Tax Policy and European Union Governance

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Abstract: The governance of tax policy is one of the key issues that must be resolved by a constitution for the European Union. Taxation is an area in which the tension between subsidiarity and coordination is acute. This paper reviews recent Union policy alongside an analysis of the underlying economic issues. The provisions of the constitution proposed in 2005 are then assessed to determine whether they provide the powers that the Union requires to ensure efficiency.

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1. Introduction
The Constitution for the European Union proposed in 2004 provided a clear vision for the future. It foresaw the Union as a single market with efficient trade and unhindered movement of capital and labour. Allied to this was the aim of balancing the freedom of competitive economic activity by support for the disadvantaged within a social market economy. These objectives were stated precisely in Article I-3 of the Constitution:

*The Union shall offer its citizens an area of freedom, security and justice without internal frontiers, and an internal market where competition is free and undistorted.*

*The Union shall work for […] a highly competitive social market economy.*

The Constitution also allowed for Member States to sustain a degree of independence in their policy choices. This was granted by the principle of subsidiarity which featured throughout the Constitution. For example the intention of the Union to respect subsidiarity was promised in Article I-11:

*The use of Union competences is governed by the principles of subsidiarity and proportionality.*

Even though the Constitution granted subsidiarity, it also envisaged some limits upon the application of this principle. These limits were also described in Article I-11:

*Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and insofar as the objectives of the proposed actions cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.*

The drawback of subsidiarity is that individual Member States may make policy choices which are privately rational but not socially optimal. To counteract this, the Constitution provided the Union with a coordinating role in policy. As set out in Article I-1:

*The Union shall coordinate policies by which the Member States aim to achieve these objectives.*

The rejection of the proposed constitution by voters in France and the Netherlands leave the current position in doubt. What is clear is that any future constitution (or, possibly, any less formal set of new rules) must provide a solution for trading subsidiarity against coordination. The same economic issues will arise whatever the form of the final solution for the political structure of the Union. The need to address the divergence between the private and social benefits of the actions of Member States requires rules that permit a coordinating role for the Commission or its successor body.

In the context of tax policy there are a range of conflicts introduced by the multiple objectives of economic efficiency, sustaining a social market economy and subsidiarity. The special feature that makes issues of governance so central is that tax policy bears directly on the efficiency of the single market and provides the revenue to finance social market activities. Taxation is also symbolic of the freedom of Member States to maintain independent control over a central component of economic governance. The study of tax policy brings into stark focus how conflict can
arise between the coordinating role of the Union and the rights of Member States to pursue their own distinguished policies under the principle of subsidiarity.

The paper begins by reviewing the VAT harmonization process that was begun by the Union in the late 1980s. This short history provides an illustration of many of the issues involved in tax governance. The focus is then placed upon some of the further challenges facing the Union in connection with tax policy. The first section studies the taxation of commodities and links the issues surrounding subsidiarity with the principles of international taxation. The second section focuses on the taxation of capital as an example of the process of tax competition. The final section returns to the proposed Constitution to assess a number of its articles in the light of the how they could have been applied to provide remedies for the problems identified in the discussion.

2. The Single Market and Harmonisation

The history of the tax harmonization process undertaken by the Union from the late 1980s succinctly captures the key issues of tax governance. Reviewing the process reveals the tensions between subsidiarity and efficiency, and between subsidiarity and coordination.

Harmonization refers to the process of bringing about equality in the rate of VAT in Member States. It has been part of Union policy proposals since at least the Neumark Report of (1963). The European Commission has understood that the single market implies a need for a degree of harmonization of indirect taxes because of cross-border shopping and also because of potential protectionist use of national taxes. It is also concerned about the impact of different tax rates on mobile factors such as capital. Finally, certain countries are concerned about the possibility of “tax evasion” being induced when countries retain autonomy over the setting of tax rates. The variation in the tax treatment of income from interest on capital is a prime example. Harmonization can be also encourage trade by leading to simplified accounting.

