world, Communication from the Commission, COM (2005) 525 (final), Brussels, 20th October 2005.

6 European values in the globalised world, Communication from the Commission, COM (2005) 525 (final), Brussels, 20tth October 2005.

7 European values in the globalised world, Communication from the Commission, COM (2005) 525 (final), Brussels, 20th October 2005.

8 European values in the globalised world, Communication from the Commission, COM (2005) 525 (final), Brussels, 20th October 2005.

9 European values in the globalised world, Communication from the Commission, COM (2005) 525 (final), Brussels, 20th October 2005.

The political class however appears determined to preserve the status quo, and it is clear that the Commission, far from allowing diversity to lead to choice and inter-State competition, sees Member States as having autonomy only within the defined limits of the common fixed European Social Model.

This fear of change has serious implications for tax policy in the EU, and it is this desire to preserve the old Welfare State that has caused the shift in EU-level tax policy from relative autonomy for Member States to the openly expressed desire for tax harmonisation. A Welfare State at the levels seen in the EU requires high taxes for its funding, and this is reflected in the tax rates seen, particularly in the ‚old' Member States.

This does not mean that tax levels are the same throughout the EU; Ireland's tax revenues (as a share of GDP) are comparable to the USA, Spain and Portugal are both below the supposedly low-tax UK, and even France and Belgium have comparatively low tax rates - even if only when compared with Sweden. However there does appear to be a general consensus amongst EU Member States that the government should spend roughly 40 % of GDP, to fund its high levels of social intervention.

In the past the relative autonomy of Member States has led to variety, and so to ‚tax competition'. Because there have been different tax systems within the EU, and citizens have been free to move to take advantage of more favourable regimes, governments have been forced to consider the wider effects of their tax policies as well as their revenue-raising potential. This does not mean that tax levels have been reduced in the EU (the so-called ‚race to the bottom' as governments successively reduce their tax rates in an attempt to attract people and capital); on the contrary, average tax rates have risen. However it may well mean that the rate of increase has been lower than it would otherwise have been, and it certainly seems to have changed the mix of taxes, with taxes on capital (seen as being more mobile and therefore more responsive to tax competition) remaining static while taxes on labour and consumption have increased.

This ‚tax competition' causes two problems for EU governments. In the short term it can lead to loss of tax revenues for high-tax countries, as their citizens take advantage of lower rates elsewhere in the EU. More importantly, in the longer term it acts as a constraint on their future tax raising powers; if some EU Member States raise their taxes and others do not, the tax raising states would suffer an outflow of workers and capital (so that an increase in tax rates may even result in a decrease in tax revenues collected).

As seen above, the Commission is explicit in its aims and motives; tax policy is to be harmonised to avoid this tax competition, to maximise Member States' revenue-raising potential in order to prop up at all costs the failing social model of the extensive Welfare State.

The mechanism for this is to elevate the desire to maintain the status quo of the social model, with its high levels of social security payments, so that it becomes an overriding policy objective of the EU, with a quasi-constitutional position. The theoretical autonomy of Member States' governments over their internal tax policies will be subject to this requirement to protect the Social Model, which will result in a movement towards harmonisation and other measures designed to prevent tax competition.

But if the supposed freedom of Member State governments, and indirectly their citizens, to set their own tax policies is no longer seen as being a suitable policy objective, what practical impact is this having on taxation within the EU?

Current tax harmonisation in the European Union[10]

It is not generally acknowledged in the political debate, but in fact taxes are already harmonised and imposed at the EU level, and indeed have been for some time. The process began many years ago with indirect taxes, particularly VAT where the tax system is set at the EU level. It is compulsory for all EU Member States to adopt VAT, in the form and under the rules prescribed[11], and charge it on all sales except those that the EU permits to be exempt.

Two arguments are used to claim that this does not amount to an EU-imposed tax, and that the power of national parliaments over tax is retained.

The first argument is that although the *system* of VAT is imposed by the EU, the rates are not, and so the decision to charge tax, and how much, is therefore still the prerogative of national parliaments.

10 For more on the current status of tax harmonisation in the EU, see Teather, R., „Locking in high tax rates", *Journal of the New Europe*, Centre for the New Europe, Brussels, 2(1) 2005, pp 33-48.

11 Currently the „6th Directive on the harmonisation of the laws of member states relating to turnover taxes", Dir 77/388 (1977).

