TAX POLICY IN THE EUROZONE: HARMONIZATION OR COMPETITION?

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Abstract:
The aim of this paper is to analyze the main issues involved with the tax harmonization or competition in European Union. Since the foundation of the European Economic Community in 1957, there is a perpetual debate going on over the necessity of an overall tax and fiscal co-operation and harmonization in Europe, which recently has been intensified mainly because of EMU. Although issues of tax harmonization and fiscal integration in Europe have been discussed since the Treaty of Rome, they have recently become a very live and contentious issue. By reviewing briefly the literature, the paper argues that closer co-operation in tax issues – for both indirect and direct taxation – needs to accompany the current state of integration in the EU.

Key words: *fiscal policy, tax harmonization, tax competition, European Monetary Union, Eurozone*

JEL classification: E62, H2, H87

1. Introduction

The European integration has been initiated by France, Germany, Italy, Holland, Belgium and Luxembourg a half century ago. The other 21 countries that have been integrated into EU had to go through more fazes. All fazes till the present form of integration supposed a permanent dialogue between countries regarding the harmonization proceedings. As higher is the integration level, higher harmonization is necessary.

In this context, the aim if this paper is to analyze one of the aspects of the harmonization in EU, regarding the fiscal policy, taking into account the fact that tax competition could undermine economic integration in Europe, while fiscal integration could enhance economic efficiency and economic integration within the common market.

On January 1, 1999, eleven of the fifteen EU member states integrated into monetary union, thereby assigning control of all national monetary policy to the European Central Bank (ECB). According to Bordo[1], a monetary union is “one in which across the geographical area of the union, a common currency (high powered or outside money) and bank money (inside money) is accepted at par. In the modern context it also refers to having a common monetary authority or central bank”. In the next years, Greece, Slovenia, Cyprus, Malta and Slovakia entered into Eurozone.

Exchange rates between the countries are irrevocably fixed and control over money supply and interest rates is made exclusively by the ECB. The major concern over the loss of monetary adjustment mechanisms is the potential difficulties Eurozone countries may have in absorbing future economic shocks in their absence. Many theorists believe active fiscal policies will become increasingly necessary to ease the negative impact of such shocks, a situation formerly dealt with mainly through

[1] Bordo, M., *Does the Euro have a Future?*, November 2003, p. 3. Access from: <http://econweb.rutgers.edu/bordo/cato_paper.doc>.

exchange rate and interest rate adjustments. Unlike most monetary unions however, the Eurozone have not a central authority to determine fiscal policy. This results from the reluctance of member states to give up control of taxation and expenditure policies. The thought of entering monetary union without fiscal coordination consequently bred fears of greater fiscal laxity and budgetary indiscipline within the Eurozone. As a result, euro countries agreed upon strict fiscal guidelines as outlined in the Maastricht Treaty (1992) and the Stability and Growth Pact (established in 1997 and reviewed in 2005).

Related to our study, there seems to be two central questions[2] that need to be answered when forming a judgement about the design of European fiscal policy. First, is greater coordination of fiscal policies needed in the context of a monetary union? To some extent, EU countries have already answered yes to this question, and the provisions of the Maastricht Treaty on excessive deficits and the Stability and Growth Pact are the result. However, the issue remains whether the system will work adequately without further changes. And second question, if greater coordination in some form is needed, can it be achieved through greater harmonization and inter-governmental coordination or will it require some form of fiscal federalism, as implemented by nation states such as the United States, Germany, or Canada, among others?

2. Tax policy framework in the European Union

Tax policy is a symbol of national sovereignty[3] and part of a country's overall economic policy, helping finance public spending and redistribute income. In the European Union, responsibility for fiscal policy mainly lies with the member states, who may delegate some of it from central to regional or local level, depending on the constitutional or administrative structure of government.

The EU ensure that national tax rules are consistent with the Union's overarching goals of job creation and that they do not give businesses from one country an unfair advantage over their competitors in another country. So, EU tax policy is about upholding the principles of the single market and free movement of capital[4].