The 1987 proposal on harmonization was to restrict member states to a two-rate system of VAT – a standard rate of 14-20 percent and a reduced rate of 4-9 percent for basic goods, combined with uniform excise duties. The proposal met with objections because of the substantial impact on some members’ tax revenues and the implications for tax rates on socially and distributionally sensitive goods. Instead, a system of minimum tax rates was proposed in 1989 and introduced in 1993 - a minimum standard rate of VAT of 15 percent and one or two lower rates of at least 5 percent but the existing zero-rating as in the UK (of food, children’s clothes) was allowed to continue and a set of minimum excise rates was also proposed. The “approximation” of tax rates remains a long-term goal.

Table 1 provides some data on the evolution of VAT rates in the Union since 1970. It can be seen from this data how little progress there has been towards convergence. Despite the operation of the harmonization process there are still wide disparities in VAT rates.

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<td>Standard (normal)</td>
<td>Reduced (essential)</td>
<td>Increased (luxury)</td>
</tr>
<tr>
<td>Germany</td>
<td></td>
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<tr>
<td>Standard</td>
<td>11</td>
<td>5.5</td>
<td>-</td>
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<td>Reduced</td>
<td>23</td>
<td>7.5</td>
<td>33</td>
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The work of the harmonization process remains a long-term goal.
Variations in levels of excise duty and capital taxation in different EU member states have also caused concern. Less concern has been shown over differences in personal income taxation. This is perhaps surprising since, together with social security contributions, they yield more than 40 percent of total tax receipts in the Union. The explanation can probably be found in the relative immobility of labour compared to capital. As part of its internal market programme, the Commission also proposed the harmonization of excise duties on mineral oils, tobacco products and alcoholic beverages. This was rejected by Member States and a system of minimum rates was introduced in 1993. Despite this, as shown in Table 2 the dispersion of rates remains substantial giving rise to substantial cross-border shopping flows.

<table>
<thead>
<tr>
<th></th>
<th>Cigarettes (per 100)</th>
<th>Wine (per litre)</th>
<th>Petrol (per litre)</th>
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<tbody>
<tr>
<td>Germany</td>
<td>7.67</td>
<td>0.00</td>
<td>0.58</td>
</tr>
<tr>
<td>France</td>
<td>8.64</td>
<td>0.03</td>
<td>0.63</td>
</tr>
<tr>
<td>Belgium</td>
<td>7.49</td>
<td>0.47</td>
<td>0.55</td>
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<tr>
<td>UK</td>
<td>18.40</td>
<td>2.30</td>
<td>0.81</td>
</tr>
<tr>
<td>Spain</td>
<td>4.84</td>
<td>0.00</td>
<td>0.40</td>
</tr>
<tr>
<td>Sweden</td>
<td>10.36</td>
<td>3.11</td>
<td>0.59</td>
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</table>

Source: Molle (2001)

Table 2: Excise Taxes in Euros, 2000

Given the high mobility of capital, differences in corporate tax rates (and systems) could result in significant distortions. In the face of hostility from member states, however, the Commission has made virtually no attempt to harmonize corporate taxation (it largely ignored the recommendations of the Ruding Committee) limiting itself to measures that limit double taxation. Tax competition has, however, resulted in some convergence of rates over the past decade. Some interpret this convergence as the process of tax competition succeeding in removing an economic distortion, others perceive it as a sign of a race-to-the-bottom.

Finally, Germany in particular has been concerned that a number of its citizens are evading taxes on their savings (or rather on the interest that they earn on these savings) by holding them in banks in other countries. It has pressed for the introduction of a common withholding tax on all interest paid on bank deposits and portfolio investments; this was supported by the Commission. This common withholding tax was opposed by other countries – most notably Britain – which saw it as threatening the City of London. At present, discussions continue on a hybrid system in which banks either withhold part of the income payable to non-residents or would provide information to the authorities in other member states on how much interest has been paid and to whom.

The current position for harmonization is captured in the following two quotations. First, from the European Commission:
Member States have shown little enthusiasm for the proposals in Council meetings and [...] have been reluctant to accept the greater harmonisation of VAT rates and tax structures. (European Commission, 2000, p. 18)

Second, from the 2003 Draft Report of the Committee on Monetary and Economic Affairs which states that

The European Parliament is strongly committed to the introduction of the definitive system of VAT, but given the lack of progress in that regard, there is no urgent need to harmonise rates.