The second argument is that EU decisions on tax still require unanimity, and therefore an EU decision to tax is in fact a decision by each national government. Indeed the UK government, in its commentary on the constitutional treaty negotiations, cited this requirement for unanimity as proof that it has successfully resisted tax harmonisation:

> „The Government committed itself in the September 2003 White Paper (paragraph 76) to ensure that tax matters would continue to be decided by unanimity, in line with its manifesto commitment. This commitment has been delivered upon. The Convention's proposals that certain aspects of indirect and company taxation could be adopted by qualified majority voting have been deleted."[12]

Unfortunately these arguments are not valid; the first is untrue, and the second is insufficient to ensure national democratic control.

Firstly, tax rates *are* imposed at the EU level; the 6th Directive on VAT sets minimum VAT rates of 15 % as a standard rate and 5 % as a reduced rate[13] for favoured products.[14] It is therefore unlawful for an EU Member State to reduce its VAT levels below this point, and so tax could be imposed by the EU against the wishes of a national government.[15]

Moreover, this is not just a theoretical provision; it has already inflicted tax on UK taxpayers. In 1997 the UK Parliament voted to charge VAT at the full rate on domestic fuel and power[16] (it had previously enjoyed a preferential 0 % rate[17]). Later in the same year Parliament desired to restore the 0 % rate, but was unable to do so because although the EU Directive permits historic lower rates of VAT to remain as a ‚transitional' measure, it forbids any new products to be added to the list or for products to return to a lower rate once their rate has (however temporarily) been increased. VAT is therefore charged on domestic fuel at 5 % in the UK, the lowest rate permitted under the EU Directive.[18]

Taxes are therefore imposed by the EU. Of course this minimum tax initially had to be unanimously agreed by the governments of the Member States, which is the second argument against the claims that the EU now has taxing rights. However this defence is only valid immediately, not temporally; the initial adoption of a tax rate needs to be unanimous, and so may not involve a transfer of taxing rights from national governments to the EU, but once that agreement has been reached national parliaments are unable to change their tax rates unilaterally. The citizens of a Member State are therefore unable to reduce their tax rates below the level prescribed by the EU, even if they elect a new government for that precise purpose, unless their government can persuade all other Member States' governments to agree.

Effectively this allows governments to bind in their successors to high tax rates, by agreeing to an EU minimum tax that cannot then be lowered without unanimous agreement across the EU. This flouts the basic democratic principle that future governments cannot be bound (except by a constitutional provision, which usually requires a super-majority or referendum), and so the use of the EU to impose taxes grants powers to current governments that should rightly belong to future electorates.[19]

The EU has therefore, at least in part, gained the ability to impose taxes; Member State citizens are unable to vote for a national government that can reduce their VAT levels below the EU minimum. If they did so then legal action would be taken against that country's government through the European Court of Justice, either by the Commission itself or by businesses from other states which were made less competitive by the ‚unlawful' tax reduction.

At the root of this harmonisation is the fear of tax competition and loss of revenue, particularly by the high-tax countries. This was exacerbated by the introduction of the Single Market in 1992, which was meant to enable EU citizens and businesses to treat the whole of the Union as a single trading territory.

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12 UK Foreign & Commonwealth Office, „White Paper on the Treaty establishing a Constitution for Europe", Cm6309, September 2004.

13 6th Directive on the harmonisation of the laws of member states relating to turnover taxes", Dir 77/388, paragraph 12(3).

14 In addition, the products favoured by being taxed at reduced rates must come from approved categories listed in Annex H of the Directive.

15 Admittedly these provisions are currently temporary, being imposed for 5 years at a time.

16 Finance Act 1997.

17 This ‚zero-rating' is partly a mechanism by which the UK government avoided the EU prohibition on exempting any products and services from VAT other than those on an approved list; technically VAT is charged, but at the rate of 0 %. It is also more beneficial than exemption, in that businesses making supplies of zero-rated products are able to reclaim VAT paid on their costs, so removing all VAT from the supply chain.

18 Finance (No. 2) Act 1997, s6.

19 There is a further constitutional problem, that EU decisions are generally made by government ministers whereas taxes generally have to be set by parliaments.

Theoretically there are two main options for charging VAT on international activities, giving taxing rights to either the system of the country where the supplier is based (the „origin system") or that of the country where the customer is based (the „destination system"). In practice around the world VAT and similar taxes generally all use the destination system for the bulk of transactions, not particularly a result of co-ordination (although it is the method adopted by the IMF's model tax code), but merely because the purpose of VAT - as a consumption tax - makes it more logical for the tax to be levied where the consumption takes place, presumably in most cases the country of residence of the consumer.

For cross-border trading within the EU however, the Commission's desire to promote the Single Market and remove barriers to inter-Member activity led to a different approach, which resulted in a conflict with Member States' governments' agenda of enforcing compliance and preventing tax competition.

