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TAXATION IN EUROPE: TOWARDS MORE COMPETITION OR MORE CO-ORDINATION

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Abstract: Tax to GDP ratios stand at around 40%in EU countries as compared with 25% in Japan and the US. This high level of taxation allows the funding of the European social model characterised with a high level of public expenditure and transfers. This article discusses how the European social model is at risk in a global world; it presents several strategies for European taxation: competition, unification, coordination. It provides a descriptive analysis of tax structures and trends in Europe. Tax competition plays more and more for higher earnings or wealthy people; so tax coordination is needed also for income taxation. Social contributions coordination is less useful as far as social contributions finance contributive benefits. The corporate taxation coordination raises two problems: the tax base and the tax rate. . Corporate taxation is not the most appropriate tool to attract firms to locate in less developed countries due to risks of profit shifting. Our preferred strategy would be to give more freedom given to Member States to subsidize their companies against some tax coordination by a clear recognition of the source principle and the introduction of minimum rates, depending on the level of development reached by the country.

Keywords: Taxation, Taxation coordination, European Economic Policy.

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1. Introduction

Taxation is high in EU countries. Tax to GDP ratios stand at around 40% as compared with 25% in Japan and the US. This high level of taxation allows the funding of the European social model characterised with a high level of public expenditure and transfers. Apart from governing powers (armed forces, police, justice), the State provides free services to households (education, health); finances public infrastructures, research, culture; pays significant social transfers (family policy, minimum income) and social insurance (pensions, unemployment). The ageing of populations implies higher pensions and health spending; technical progress requires higher education and research spending; rising social exclusion implies higher assistance benefits. People ask for more public infrastructure and higher security spending. Military spending as well as aid to developing countries seem to be required if countries wish to play a major role internationally. All these elements make the rising trend in public spending difficult to resist. Besides, European countries think that public spending should be according to contributory capacities. People with highest incomes or wealth should pay more for collective spending, as they benefit most from the way the social system is organised. Taxes must reduce income inequalities. It is hence crucial for European countries to keep their capacities to collect tax revenues, according to democratically agreed rules.

Section 2 discusses how the European social model is at risk in a global world; it presents several strategies for European taxation: competition, unification, coordination. Section 3 provides a descriptive analysis of tax structures and trends in Europe. Section 4 deals with income tax coordination. Section 5 addresses social contributions coordination. Section 6 deals with corporate taxation. Section 7 concludes with a strategy for tax co-ordination.

2. The European social model in a global world

In recent years, the European social model has been put under pressure both on political and economic grounds. In the last two decades, economic policy has moved from implementing social-democrat policies to free-market reforms. Priority is now given in many countries to strengthening competitiveness and the attractiveness of the country as a location of productive activities. Saying that working incentives should be increased both at the upper and lower ends of the wage scale governments wish to cut social redistribution and public spending, to

cut the highest marginal income tax rates and to lower social benefits in order to make the poorer work. Governments wish to cut 'social contributions' to boost domestic competitiveness. This prevailing model makes it difficult to implement tax co-ordination in Europe.

The European social model is threatened by globalisation that puts tax and social domestic systems into competition. Free capital and products mobility enables companies to choose to locate their production among industrial economies or between industrial and emerging economies. Taxing the more mobile factors (big companies, financial capital, highly skilled workers and wealthy people) is more and more difficult, which undermines domestic redistribution policies. Some countries may choose to offer low public spending and hence need low tax revenues. These countries may thus attract wealthy foreigners, as is the case for the UK, although this is not the result of a deliberate policy. The race to the bottom strategy aiming at attracting the more mobile factors is all the more successful that a country is small (it will be able to attract relatively large capital flows that will raise its tax revenues, albeit lowering its tax rates). It may be worth for small countries to introduce low tax rates that will attract foreign capital flows (like in Luxemburg or Switzerland). Last, very small countries may decide to become a pure 'tax haven'. Competition may oblige countries either to cut their public spending or to tax mainly immobile factors: labour and dwellings. Countries lose the ability to implement satisfactory redistribution: similar incomes will not be taxed similarly. In a world with free factor mobility, taxation measures would necessarily have a similar and immediate counterpart: no redistribution would be possible. Moreover, some economic agents may adopt a free rider's behaviour and benefit from the high level of public spending in a country while being taxed in another country. For instance, a high skilled worker educated in France (owing to the free education system and family allowances) may decide to leave and work in the UK where he will not have to pay for his parents' pensions. Old and rich people may leave the country where they built their wealth to retire and die in a country where property and inheritance are tax exempt. Companies may decide to locate their profits in country different from the country where their production is located. The development of such behaviours would necessarily lead to the expansion of paying schools, private pension funds.

However, taxes and public spending have not significantly been cut as a share of GDP in Europe. The characteristics of the European social model have in no European country been fundamentally put into question. No European country has implemented the 'Big Reform', consisting in cutting strongly taxes and altering their structure. In most cases, reforms have applied to specific areas.

Will European integration, especially the Economic and Monetary Union, the single market and the single currency, add to globalisation to put pressure on European tax and social systems, or will they help securing the European social model?