3. The Taxation of Commodities
The discussion of harmonization has described some of the issues that the Union faces in connection with the taxation of commodities. Amongst these, it was noted that the system in use results in extensive cross-border shopping. That this would happen upon the completion of the single market was well understood at the time the policy was implemented. To counteract it the Union had the intention of significantly revising the system for commodity taxation. As will be described below, this intention has not yet been realised.

It is first interesting to discuss why cross-border shopping can be viewed as unwelcome since this is contrary to the viewed expressed in some publications of the Union (the report “Unlocking the Potential of Cross Border Shopping in the EU” published in 2002 expresses dissatisfaction that over the survey period of a year only 13% of the EU population engaged in cross-border shopping). The explanation can be found in the different forms that such shopping takes. It is economically efficient for consumers to purchase from the cheapest source and in an economy without distortions this is a necessary condition for efficiency. From this perspective, cross-border shopping should be encouraged.

The view of cross-border shopping as a problem in the Union arises from the fact that the market is not undistorted. Instead, much cross-border shopping is driven by differentials in the tax treatment of commodities in different Member States. This is a case of one distortionary activity generating a further distortionary response which causes additional deadweight loss.

There are four routes through which cross-border shopping is damaging. First, there is a direct waste of resources if consumers undertake travel simply to exploit tax differentials. The private importation of commodities by consumers is less efficient because it cannot exploit the economies of scale enjoyed by transportation companies. Second, as well as the direct use of economic resources in inefficient transportation, private importation also imposes additional environmental costs. Third, cross-border shopping distorts the regional patterns of trade by encouraging the agglomeration of companies supplying the trade around border locations. Finally, the ability of governments to pursue independent objectives is undermined by the ability of consumers to employ cross-border shopping as a means of avoiding punitive taxation.

As an example of the final point, the UK government has long pursued a policy of imposing a high tax upon cigarettes to discourage consumption for health reasons. But if cigarettes can be purchased elsewhere in the Union with a lower rate of tax and personally imported back into the UK then, at best, the policy is only partially effective. At worst, it simply becomes an irrelevance. (In conjunction with HM Customs and Excise, a football club collected discarded cigarette packets after a recent match. 22 percent were found to have been unofficially imported.) In such
cases, the perfectly acceptable objective of one Member State is undermined by cross-border shopping exploiting the tax choices of other Member States that do not subscribe to the same set of objectives.

The completion of the single market in January 1993 had a significant impact upon tax policy in the Union. Prior to the completion of the single market the system of taxation involved exports from one Member State to another being zero-rated. Importers paid VAT at the rate of the destination country in which final consumption would take place. For this system to work, the tax authorities had to be able to determine when goods crossed borders. This was possible using cargo manifests and other documents before 1993; but after that date, there was, in principle supposed to be no difference between shipping goods from, for example, Milan to Munich and Milan to Manchester. The removal of borders ensured that there was no documentary trail on the basis of which tax liabilities could be determined.

The European Commission’s White Paper of 1987 proposed that after the abolition of border controls Union procedures would mirror national ones. Exports would carry the VAT of the origin country, which could be reclaimed as input VAT in the destination country if the good was used as an input rather than a consumption good. The VAT charged to the final consumer would still be that of the destination country and a “Clearing House” would reallocate revenues to the appropriate country. For example, a German firm buying a French product would reclaim French VAT contained in the price from the German Revenue Office and pay the German VAT on its sales instead. Since the importing country rather than the exporting country gives a credit for pre-paid VAT, a clearing mechanism would be necessary to redistribute the tax revenue between jurisdictions. The intention of the redistribution was to ensure that no major shifts in revenue occurred on the completion of the single market.

This proposal was never implemented because of the administrative problems which it would have generated. An interim scheme is currently in operation which attempts to mirror the pre-1993 zero-rating of exports. It does this by substituting accounts auditing for the role previously performed at frontier controls. It was initially foreseen that the interim procedure would be replaced by the “definitive” system by 1997. This has still not happened. In fact, the nature of the definitive system has not yet even been determined and discussions about the future functioning of VAT continue.