As the Single Market legislation opened up Europe's internal borders and allowed the free movement of goods throughout the EU, the Commission wanted the „origin principle" to apply within the EU, so that the VAT charged depended on the location of the selling business rather than the country of residence of the customer. This was intended to promote the Single Market by removing barriers to inter-Member trading by businesses (under the destination principle the complications of dealing with multiple VAT systems depending on the customer's place of residence would be a serious administrative barrier, particularly for small businesses). However one consequence of a shift to an origin system would be that individuals in the EU would become able to travel to other EU Member States to make their purchases, pay the taxes of the country in which the purchase took place, and bring them back to their home country without paying any additional tax. Moreover this right would be unrestricted; unlike the old system of „duty free allowances", still used for purchases made outside the EU, this new Single Market system puts no limit on the amount of imports, provided they are for personal use rather than resale.

Governments with high levels of VAT were therefore worried about tax competition if their citizens could shop in lower-tax countries. This was a serious concern: not only did the high-tax countries face the loss of consumption tax revenues, but also their domestic businesses would lose custom to suppliers in lower-taxed countries, having a knock-on effect on profits tax and employment. The UK government has been less concerned, partly because its VAT rate is one of the lowest in Europe (at 17.5 %), but also because the only land border the UK has with another EU country is that between Northern Ireland and the Republic

of Ireland - hence transport costs will reduce the opportunities for most UK residents to take advantage of lower rates elsewhere.

However for high VAT countries, particularly those with extensive land borders with other, lower taxed, Member States, this tax competition was a serious concern. A compromise was therefore reached to restrict the Single Market: the ability to bring purchases back from other EU countries without paying tax on imports only applies if the individual physically travels to the other country, makes the purchase in person and brings the goods home himself (known as ‚personal import'). It was felt that this was unlikely to result in high levels of tax competition in relation to VAT, because the tax differentials were not generally great enough to make physical travel worthwhile (especially as ‚big-ticket' items, such as cars, are excluded from this personal import regime).

Almost all other sales between different EU Member States are subject to the destination system, so that a company delivering goods to a consumer in another Member State must charge the VAT of the customer's country (with consequent administrative problems)[20]. This removes the possibility of tax competition, because the same VAT will be charged wherever the supplier is based.

This requirement for physical travel limits the effectiveness of tax competition; the maximum VAT saving for most goods within the EU is 10 % (Sweden's 25 % against Luxembourg's 15 %), and it was thought unlikely that significant numbers of taxpayers would travel between countries for a 10 % VAT saving. There is of course a greater saving where some countries have reduced VAT rates for particular items, but here again the EU has attempted to harmonise and restrict the list of items to which these can be applied. However due to political pressures countries were able to retain existing reduced rates, or even super-reduced rates such as the UK's 0 % rate, for a range of product types, which widens the potential VAT saving to 25 %. The European Commission has been trying to restrict the scope of reduced rates, limiting them to areas where there is a social policy justification, and it is now impossible to introduce new super-reduced rates (i.e. those below 5 %), and other reduced rates are restricted to certain categories of goods.

At first sight the scope for tax competition through reduced rates seems limited by the type of product subject to reduced rates; the possibility of a 6 % VAT rate for hairdressing in Luxembourg, or bicycle repairs in the Netherlands,

20 There is an exemption from this for very small businesses, to reflect the administrative difficulty of operating 25 different VAT systems, but the limit for this exemption is far too low.

does not appear likely to result in significant cross-border activity. However the European Commission's report on the issue (COM(2001) 599 final) reveals some concern; „French representatives of biscuit, chocolate and confectionery manufactures maintain that their products are suffering distortions of competition" (particularly from Luxembourg, where the rate is just 3 %),[21] and similar problems are reported concerning agricultural products. It is also possible that the UK's zero-ratings could enable tax competition, particularly medicines (where there is a growing international market), food (subject to cultural differences), books and children's clothes.

In this way the governments of the EU Member States restricted the Single Market and the free movement of goods to protect themselves from effective consumption tax competition, and to reduce barriers to their ability to raise consumption taxes in the future. The only way to take advantage of lower consumption taxes within the EU is to buy from a very small business (as these are exempt from the „distance selling" rules and operate under the origin principle) or to physically travel to another country with either a lower general VAT rate or a specific reduced rate (in which case the costs and time would reduce any tax advantage).

Tax competition in VAT is therefore limited, making it easier for governments to increase VAT rates, but there remains real scope for widespread consumption tax competition in relation to products with specific high taxes, such as alcohol, tobacco and petrol, where domestic political pressures have so far prevented harmonisation. The UK government for example loses substantial amounts of revenue from cross-border purchases of alcohol and tobacco (estimated by Customs Associates Ltd for the European Commission at EURO 400 million p.a. in 2001), because it has set excise duties on these items at rates far higher than neighbouring countries so that it is highly profitable for British citizens to travel to France, Belgium or Spain to make these purchases.