This is not to argue that there is no economic rationale for any EU involvement in tax policy matters. Instead, there may be some cases, when some degree of EU involvement is justified, such as[5]:

- Increased economic integration and mobility of factors of production may lead to a situation in which, on the one hand, member states develop "harmful" strategies to attract or retain mobile tax bases and, on the other hand, taxation would increasingly be shifted to the immobile factor, labour. A coordinated action at the EU level could therefore be needed.
- There are tax obstacles to the implementation of the Single Market and a common action is required to tackle those because action at national level could lead to an inefficient allocation of resources;
- There are tax externalities that can be better tackled at the EU level;
- The architecture of the EU limits its role in stabilization and redistribution, so cooperation at the EU level may actually help member states to preserve the resources needed to achieve these policies at the domestic level.

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[2] Masson, P., *Fiscal Policy and Growth in the Context of European Integration*, IMF Working Paper, nº. 133/2000

[3] European Commission, *Tax Policy in the European Union*. Acces from: <http://ec.europa.eu/publications/booklets/move/17/txt_en.pdf>

[4] http://europa.eu/pol/tax/overview_en.htm

[5] Gaetan, N., *Corporate Tax Competition and Coordination in the European Union: What Do We Know? Where Do We Stand?,* European Commission, Economic Papers. Access from: < http://europa.eu.int/comm/economy_finance>, June 2006

- Because of common monetary policy, there may be a need for multilateral surveillance on the impact of taxes on economic output and stability.

The most important moments in the development of Community' fiscal policy was Neumark Rapport (July 1962), in which professor Neumark has proposed a gradual harmonization of European tax systems, Werner Rapport (1971), which has specified that fiscal harmonization should accompany the creation of monetary union, The Rapport of European Commission about the perspectives of tax systems convergence (1980), and although the Fiscalis Programmes.

On 11 December 2007 the European Parliament and the Council adopted the Fiscalis Programme[6] establishing a Community programme to improve the operation of taxation systems in the internal market (Fiscalis 2013). The predecessors of the Fiscalis 2013 Programme were set up in 1993 following the creation of the internal market and the abolishment of the internal borders within the EU. Fiscalis 2013 Programme (2008-2013) is a follow-up programme to the Fiscalis for 2003-2007.

The adoption of euro has intensified the pressures of fiscal competition because of decreasing the monetary exchange risk, approaching interest rates and supplementary transparency conferred by using a single currency. If EMU is to be successful, member states have not only to comply with budget disciplines but also to deepen and strengthen economic policy coordination, particularly in the area of taxation. The Council's annual broad economic policy guidelines contain recommendations on the volume and structure of national taxes and social security contributions and the increasing need for coordination between member states. Tax systems have to be structured in a way which will promote economic growth, competitiveness and employment while at the same time bringing in sufficient revenue to finance social welfare spending.

The efforts of fiscal harmonization in EU have been centred to limited areas, where there are strong arguments in favour of the harmonization, being the case of indirect taxes that needed a high degree of harmonization for accomplishing the Single Market and especially for the elimination of the customs control.

The cooperation under the form of political agreements is used especially in the case of direct taxes, where some rules of behaviour have been adopted (The Code of Conduct for Business Taxation, The Code of Conduct for Transfer Price).

3. Indirect tax harmonization

In terms of application particularities, the fiscal harmonization is distinctively conceived, according to the Community acquis in two big taxation categories: direct and indirect. In the field of indirect taxation we can notice the progresses registered at the EU level, until now, thing which can also be noticed from the table below that analyses the level of the tax rates from the 27 EU states.

Table 1 Tax rates in the EU countries

Country	*Income tax*		*VAT*
	Corporate	*Individual*	
Austria	25%	21%-50%	20%GST
Belgium	33.99%	25-50%	21%
Bulgaria	10%	10%-24%	20%
Cyprus	10%	20-30%	15%
Czech Rep.	24%	12-32%	19%
Denmark	24%	38-59%	25%
Estonia	22%	22%	18%
Finland	26%	9-32%	22%
France	33.33%	10%-48.09%	19.6%
Germany	38.34%(average)	15-42%	19%

[6] http://ec.europa.eu/taxation_customs/taxation/tax_cooperation/fiscalis_programme/index_en.htm

Greece	22/25%	0-40%	19%
Hungary	16%	18-36%	20%
Ireland	12.5%	20-41%	21%
Italy	33%	23%-43%	20%
Latvia	15%	25%	18%
Lithuania	15%	15%/27%	18%
Luxemburg	29.63%	6-38.95%	15%
Malta	35%	15-35%	18%
Netherlands	29.6%	0-52%	19%
Poland	19%	19-40%	22%
Portugal	27.5%	10.5-40%	21%
Romania	16%	16%	19%
Slovakia	19%	19%	19%
Slovenia	25%	16%-50%	20%
Spain	35%	15-45%%	16%
Sweden	60%	28%	25%
U.K.	30%	0-40	17.5%

Source: http://www.worldwide-tax.com/

Note: In countries in which VAT is charged at a number of different rates, the Percentage in the Table is the highest percentage.