The source of these problems is the method of taxation (or tax “principle”) employed by the Union. The form of taxation employed prior to the completion of the single market is known as destination taxation. Under this principle commodities are taxed in the country of final consumption. Exports are tax free, with taxes imposed once the border is crossed. Consequently, destination taxation requires the maintenance of borders so that the appropriate border tax adjustments can be made. The borders ensure that all commodities carry the tax rate of the country of consumption. This allows each country to pursue an independent tax policy, hindered only by the limited amount of smuggling that might take place. Under the destination principle with border controls, consumers cannot legitimately undertake cross-border shopping to exploit tax differentials.

The fact that the destination principle is not a suitable system of taxation for a single market was recognised at a very early point in the development of the Union. The Tinbergen Report of 1953 prepared for the European Coal and Steel Community recognised that destination taxation would not be sustainable once the single market
was completed. This implied a choice between either accepting an outcome with cross-border shopping exploiting tax differentials, placing limits on the possible differentiation of tax rates between Member States or the replacement of the destination principle with an alternative system of taxation.

The alternative system of taxation proposed by Tinbergen was the *origin principle* which taxes goods in the country of production. In brief, under the origin principle a good is taxed by the country in which final production takes place prior to supply to consumers. When applied to the Union, the origin principle would require each Member State to tax the production occurring within its borders. Products produced by one Member State would bear the same rate of tax regardless of where they were consumed in the Union. The advantage of the origin principle is that no border tax adjustments are required so that it is consistent with the operation of a single market (in that tax differentials do not induce cross-border shopping) and it leaves each Member State free to pursue its own tax objectives.

The switch to the origin principle of taxation has long been established as a goal of Union tax policy. A recent statement of support for this position was contained in Amendment 2, Recital 5 of the 2003 Draft Report of the Committee on Monetary and Economic Affairs. The relevant passage states that:

*The Community’s long term objective is moving to a definitive VAT system, based on the principle of taxation in the country of origin, this implies that there should be a gradual continuation of a systematic and coherent approach towards approximation of VAT rates, as needed.*

Many economists since Tinbergen have argued for a switch to the origin principle (for example Lockwood *et al.* (1995, 1995)) in preference to remaining with a destination system that is inappropriate. One argument that might be thought to have held back the Union in making the change is that a transition in the basis of taxation, from taxing consumption to taxation production, would cause a major disruption in revenues. This need not be so. The basis for this statement are the equivalence results which demonstrate (with uniform taxation of commodities) that the destination principle with border controls leads to exactly the same economic outcome as the origin principle without.

In a closed economy this result is easy to understand. The levels of production and consumption must be equal, so the change in the principle has no effect upon the size of the tax base. If the tax rates are the same under the two principles they must lead to the same relative prices and hence to the same equilibrium. In an open economy the change in the principle must cause the relative tax rates on different goods to change. For example, if the one country has a lower rate of VAT than a trading partner then imported goods will bear a higher rate of tax after the switch. However, this change in relative taxes between the two principles is compensated for by adjustment in the relative wage rates in the trading countries. Even more surprising, if tax rates are not uniform within each country then the origin principle may even lead to higher economic welfare than the destination principle (Keen and Lahiri (1998) and Hashimzade *et al.* (2005)).

This literature suggests that a switch from destination taxation to origin taxation is both feasible without major changes in tax revenues and more than likely would be beneficial. In particular, the effects of the switch would be minimized if undertaken once the labour market is liberalized.
As will be discussed in more detail below, the Constitution that was proposed did not explicitly enter into a prescription of the future system of taxation. What it did provide was a statement of what the Union wished to achieve and the powers that it would have to achieve it. Until the a Constitution is adopted, or other set of new rules implanted, the Union will remain in the current unsatisfactory position.

4. Capital Taxation and Tax Competition
The discussion of commodity taxation has focused upon the choice of the tax principle and whether tax rates should be harmonized. In contrast the discussion of capital taxation in the context of the Union has emphasized the consequences of jurisdictions competing for mobile capital by strategically setting their tax rates. Such competition can lead to inefficiently low tax rates and can even culminate in the “race-to-the-bottom”.

The serious economic analysis of tax competition began in Mintz and Tulkens (1986) and Wildasin (1988). The extensive literature that has developed since is surveyed in Wildasin (1999). The basic source of tax competition is that an increase in the rate of tax on corporate income by one Member State will lead to a capital outflow to other Member States. This raises the tax revenue of the other Member States so that there is a positive tax externality and, as expected with a positive externality, equilibrium tax rates will be too low.