21 COM(2001) 599 final, footnote 14.

Expanding tax harmonisation in the European Union[22]

I – The Savings Tax Directive

In addition to its powers over VAT, the EU also has new powers to impose taxes on investments, through the ‚Savings Tax Directive'. This is the widely reported process by which the EU governments are hoping to stop their citizens from sheltering their savings in low-tax countries.

Although defeated many times, the Directive was finally passed on 24th June 2005,[23] just before it came into force on 1st July 2005. Under this Directive all interest payments to EU residents will be subject to a minimum tax of 15 % for the first 3 years of operation of the system, then 20 % (the international norm for tax deductions from bank interest) for the next 3 years, rising to a clearly punitive 35 % thereafter.[24]

Alternatively Member States can opt for a system of ‚automatic reporting', where the bank has to notify the amount of interest paid to the recipient's national tax authority so that they can tax it themselves. This would make it easy for the investor's home authority to impose tax, but would run against the tradition in many countries of protecting investors through client confidentiality and banking secrecy.[25]

The European Commission had been pushing for such a scheme for 15 years, but the process was held up primarily by two members of the EU that effectively act as on-shore tax havens.

The first, Luxembourg, has for its size a massive financial services sector, fuelled by its tax exemptions for interest payments and its strong banking secrecy; its government was therefore unwilling to agree to anything that would risk losing any of this business. Indeed it was the loss of tax revenue to the German

22 For a discussion of the wider implications of the EU's policy in this area, see Teather, R., „Death by Taxes", Turks & Caicos *Times of the Islands*, Winter 2004/5. Unfortunately my prediction in that article that the Savings Directive would not actually be passed was proved incorrect.

23 Council (ECOFIN) decision, document 10038/05 FISC 69.

24 The proceeds of this tax will be split, with 75 % going to the Member State where the investor is resident and the remaining 25 % retained by the country where the interest is paid.

25 Reporting also acts as tax harmonisation ‚by the back door', as it makes it impossible for many taxpayers to take advantage of lower tax rates on offer in other EU states.

government through its citizens putting their money into Luxembourg banks (a process made easier by the removal of border controls in the EU, and by the introduction of the Euro) that arguably started the whole process that finally led to this Directive.

Austria also has banking secrecy and is involved to a lesser extent in the same sort of financial business as Luxembourg, and so had an interest in preventing the Directive, but a lesser one due to the lower relative importance of its financial sector.

The other major EU tax haven is the UK, whose massive $3 trillion Eurobond market is tax-free. This allows multinational corporations to issue bonds, traded on the London Stock Exchange, and pay interest without any requirement to deduct withholding tax. Clearly this enables companies (mainly but not exclusively US and Japanese) to borrow money more cheaply by paying interest to investors gross (particularly if the investors avoid tax on their interest receipts in their home country), and so promotes the investment needed to generate employment and wealth. The existence of this market in London brings much wealth to the UK, particularly highly paid financial sector jobs, associated legal and accountancy work, and rents and taxes paid by banks and traders.

For both of these countries therefore, the Savings Tax Directive could damage their national economies; both the Luxembourg bank deposits and the London Eurobond market are attractive primarily because they are tax-free. It is true that both countries also have reasonably efficient banking and dealing sectors, but no more than many other jurisdictions, so if tax had to be imposed because of the EU then there would be no particular reason for this activity to stay in either country.

This relocation risk was one of the strongest arguments used by the UK and Luxembourg against the Directive. In today's integrated world financial markets bank deposits are clearly highly mobile, and so the Savings Tax Directive could do only harm, not good; if all savings within the EU are taxed then investors would simply move their money outside. The EU would therefore lose valuable financial sector business and the related income (and employment), but without collecting significantly more tax.

This capital market mobility is not just a theory; the London Eurobond market was initially formed in 1964 when the USA started levying tax on bond interest, and corporate borrowing (and the associated trading) was swiftly relocated to London. Market mobility is if anything even greater than it was in the 1960s, so the loss of the Eurobond markets if a withholding tax were levied would be very rapid.

Indeed there is evidence that capital flight has begun; the Hong Kong Securities & Futures Commission reported that in 2003 investments in collective investment schemes soared by 56 % after years of relatively stable growth. Although the source of these inflowing funds is unknown there is speculation that it represents European capital moving out before the Directive was implemented.