The VAT was introduced in 1970 in the European Economic Community and replaced a series of taxes existent at that moment for the production and consumption that made more difficult the trades between the states.

In 1977, by means of the Sixth Directive[7] it is initiated the harmonization of the VAT in the member states, a legislation that was subsequently modified. The taxation principle of the VAT is that of the consumption (the destination of the goods); the tax is to be applied for the delivery of goods and services in the state where they are consumed.

In 2003, as a result of a balance[8], accomplished in connection to the results of the strategy, regarding the improvement of VAT system's functioning, the following aspects were mentioned:

- The invalidation, after January 1st 2003, of the possibility for the member states to impose to the intra-community operators the obligation to designate a fiscal representative for the operations performed in other member states than those where they are established;
- After January 1st 2003 all taxpayers (residents or non-residents) have the right to submit VAT declarations in an electronic form;
- It was established the legal frame for the electronic invoicing and the electronic storage of the invoices;
- The unification of the reduced VAT quote and its scope.

The right of the VAT deduction is rendered in the member states of the EU equally for all the taxpayers, when the goods and services are performed for their economic operations and the performing of trades that give rise to this deduction right. There are also offered for the VAT free operations, which give this deduction right.

In the European legislation there are provided also a series of special conditions in respect to the VAT for small companies, agriculturists, second-hand goods, and art works, antiquities, gold, and tourism agencies.

It was created the possibility that also the trading companies that don't have a registered office in a member state of the EU, but performs their activity there, to request a VAT registration number, in order to submit the declarations and pay the VAT

[7] Directive 77/388/CEE from May 17th 1977, regarding the harmonization of the turnover taxes in the member states

[8] COM (2003) 614 – The Balance of the accomplishments for the VAT strategy

directly to that state, where they perform their activity, without resorting to a fiscal representative.

It has been introduced the VIES system (VAT Information Exchange System), that allows the verification of the VAT's identification number by those involved – trading companies, fiscal authorities.

In this way, it has been achieved, for the VAT, a common trim for the entire community and it has been established a series of common rules. It has also been established some minimal limits of the tax rates (for the normal rate -15% and for the reduced one – 5%). The other regulations regarding the VAT in the EU must put an end to the market's segmentations and to the exacerbation of member states' fiscal sovereignty, to establish a methodology of the simple and modern VAT, to guarantee an equal treatment for all operations performed within the EU and to ensure the security and control of the taxation in order to ensure a high level of incomes that arise from this tax.

In respect to the excises, the common schedule in the EU came into force on January 1st 1993 by the introduction of a Common Market. The excises (harmonized) may be applied for three main categories of products: tobacco products, alcoholic drinks and mineral oils. The products to which the excises apply are taxed in the status in which they are consumed. The legislation regarding the excises provides also the existence of a minimal excise for each category of products. The minimal excise was established in 1992 for alcohol and liquors, cigarettes and tobacco.

Each member state of the EU will establish, complying with the Community's dispositions the legislative frame for the production, transformation or possession of products to which the harmonized excises are being applied.

For all that, in the field of indirect taxes, the harmonization process isn't over. The commission wants to make everything that is possible to follow the simplification and modernization strategy and the strategy of a more uniform application of the present VAT system, depending on the destination. This is to the benefit of the European consumers and is the best method to reduce the bureaucracy, with which the business environment confronts. One of the priorities aimed is the simplification of the obligations afferent to the VAT payment in case of the activities performed within the Community.