The more extreme versions of this argument see Member States engaged in a race-to-the-bottom in which a succession of tax cuts driven by tax competition gradually erode government revenues. The lack of revenue then prevents the governments from financing desirable social policies. The extreme versions of this scenario see tax competition undermining the entire basis of the social market economy envisaged by the new Constitution. A particularly strong expression of this argument can be found in Sinn (2002).

The paradox facing the Union is that the free movement of capital and labour is necessary to achieve economic efficiency within the single market yet it is these factors that give rise to tax competition. It might be thought that some hope for the Union could be obtained by appealing to the Tiebout hypothesis (Tiebout 1956) which claims that competition between jurisdictions will lead to the founding of a range of heterogeneous jurisdictions that ideally meet the needs of all members of the population. Whether this holds in practice has long been a contentious issue, although the latest evidence on US data does offer some support for the hypothesis (Rhode and Strumpf (2003)). Even so, it is unlikely to apply given that the Union contains only a small number of Member States, thus preventing application of the hypothesis.

As well reducing equilibrium tax rates, tax competition can also limit the redistribution that can be undertaken. In the economic analysis it is assumed that individuals relocate to seek the best benefits package obtainable. Any government that attempts to imply redistribution will attract recipients and drive away contributors. The government is then forced to cut benefits, so as not to attract a population of a type it cannot afford. As Hindriks (1999) has shown, this process results in less redistribution in equilibrium than jurisdictions wish to have. This reduction in redistribution may be offset by the emergence of endogenous transfers between jurisdictions that offset the externality (Hindriks and Myles (2003)). Intriguingly, the structure of these transfers demonstrate the characteristics of the reallocation of own
resources in the Union. In any case, there remains a beneficial coordinating role for a central authority.

As well as the direct effect upon tax revenue, there are several further reasons why the level of corporate taxation matters. Taxes determine the return on corporate assets so affect the decisions of firms to invest and the portfolio allocation of financial resources across assets. If there is variation in the tax rates of Member States for reasons of tax competition, then these decisions will not be made efficiently. Variation in tax rates can also be exploited by the internal accounting of firms to manipulate the allocation of profit across member states to minimise tax liabilities. Tax rates can also influence the choice plant location for companies with the possible introduction of long-term inefficiency.

Evidence on the extent of tax competition is contained in the OECD report of 1998. It can also be witnessed in the data on corporate tax rates of Union Member States. A sample of this evidence is reported in Table 3 which details the statutory corporate income tax rate in 1982 and 2001. In all countries, with the exception of Italy and Ireland, the statutory tax rate has fallen, in some case dramatically. These reductions are usually interpreted as being driven by the success of the low rate of corporate tax introduced in Ireland.

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<thead>
<tr>
<th></th>
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<tr>
<td>Sweden</td>
<td>61</td>
<td>28</td>
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Source: Devereux et al. (2002)

Table 3: Statutory Corporate Income Tax

The evidence in Table 3 provides an indication of the direction of change in tax rates but it does not provide the complete picture. The data in Table 3 is for the statutory rate which is the value set in legislation. Most tax legislation also includes a series of reductions, exemptions and relief for capital investment. The rigor of enforcement is also variable. It is therefore quite possible that a reduction in the statutory rate can be offset by a broadening of the tax base through a reduction in exemptions. Such broadening can offset the effect of the rate reduction upon revenue.

Some evidence of the net effect of rate reduction and base broadening is presented in Figure 1. This figure graphs the revenue from corporate taxation as a percentage of GDP for a number of economies. The percentage value for each country is weighted by GDP, so that the effect in small countries cannot dominate the overall picture. Contrary to the evidence from looking at the statutory rate, revenue from the corporate income tax remained mostly constant until the early 1990s and has shown a
strong growth trend over the previous 10 years. While an increase in corporate profitability may explain at least some of this increase, the fact remains that revenues from the corporate income tax are not being adversely affected by the effects of tax competition.

Figure 1: Corporate Income Tax Revenue as a Percentage of GDP

Figure 2 plots the same information for the UK over the period 1982–2001. The reason why UK data may be particularly interesting is the argument that tax competition in the Union has been driven by the aggressively low rate of tax in Ireland. The UK is Ireland’s closest geographical neighbour and shares a common language. It is natural to expect that if the low tax rate has benefited Ireland then it will have done so at the expense of lost capital for the UK.