In the European Union tax measures can only be imposed by unanimous agreement of all Member State governments, which means that Luxembourg and the UK could, and did, veto early moves to introduce the savings directive. However after several years of strong pressure they extracted valuable concessions and finally gave way[26].

One important concession was that the Savings Tax Directive was conditional on its rules also being accepted by various non-EU countries, to ensure that there was nowhere for these markets to move to. Specifically it had to cover:

- The main non-EU European tax havens:
  Switzerland, Liechtenstein, San Marino, Monaco and Andorra; and
- ‚Dependent or associated territories' of EU members:
  the Channel Islands, Isle of Man, the Dutch Antilles and Aruba, and the UK's dependencies in the Caribbean.

Although the EU has no formal jurisdiction over these countries, it clearly believed that it could pressure them into agreeing to its demands, either due to geographic proximity or political or economic ties. In the end this proved to be correct; the dependent territories eventually all agreed to participate, after pressure from the UK Treasury that even the UK's Foreign & Commonwealth Office regarded as excessive.

For a while after the Directive was passed, it was therefore widely believed that it was an irrelevance because the process was conditional on Switzerland also agreeing. The Swiss government was thought to be unlikely to ever agree to

26 One of the concessions was an exemption from the new rules for existing Eurobonds; this was essential as many of them included a clause for automatic redemption if withholding taxes were ever imposed, a factor that proves the importance of the tax exemptions to market location.

anything that might damage its international banking sector. However the Swiss were put under intolerable pressure, particularly by Germany (which was losing the most under the old system through its citizens investing in Luxembourg banks) introducing excessive customs checks and administrative inconveniences in an attempt to practically close the Swiss border (the Spanish have been using similar tactics against Gibraltar).

Finally in June 2004 the Swiss government, after extracting other (primarily non-tax) concessions from the European Union, agreed to sign up to the Directive, and in June 2005 the European Union members (in the Council of Ministers) accepted the 15 bi-lateral agreements and gave the ‚green light' for the Directive to come into force, just in time for its due date of 1st July.

Those new Member States from Eastern Europe, such as Estonia, who have celebrated their escape from communism by repositioning themselves as low-tax dynamic economies, may now find their renaissance damaged through having allowed the EU to reverse this policy by imposing Europe-wide taxes.

So far the Directive seems to have had only a limited effect, because in its current form it is full of loopholes and should be easily avoidable; indeed the Swiss have dubbed it the „fools' tax" because only those who do not take proper advice will be harmed by it. However this depends on how it is interpreted and implemented; since the primary duty of the European Court of Justice is to advance European integration (rather than to determine the meaning of new laws), there is a real danger that future disputes on the application of the Directive will see a widening of its scope, and a reduction in the opportunities for avoidance, by the Court.

The Directive is therefore a powerful tool for EU governments, once again weakening the barriers to future tax rises and leaving taxpayers unprotected.

Expanding tax harmonisation in the European Union

II – Company taxation

The taxation of companies is another important area where the EU has been interested in harmonisation. Business is thought to be more geographically mobile than individuals, and therefore there is a serious risk that they will migrate away from high-tax countries, which will lose not only the direct tax revenues on business profits but also the employment that those businesses provided. With unemployment in the EU now at 19 million[27] (plus much disguised unemployment in government ‚job-creation' schemes), it appears that this process may have already begun.

The EU has been examining the possibility of corporate tax harmonisation for many years, most notably in 1992[28], but it is only recently that any concrete progress has been made.

In general the EU's activity in the corporate field has been more subtle than in other areas, and is even capable of doing some good in that it corrects the natural tendencies of politicians to meddle with their tax systems to favour particular client groups. This ‚corporate welfare', the state benefits given by politicians to particular industries, has recently started attracting more critical attention.

Clearly it is economically foolish for governments to tax successful businesses to fund unsuccessful ones: the successful activities will have their expansion hampered by high taxes whilst unsuccessful businesses will expand beyond the point at which the cost of their activities is equal to the benefit. Sadly however corporate welfare remains popular, particularly because politicians insist on believing that they have a particular insight that allows them to ‚pick winners' which have unfairly been denied funding by bankers and other financers. Effectively this is another manifestation of the persistent belief in State planning over the market. In addition it is another way in which politicians can divert resources to their client groups in the electorate, funding increased employment in their constituencies at the cost of slowing down the general economy.

27 European values in the globalised world, Communication from the Commission, COM (2005) 525 (final), Brussels, 20th October 2005.