4. Direct tax coordination

Regarding direct taxation, we cannot say that exists a complete harmonization in EU. The progresses we can remark are resumed to specific answers in the field of double taxation or cross-border activities. In this context we have to mention that the EU acquis refers to The Code of Conduct for Business Taxation and the member states have to adapt the domestic fiscal law to its provisions and to avoid the introduction of contrary measures. There are also provisions about administrative cooperation and reciprocal assistance between the institutions of EU countries, which attempt to obtain useful information about enterprises and to fight against tax evasion.

Because of different tax systems in EU, mainly regarding direct tax, at EU level it has been made various studies and it has been proposed different harmonization solutions. Even though, theoretically it is possible a direct tax harmonization, in practice it is difficult to realize because the member states do not want to give up on their fiscal sovereignty. This can be an obstacle for the movement of capital and labour.

Decisions about the location of investment, business activities, jobs and earnings are sensitive to differences in national tax regimes and social welfare systems. With increasing mobility and differentials in tax bases, businesses can identify the components on which they are taxed (taxable bases) and shop around to find the country where tax is lowest. Such competition between member states puts downward pressure

on the level of tax and contributions which may be damaging if it is not regulated, as it undermines the fairness and overall efficiency of tax systems."[9]

In the above mentioned context it is possible that the risk of "harmful" fiscal competition to increase. The preoccupation for the negative effects dragged along by the fiscal competition can be understood and a better coordination in this respect would have a positive impact, especially in the case of the direct taxes regarding the incomes from savings as well as in the case of the sales tax. In this way, among the reasons that justify a better coordination in the case of direct taxes, there are:

- The increase of the financial investments towards the real investments, due to some reasons, such as a greater liquidity of the financial assets, the reduction of the inflation, the reduction of the rate of interests, the extinction of the currency risk, aspects that involve a greater stability of the markets but that, at the same time, make them more sensitive to the fiscal differences between the states.
- The fiscal competition can cause a reduction of the fiscal incomes, a fact that would make more difficult the compliance to the provisions of the Stability and Growth Pact by the member states, putting in danger the financial viability of the social protection systems and hindering the appliance of the redistribution policies. This could happen because the government, aiming to attract foreign capitals, will want not only to reduce the tax rates but also to apply a special fiscal schedule (convenient) for this. The reduction of the fiscal incomes can be established also by the fact that the existence of different direct taxes between the states could determine the apparition of the fiscal frauds, a fact that would make absolutely necessary a very close administrative cooperation between the national fiscal authorities. We should not forget that although the fiscal factor plays an important role in the decision making of an enterprise for establishing the place where it will perform its activity and must take into consideration also other aspects, as the infrastructure, the available man power, legislation, the quality of the local services, etc. If the enterprises decide to establish their activities there where the fiscal charge is more reduced and not there where the production costs are smaller, the production will be less efficient.
- The costs associated to the existence of more fiscal schedules are higher both for the enterprises, that, in order to make an adequate decision for the establishment of the location, must know well these regimes and to operate with 27 fiscal authorities, and the fiscal authorities for preventing the tax evasion.
- The toughest criticism for the fiscal competition in the field of direct taxes refers to the discriminations between the production factors that are caused by these, especially against the factors with a reduced mobility (especially, labour). The fiscal competition caused a un-taxation of the capital that was compensated by an important increase of the labour taxation (including the social contributions).

At all events, in spite of the anterior arguments, which are in favour of the coordination, the fiscal competition is not bad as such, and it can also have positive effects over the economy, ensuring a more efficient allotment of the resources, as one may notice in the following table:

Table 2 Arguments pro fiscal coordination/competition

Pro fiscal coordination	Pro fiscal competition
• When the exchange risks are eliminated, the differences between the fiscal systems are more obvious and have a greater impact over the capital flows. The allocation of the capital will be distorted if the taxation is taken into consideration; • The fiscal competition can erode the taxation basis of the	• The countries that have bigger fiscal incomes (less attractive due to the high rate of taxation) can perform bigger public expenditures, a fact which makes them more attractive; • Because the countries from the Eurozone have lost the