There is a weak trend for a decrease in revenue but the data are clearly driven changes in corporate profitability. If anything, revenues are currently on a rising trend. It might be expected that if tax competition is driving down capital tax rates, the process would have accelerated since the completion of the Single Market in December 1992. To test this idea, consider the data in Figure 2 since 1993. It can be seen in the figure, and easily confirmed by plotting the data, that the effective burden on capital has actually risen very slightly since 1993 – the converse of what the tax competition argument would suggest. If the Member States are engaged in tax competition then it is not necessarily leading to the collapse of revenues even for the countries that may be expected to suffer most.

Source: Devereux et al. (2002) (using OECD data)
(Weighted average for 14 EU countries plus Canada, Japan and the US)
Figure 2: UK Revenue from Taxes on Capital as % of GDP

The current policy of the Union towards tax competition is encapsulated in the Code of Conduct for Business Taxation. The Union’s Finance Ministers established the Code of Conduct Group (Business Taxation) at a Council meeting on 9 March 1998. The Code is not a legally binding instrument but it clearly does have political force. The Code of Conduct requires that Member States refrain from introducing any new tax measures that may be harmful (“standstill”) and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code (“rollback”). The Code covers tax measures (legislative, regulatory and administrative) which have, or may have, a significant impact on corporate location decisions within the Union.

There are a range of criteria for identifying potentially harmful measures. The first of these is the use of an effective level of taxation which is significantly lower than the general level of taxation in the country concerned. Similarly, the Code identifies as harmful any tax benefits reserved for non-residents. Both of these measures influence the location decision of a corporation. In addition to these, other measures judged as harmful are tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base and the granting of tax advantages even in the absence of any real economic activity. The Code also requires that accepted accounting conventions are adhered to, with it judged harmful if the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD. Finally, a lack of transparency in the tax treatment of corporations is also judged harmful.

Economists have identified tax competition as harmful because it leads to equilibrium rates of tax which are below the efficient level. In turn, the low tax rates lead to reduced government revenues. The mobility of labour can also undermine an attempt to conduct redistributive policy. Observation of the fall in statutory corporate income tax rates is usually given a evidence for tax competition within the Union. A review of the data shows that corporate tax revenues as a percentage of GDP have not fallen. This can occur through the tax base broadening and through an increase in corporate profitability. The Union has a voluntary Code of Conduct designed to lessen tax competition. As will be shown in the next section, the proposed Constitution
appeared to grant the Union powers to coordinate the policies of individual Member States. Coordination is the natural policy to combat tax competition.

5. Tax Policy under the proposed Constitution

The purpose of this section is to review those articles of the proposed Constitution which may have some bearing upon tax policy. In doing this the Constitution has been read fairly literally.

The most fundamental requirements of economic activity were enshrined in Article I-4 which guaranteed:

*The free movement of persons, services, goods and capital*

and that:

*Within the scope of the Constitution ... any discrimination on grounds of nationality shall be prohibited.*

The need for free movement is fundamental to the development of the Union as a single market with competitive basis and an efficient outcome. With taxation organized as at present, an increase in mobility is not without a cost since it enhances tax competition. As a consequence the Union will have to face tax competition if it does not revise its processes as mobility increases.

The articles committing to non-discrimination are interesting if they applied to products rather than just people. One of the proposals that has been discussed for revised tax governance is the use of origin rather than destination taxation. However the basis of an origin system is that it does discriminate between products on the grounds of nationality. That is, a product produced in different countries will be taxed at different rates in any country of consumption.

This point can be emphasized by considering Article III-170 which dealt with the equal treatment of commodities in trade:

*No Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products.*

*Where products are exported by a Member State to the territory of another Member state, any repayment of internal taxation shall not exceed the internal taxation imposed on them whether directly or indirectly.*

Suppose a Member State wishes to use an origin subsidy on its product whereas other Member States employ a tax. Does the use of a zero tax class as an internal tax in excess of the subsidy on the domestic product? Is this discrimination because of nationality? This is a point where the origin principle may be in conflict with the wish to move to origin taxation.