28 Ruding, „Report of the committee of independent experts on company taxation", Commission of the European Communities, March 1992

The European Commission has, to its credit, taken action against this tendency (although political action between Member State governments has sometimes made it less effective) through the rules against ‚State Aid'. Initially these rules were only used against direct subsidies, but in 2001 the Commission began to use the state aid rules to stop tax breaks for specific business sectors. Its greatest achievement was the abolition of the Irish International Financial Services Centre (IFSC) regime, under which companies based in the Dublin docklands and operating in the financial services sector were only subject to a 10 % tax rate rather than the 30 % then levied on other Irish companies.

The European Commission successfully argued that the Irish IFSC regime amounted to illegal State Aid, because offering a tax reduction to a particular industry was effectively equivalent to a government grant to that industry.[29] However there is a limit to the use that can be made of such provisions; the Irish government's response was to replace the special reduced 10 % rate of tax for particular industries with a general low tax rate of 12 % for all companies, which is immune from challenge under the state aid rules because it is not targeted at specific industries.

An additional strand of the EU's moves against tax breaks for specific industries is its Code of Conduct for business taxation, which was agreed to in 1997 as part of a package of measures that included the Savings Tax Directive.

The Group reported in 1999, and had as its basis a similar objective to the OECD, to address *„those measures which affect, or may affect, in a significant way the location of business activity in the Community".* However Member States were keen to protect their independent authority to set their own tax rates, so measures were only to be examined if they led to *„a significantly lower effective level of taxation ... than those levels which generally apply in the Member State in question"*. In other words it was a similar approach to the use of the state aid rules; Member States were free to adopt general low levels of taxation, but not low rates (or low effective rates) for particular classes of business operations.

Again, like the Savings Directive, the Code was to be extended to associated and dependent territories of EU Member States because of the risk of simply moving tax avoidance outside the EU. It did not however extend to independent jurisdictions such as Switzerland.

The Group's report in 1999 identified 203 separate regimes within Member States that were potentially harmful, plus a further 86 in the dependent and associated territories (including the island of Sark, whose mere existence seemed to be regarded as an abusive tax practice[30]).

The Code is intended to lead to a „standstill and rollback" process, where firstly no new abusive regimes were to be introduced and then existing ones were to be progressively abolished (with a transitional period in which regimes were to be closed to new entrants but existing beneficiaries were allowed to continue).

The practical implementation of the Code of Conduct has two of the problems associated with the OECD's action against its own members' tax exemptions: it is a voluntary process with no enforcement powers, and it is a political process with no objective judicial arm to decide what practices constitute harmful tax competition (as a voluntary agreement between Member States' governments the European Court of Justice has no role). However the Code is expected to become more powerful over time.

The Code of Conduct process may appear to be generally beneficial, as it mainly attacks economically foolish tax policies that benefit politically favoured businesses at the expense of the general economy. However it shares the problem of all harmonisation, that it prevents choice and experiment, and the requirement for unanimity in tax matters means that proposals, once agreed, become fixed and increasingly inflexible. The EU may therefore find itself unable, as well as unwilling, to make the necessary adaptations to future changes in world conditions.

29 It also took similar action against other governments, including Spain's whose co-ordination centres in the Basque region were allowed to calculate their taxable profits on a non-commercial basis so that although the headline tax rate was the same as for other companies their taxable profits, and hence their effective tax rate, was artificially low. Similar regimes in Belgium, France, Luxembourg and Germany were also targeted.

30 Most of the jurisdictions only had specific aspects of their tax systems listed as being potentially harmful; Sark was treated as harmful in its entirety.

Does tax harmonisation matter?[31]

Of course one potential answer is that tax harmonisation does not matter; the EU has many powers, and imposing taxes is just one other.

Historically tax *does* matter; „no taxation without representation", the need for democratic consent to a tax, is a common theme of revolt against autocratic governments, and it was a sound practical understanding of power that put control over taxes at the heart of democratic sovereignty. Now that taxes can be imposed at the EU level, against the will of future democratically elected national governments,[32] then sovereignty has been transferred. This may be supported or opposed, but we should no longer pretend that it has not happened.

The imposition of minimum taxes at the EU level also raises wider issues. The minimum tax rates are part of a move towards tax harmonisation, the equalisation (or approximation) of tax rates across the EU. The motive for this is to reduce tax *competition*, the ability of national governments to improve their economies by reducing their tax rates and so attracting business activity and investment. Once tax competition is restricted or made more efficient, the EU Member State governments are free to introduce the tax increases that they see as necessary for their desire to retain the ‚European Social Model'.