[9] European Commission, *Tax Policy in the European Union*. Acces from: <http://ec.europa.eu/publications/booklets/move/17/txt_en.pdf>

member states and reduce their incomes; • There is an imbalance between the monetary policy (coordinated) and the fiscal policy (uncoordinated); • The competition may ensure an optimal allocation of the resources if the capital and the labour can be freely displaced. If one of the production factors present a high mobility (the capital) and the other a low mobility (the labour), the resources' allocation won't be efficient; • The fiscal competition increases the fiscal charge over labour, a fact that increases the unemployment rate; • The fiscal competition makes harder the use of the fiscal systems for achieving the objectives at a social level and those regarding the environment; • Important costs for the enterprises that must work with 27 different fiscal authorities.	capacity to modify the rate of interest and the currency exchange, the only instrument left for the achievement of the stabilization policies is represented by the modification of taxes; • The benefits that result from the fiscal competition are not allocated uniformly between the participants. The small rates of taxation represent a way used by the small countries in order to attract investors, while the cooperation is an instrument that allows the developed countries to maintain their incomes; • The wished combination incomes – costs is not the same in all the countries, because the decisions in the field of taxation reflect also the preferences of the citizens.

Source: Rubio Guerrero, J. J.; Barusso Castillo, B., *El futuro de la imposición directa en la Unión Europea. Access from:* <http://www.unav.es/economia/economiasectorpublico2/research/1ArmonizacionImpDirectos.pdf>, *p.18.*

5. Conclusions

Our study allows several conclusions.

The impulse that was given to the initiatives of harmonization of the taxation regarding savings (deductions and information referring to the interests paid to persons), to investments (The Code of Conduct for Business Taxation) and of elimination of the double taxing between community corporations, reflects the concern for the potential adverse effects of the tax competition within the context created by the European Monetary Union.

By means of the arguments presented in our work we are trying to justify the idea that the absence of a very tight harmonization should not be worrying.

The principle of subsidiarity represents the first aspect faced by the harmonization initiatives. According to this principle, no community action can cross the threshold of necessity in order to accomplish the objectives of the EU Treaty. And in order to protect the right that states have of shaping their own tax policy according to internal criteria – as far as they do not contravene the functioning of the Single Market – the EU Treaty calls for unanimity in decisions regarding the tax system.

The second aspect that strikes the harmonization proposals is represented by the possibility of applying the taxing principles that could protect the national taxing systems against the tax competition in a globalized world. Applying residency and destination principles would prevent the harmonization need, but practically all countries deviate, to a certain extent, from these principles.

The deductions, exemptions and imperfections of the tax control mechanisms limit the harmonization initiatives. As long as there are tax paradises or areas in which there are very low tax rates, inside and outside EU, a harmonization that would set very high standards would probably generate high costs in the EU member states.

In present, the tax policy in EU – for both indirect and direct taxation – constitutes a temporary solution and it is at transitional stage. In fact, the different tax systems in the SEM (Single European Market) are not in accordance with the current state of integration. On the other hand, the response to increasing economic integration and tax competition in Europe cannot be simply tax harmonization. As emphasized by the literature, in certain cases such a development would have negative welfare effects for some members and does not fully address the fiscal aspects of the integration process. However, it lays the foundation for closer co-operation in the tax field and paves the way for fiscal integration in the EU. Several new initiatives to further promote co-ordination of national direct tax systems in the EU are currently being discussed.

Work is also progressing on a proposal that would allow companies to use EU-wide rules to calculate their corporate tax base (common consolidated corporate tax base).

The literature often condemns tax autonomy because of possible free-riding behaviours. In the other hand, the competition could conduct to the lowest tax rate of all countries, condemning others to diminish their public spending. Some, but not all, measures of tax competition may be damaging as well as some, but not all, measures of tax coordination may be beneficial. Even so, it doesn't exist a measure which prohibit the tax competition, as long as it isn't harmful.

In this context, there seems to be a strong rationale for increased coordination to introduce more coherence into European economic policy-making, although there are diverging views of how to go about. It is widely accepted that the governance structure of the Eurozone has until now struck an inappropriate balance between the need for procedures that ensure fiscal discipline and the need to ensure that such procedures do not impart an unbalanced, deflationary bias to the Eurozone's whole economic architecture. If sustained, this deflationary bias could put at risk the whole single currency project, and perhaps even the EU itself. Ultimately, decisions to reform the Eurozone's economic governance structure are connected to political and institutional choices by the members of the Eurozone. These choices will not be easy ones. But if the growing sense of unease throughout Europe with the workings of the single currency is justified, time is limited for the introduction of necessary changes to improve the economic and political workings of the Eurozone.

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