The issue of the encouragement of mobility was repeated in several further Articles. In Article III-133 the right of workers to move freely was stressed:

*Workers shall have the right to move freely within the Union.*

More specific methods to achieve this mobility were described in Article III-136:

*In the field of social security, European laws or framework laws shall establish such measures as are necessary to bring about freedom of movement for workers by making arrangements to secure for employed and self-employed migrant workers and their dependents:*
(a) aggregation, for the purpose of acquiring and retaining the right to benefit and of calculating the amount of benefit, of all periods taken into account under the laws of the different countries;

(b) payment of benefits to persons resident in the territories of Member States.

The free movement of capital was also enshrined in two further Articles. First by Article III-156:

Within the framework of this Section, restrictions both on the movement of capital and on payments between Member States and between Member States and third countries shall be prohibited.

In Article III-157 the freedom of movement of capital was extended to movement between Member States and third countries:

The European Parliament and the Council shall endeavour to achieve the objective of free movement of capital between Member States and third countries to the greatest extent possible and without prejudice to other provisions of the Constitution.

The implications of these Articles for tax policy are clear. Increased mobility exacerbates the problems of tax competition. Increased mobility of capital places downward pressure on the corporate income tax rate. Increased mobility of labour puts similar pressure upon the income tax rate. Furthermore, increased mobility of labour plus entitlements to benefits pressurises the welfare systems. These are the classic contributors to the race-to-the-bottom. Hence if these Articles were applied then there would have been a need for some offsetting policy intervention to control the effects they imply.

A theme that is repeated at several points in the Constitution is the role of policy coordination. Tax competition is a consequence of a lack of coordination between countries. If Member States were to coordinate policies then the externality would be internalised and efficient tax rates would be set. The statement of coordination Article I-12 set out the basic requirement that Member States should coordinate:

The Member States shall coordinate their economic and employment policies within arrangements as determined by Part III, which the Union shall have competence to provide.

If fiscal policy is incorporated under the general heading of economic policy then this requirement to coordinated would have resolved problems. When this requirement is not sufficient, the Article provided the further authority for the Union to either ensure coordination or to take supplementary actions

In certain areas and under the conditions laid down in the Constitution, the Union shall have competence to carry out actions to support, coordinate or supplement the actions of the Member States, without superseding their competence in these areas.

When tax policy is included as one of the “certain areas”, this Article opened a range of policy tools that could be used to overcome the problem of independent tax setting. The simplest action would be coordination. Alternatively, supplementation of actions could have meant the direct redistribution of tax revenues or the imposition of
equivalization rules. Neither of these policies would supersede competence of the individual member states since they would remain free to set their own tax rates. Instead both would modify the relationship between instrument and outcome. As written this article did not directly permit the Union to change the principle of taxation from destination to origin unless “support” was given a very broad interpretation.

A more detailed precise allocation of competence to the Union was noted in Article I-13. This article stated that:

*The Union shall have exclusive competence in the following areas:*

(a) customs unions;
(b) the establishing of the competition rules necessary for the functioning of the internal market;

These points were developed further in Article III-151:

*The Union shall comprise a customs union which shall cover all trade in goods and which shall involve the prohibition between Member States of customs duties on imports and exports and of all charges having equivalent effect and the adoption of a common customs tariff in their relations with third countries.*

*Customs duties on imports and exports and charges having equivalent effect shall be prohibited between Member States. This prohibition shall also apply to customs duties of a fiscal nature.*

The customs union statements are self-explanatory since the Union has long operated with a common external tariff and, since January 1993, as a single internal market. The second part was open to interpretation. The natural reading is that it refers to competition in the economic interaction of firms and consumers. This would continue the tradition of the Union in supporting an active competition policy operated for the benefit of consumers. There is, however, nothing to prevent the statement being interpreted as applying to competition at all levels of economic activity including competition between Member States in their formulation of fiscal policy. This was probably not intended when the Constitution was written but it is a legitimate interpretation. The competition rules would then refer to the process of interaction between Member States and could be used to introduce remedies to the tax cutting that is a consequence of the fundamentally oligopolistic behaviour in the tax game.