This tax competition has been a great benefit. The increase of the global market, especially the moves towards free capital markets following the ending of wartime exchange controls in the 1980s, enabled investors to take advantage of lower tax rates around the world, and the fear of capital flight forced governments to reduce their punitive tax rates. This benefit has even been acknowledged by the OECD:

> *„The more open and competitive environment of the last decades has had many positive effects on tax systems, including the reduction of tax rates and broadening of tax bases which have characterized tax reforms over the last 15 years. In part these developments can be seen as a result of competitive forces that 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 programs."*[33]

31 For an expanded analysis of this point, see Teather, R. „Harmful Tax Competition", *Economic Affairs*, Institute of Economic Affairs, London, vol. 22, no. 4, pp. 58-63 [2002].

32 Albeit accepted by an *earlier* national government.

Tax competition therefore acts as a restraint on individual governments' ability to raise taxes; politicians still face demands from their electorates for improved public services, but if these cannot be met through increased taxation they are forced to make the public sector more efficient and better directed. Tax competition therefore increases public welfare, by reducing waste and inefficiencies and allowing public goods to be provided at a lower cost. Indeed international tax competition is essential because, unlike other sectors of the economy, there are few other effective constraints on government inefficiencies.[34]

There are other knock-on benefits of tax competition; by acting as a restraint on governments' ability to raise taxes, and so keeping taxes lower than they would otherwise be, tax competition promotes capital investment and encourages business activity. The effect of taxes on economic growth is difficult to quantify, but long-term comparative studies have suggested that each 1 % of GDP taken in tax reduces growth rates by between 0.2 % and 0.4 %.[35] This may not sound like much, but that is an annual loss; over 25 years the cumulative effect of a tax reduction of just 3 % of GDP would be a national economy around 30 % larger than it would otherwise have been, with a resultant increase in employment and wages.

Numerous academic studies have been made into the harm or otherwise of tax competition, many of them focused on federal structures, real or imaginary, and so appropriate to the EU situation. However, although most of these studies concluded that tax competition is harmful, they are generally coloured by their underlying assumptions and are challenged by more recent work.

A few of the assumptions of these studies are so bizarre that, although often needed to simplify the mathematics enough to make the equations solvable, they risk invalidating the entire study. One for example assumes that the number of active entrepreneurs in the economy is a constant,[36] despite the wide debate on the effect of taxation policies on the number of business start-ups. Many make

33 „The OECD's Project on Harmful Tax Practices: The 2001 Progress Report", OECD, Paris (2001) paragraph 1.

34 See Teather, R., „Multinational Tax Competition - a legal and economic perspective", paper presented at the Tax Research Network conference, Cambridge University, September 2002.

35 For a summary of recent studies, see „The negative impact of taxation on economic growth", Leach, Reform (London), September 2003.

36 Boadway, Cuff & Marceau, „Inter-Jurisdictional Competition for Firms: Jobs as vehicles for Redistribution", University of Quebec, 1999.

the similar, often unstated, assumption that the amount of investment capital available is similarly invariable, despite the evidence that the availability of lower tax rates increases savings and therefore capital and the fact that one of the purposes of tax havens is to increase the available capital by allowing it to be pooled from a variety of countries without imposing an additional layer of tax.[37]

In the EU situation this assumption that investment capital is fixed causes even more problems; although the EU may occasionally act as if there is no world outside its borders, it is in reality part of a global economy and therefore its tax policies can cause capital flight out to the rest of the world.[38]

Largely the studies result in the conclusion that tax competition is inefficient,[39] distortionary, inequitable or generally welfare minimising,[40] as it leads to reduced revenues for governments and therefore reduced welfare spending. However this is based on the questionable assumption that government revenues automatically result in public welfare. This means that these studies all share a fundamental (sometimes even unspoken) assumption of the efficiency of government spending. Their authors believe that „levels of taxation and public goods provision within jurisdictions are settled by majority voting",[41] and taxation is transformed into the provision of public goods without loss or waste.

Recently a few writers have challenged this assumption, concluding that the effect of tax competition on public welfare is „ambiguous"[42] because a proportion of the benefits of taxation are lost through „waste and inefficiencies in the public sector",[43] but their work is generally dismissed due to lack of quantifiablity.[44] In contrast Public Choice theory, the analysis of government action by subjecting it to the same processes as we would the actions of private persons, opposes the view of taxation as necessarily beneficial[45] and points out that governments are composed of and operated not by machines but by individuals, whose livelihoods and influence are generally dependent on the increase in government power and activity; governments are therefore run by people who have a vested interest in the increase of government.

In fact there is no causal link between increased taxation and increased public welfare.[46] The inefficient conversion of government inputs (taxation) to outputs (valued public services) is caused not only by pure inefficiencies (such as overmanning and under-use of capital resources) but also by diversion (spending on outputs that are not sufficiently valued by the public).

Modern governments tend to have their own bureaucratic growth that politicians can rarely tackle in more than a few isolated areas,[47] and in a supranational system such as the EU this process is potentially even stronger, as the increased distance between the electorate and the government weakens the democratic controls and increases the opportunities for waste and self-enrichment.[48]

Tax competition is therefore beneficial in checking the trend of bureaucracies to open-ended growth, and forcing efficiency savings. However a process that is beneficial to citizens it is not necessarily one that is attractive to governments.

37 For evidence on this point see the UK parliament's Treasury Select Committee's Examination of Witnesses, Hansard, 2nd May 1999.

38 Equally important is the action of some EU governments who are trying to use the OECD to prevent tax competition in the wider world. This ‚Harmful Tax Competition' initiative is not covered in this paper, as it is an action by individual EU governments rather than an EU process. Readers who are interested in the OECD point may wish to see Teather, R., „Tax Competition", published by the Institute of Economic Affairs, December 2005.

39 See for example „Corporate Income Tax Competition, Double Taxation Treaties and Foreign Direct Investment", Janeba, Journal of Public Economics, 1995.

40 For a comprehensive over-view, see „Capital income taxation in Europe: trends and trade-offs", Gorter & Mooij, Netherlands Bureau for Economic Policy Analysis.

41 „Tiebout with Politics: Capital Tax Competition and Constitutional Choices", Perroni (University of Warwick) & Scharf (Institute for Fiscal Studies), 1996.

42 „Capital Tax Competition with Inefficient Government Spending", Eggert, Centre of Finance and Econometrics discussion paper, Konstanz University, 1999. Keen has also written in a similar vein.

43 „Do We Need Tax Harmonisation in the EU?", Boss, Kiel Institute of World Economics working papers, 1999.

44 See Gorter & Mooij (above), pg 58.

45 Buchanan is the main exponent of Public Choice theory; it is therefore unsurprising that he was one of the signatories of a letter to President Bush opposing the OECD tax harmonisation initiative.

46 Public welfare in this case must be defined as the value citizens receive from government activities, not the cost of such provision; a valuation of outputs rather than a summation of input costs.

47 „It takes a very strong Secretary of State to resist recommendations from civil servants even though these are often quite narrowly founded", Alan Clark (former UK government minister), quoted in his „Diaries", Weidenfeld & Nicolson, London (1993).

48 See „The Theory of Public Choice: Federalism", Tullock, 2000.

European politicians are currently feeling trapped between their political desire to preserve the ‚European Social Model' and the resistance of their citizens to pay any more tax.[49] The political class has rejected the option of fundamental reform, and therefore tax rises are needed to cope with increasing unemployment and an ageing population. Of course high taxes damage investment and entrepreneurship, reduce economic activity and jobs and ultimately make the whole country poorer, but the general fear amongst EU governments about the collapse of the Social Model, and their need of ever-increasing revenues to attempt to prop it up, leads them to a dangerous short-term view.

Conclusions

As a matter of law and constitutional principle, the EU has already taken tax raising powers, and can impose taxes against the will of a democratically elected national parliament through lasting minimum tax rates.

These powers are not just theoretical, but have been exercised; EU-imposed taxes have long been the norm for VAT, and (since 1st July 2005) they now also cover investment income and are expanding into general business taxes.

This is not just a constitutional or political argument, but a practical and economic one. Imposing taxes in the EU can cause capital flight to non-EU countries,[50] reducing investment in Europe.

Furthermore competition between countries for investment has kept taxes lower than they would otherwise have been; harmonisation or minimum tax levels across the EU would stifle this competition and allow governments more freedom to raise tax levels. This would tend to lower investment and damage the economy, with consequent damage to jobs and wages.

The driver for this change is the problem of the Social Model. This is increasingly threatened by choice and inter-jurisdictional competition, as both businesses and qualified individuals leave the EU for more appropriate social regimes. This gives rise to a need for increased revenues in an attempt to maintain the Social Model in an era of rising unemployment and ageing populations, and so governments see tax competition as a barrier to their ability to increase taxes.

Future generations, and the new EU entrants, could see themselves bound in to the higher tax rates needed to fund the welfare states and pension obligations of Old Europe; their prosperity would be better served by a more flexible approach. Even Old Europe would be better served by tax competition, by adopting a model based on wealth generation for all rather than redistribution.

49 In the UK for example, government advisers now believe that tax levels above 43 % of GDP (only just above the current levels) will seriously damage their electoral prospects.

50 Although the EU is hoping to minimise this effect by having forced other countries to sign up to its proposals, this is not an exhaustive process and there will still be many countries outside the scheme.

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