The issue of coordination arises again in Article I-15. The wording of this article suggested a greater degree of Union intervention and direction of policy:

*Member States shall coordinate their economic policies within the Union. To this end the Council of Ministers shall adopt measures, in particular broad guidelines for these policies.*

The use of “broad guidelines” opened the possibility for a range of policy interventions at the Union level. The policy of harmonization has already been discussed which envisaged a gradually narrowing band of permissible tax rates until complete harmonization had been achieved. The same method could be applied under this article to place upper and lower bounds on capital tax rates to lessen tax competition. If could also be used to re-start the process for harmonization.
Article III-179 expanded upon the coordination of policies and the fact that the effects of policies must be internalised. The claim to internalisation comes from observation of the phrase “common concern”. If internalised in this way it becomes immediate that some of the consequences of tax externalities between Member States will be reduced:

Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council, in accordance with Article III-178.

In order to ensure closer coordination of economic policies ... the Council ... shall monitor economic developments in each member state and in the Union, as well as the consistency of economic polices with the broad guidelines

When it is established ... that the economic policies of a Member state are not consistent with the broad guidelines ... or that they risk jeopardising the proper functioning of economic and monetary union, the Commission may address a warning to the Member State concerned.

A further general provision to assist the functioning of the internal market could be found in Article III-130. This was concerned in general terms with the role of the Union in ensuring the functioning of the single market.

The Union shall adopt measures with the aim of establishing or ensuring the functioning of the internal market, in accordance with the relevant provisions of the constitution.

Since the structure of commodity taxation is so closely linked to the functioning of the internal market, this article can also be interpreted as having implications for tax policy. The continued existence of cross-border shopping involving the waste of economic resources and the concurrent environmental damage because of tax differentials cannot be viewed as a successfully functioning internal market. If the Union wishes to have a single market where the patterns of trade are not distorted by taxation then this Article provided a further basis upon which policy could be developed.

The final article to be considered dealt with the issue of harmonization. The article refers to the harmonization of legislation, not to the harmonization of tax rates. But here there is a question of how legislation can be interpreted. Article III-171 stated:

A European law or framework law of the Council shall establish measures for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation provided such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition. The Council shall act unanimously after consulting the European Parliament and the Economic and Social Committee.

Note that this explicitly refers to harmonization to secure the efficient functioning of the market and to avoid distortion of competition. It has already been discussed how the tax differentials lead to cross-border shopping which represents a distortion of trade.
6. Conclusions
The European Union wishes to attain the objectives of a free market social economy. At the same time it also wishes to grant subsidiarity to the Member States. In the area of tax policy these two aims cause conflict. The paper has described the consequences that emerge and has reviewed some of the history of tax policy in the Union.

The history of tax harmonization in the Union reveals a policy that gradually eroded the ability of individual Member States to set their own tax rates. Although it would have removed many of the problems brought about by tax differentials it eventually had to be abandoned because of opposition caused by the perception that harmonization was threatening subsidiarity. The choice of a tax principle for the Union has made even less progress than that of harmonization. If Union cannot harmonize than an alternative would be to switch to origin taxation. This possibility has been around since the very foundation of the Union. It has also been adopted as a proposal for the Union. However, there appears to have been no progress on this issue at all. Competition between Member States in the setting of the tax rate on corporate income has lead to a fall in statutory rates. The policy to counter this has so far been restricted to the adoption of a Code of Conduct rather than a set of formal policy regulations. This is unlikely to prove sufficient to control the competition if the gains of violation are sufficiently large.

The proposed Constitution reaffirmed the commitment of the Union to an efficient market economy with freedom of movement for capital and labour with an absence of discrimination. The Constitution also perceived a role for the Union to play in the coordination of policies. Given that the aims of efficiency, freedom of movement and subsidiarity lead to the problems outlined above, the Union will clearly need to exercise this coordinating role in the area of taxation. Although the Constitution also required Member States to take account of the effect of their policies on others, so internalizing at least partially some of the externalities, there would still be an important role for the Commission to play.

In what it says the proposed Constitution in principle granted the powers the Union requires to control tax policy and to achieve the efficiency it requires. Whether it would have done so depends on how arguments over subsidiarity and coordination would have been resolved. The proposed Constitution provided the necessary balance between subsidiarity and coordination. From the perspective of tax policy it can be judged to have reached many of the correct conclusions. Any future set of rules for the European Union must achieve a very similar compromise.

References