The treaty establishing the European Community and the treaty establishing a constitution for Europe stress four 'fundamental freedoms': free movement of persons, services, goods and capital. However, the texts do not say anything on the need for countries to remain responsible for domestic taxation. Besides, the logic of European integration is such that the Commission wishes decisions to be taken at its level; it is thus not in favour and may even be against measures guaranteeing domestic taxation autonomy. Member states should therefore pay attention to keep their fiscal autonomy, although they rarely do.

The EU has difficulty in introducing a coherent tax system. Taxation is a symbol of domestic sovereignty and remains in the hands of national governments. Countries, and not the European legislative authorities (Parliament or Council), vote taxes and on decide on how to spend tax revenues. Introducing a taxation system consistent with European Treaties, with the subsidiarity principle and the unanimity principle shows how it is difficult to build an economic Europe without political integration. European Taxation in Europe is a political issue. What should the respective weights of national and European institutions be? Should the Commission and the Council be given a major role in future changes of the tax system or should domestic choices be maintained? What is the final objective: maintaining the social democrat model or moving towards a liberal model? What method should be used: tax competition, co-ordination or unification?

European countries will have to live for a long time with contradictory objectives: keeping their domestic autonomy, remaining in charge of domestic tax policy, keeping their freedom of introducing new measures while there is a need for harmonisation. One may for instance consider that countries should be allowed to set on their own the VAT rate to be applied by hairdressers, restaurants, records, alcohol... Conversely, European institutions should check that no change in VAT rates is a protectionist measure. Criteria would need to be defined. For instance, can a country be allowed: to promote the consumption of services that are by definition not imported, to tax heavily imported luxury cars if there is no domestic production, to tax wine less than alcohol in vine-producing countries, to tax heavily alcohol in countries where alcoholism is high?

Europe has to choose between three strategies. The first one would consist in aiming – more or less rapidly- at the *unification of taxation in Europe*, on the one hand through the introduction of European taxes, on the other hand through the unification of domestic taxes,

both in terms of rates and bases. This unification would be made necessary with the completion of the single market, the increasing mobility of goods, people, capital and companies. The elements of taxation remaining domestic would be subject to European rules (as is the case today for local taxation). This strategy currently seems an illusion. First, most countries dismiss it, wishing to keep their autonomy in taxation matters. A single tax system cannot be introduced if there is no legislative European authority entitled to vote taxes. Taxation unification requires political and social unification. But Europe has made no precise choice in terms of Society: the British, Franco-German, Scandinavian, Southern models differ widely. A single European taxation cannot be implemented as long as citizens do not move towards a federal Europe, as long as political and social institutions remain mainly national. In the current state of European integration, each country should remain free to set their level of public spending, degree of redistribution and social protection system.

Decision-making has until now been slow and technocratic at the European level. For instance, European authorities have kept claiming for lower fiscal deficits despite the economic slowdown of 2001. This shows that there is a risk that European institutions do not to account for domestic specificities.

Last, should taxation unification be understood as a single taxation everywhere in Europe, or as uniform rules decided by all: for instance, could countries catching up or being in difficult times be entitled to implement lower tax rates, albeit receiving community funds (as is currently the case at domestic levels), or not? Some think that European institutions are less sensitive to industrial lobbying than Member states, hence can more easily introduce painful reforms. But is this true? Perhaps industrial lobbying is in fact more powerful in Brussels than in Member States, where they be countered by national associations. The European level is more appropriate in some areas, such as environment. Will it be possible to maintain different benefit taxation rules if European companies develop? Europe could move towards a compromise, where some taxes would be set at the European level and some others not, which would raise difficult questions on tax controls and internal coherence of domestic legislations.

The second strategy would consist in letting *tax competition* play freely. Each country would remain fully responsible for domestic taxation. European citizens and companies would be free to decide where they want to settle, work, save and invest. But there is no guarantee that this strategy will lead to the taxation system European citizens would like to have. States would see their capacity of taxing the more mobile agents (multinational companies, skilled workers, financial capital) strongly constrained and this would force them to either raise taxes on immobile agents or forget about redistribution policies. A neutral liberal model would

progressively develop where everyone pays exclusively for the amount of public spending they will benefit from, i.e. a model without redistribution. If taxpayers can also pay taxes in countries different from their live or work (for instance, a company benefits from public infrastructure in a given country, but locates its profits in a tax haven), public infrastructure will lose their funding. Such practices make countries open more widely their frontiers and weaken their ability to resist the impact of globalisation on their tax receipts. Full tax competition would be unenforceable in practice since taxation rules for a company operating in several countries have in any case to be defined (multinational companies, non-residents savings, etc…)

In a softer version, the *controlled tax competition*, countries remain free to implement the taxation of their choice on their residents and companies, but harmful tax competition is forbidden, i.e. measures consisting in applying lower tax rates on non residents or new residents, or foreign companies to attract more profitable tax bases. This is roughly the view of the Commission. Derogatory regimes are forbidden, but there is no control on general regimes. Hence, a country can decide to attract rich people through abolishing wealth taxation provided this applies to all its residents. Unfortunately, controlled tax competition does not prevent the race to the bottom since smaller countries can keep on using this kind of competition, lowering their tax rates to attract more capital and rich people, while losing relatively little in terms of their domestic taxable base.

According to the *tax coordination* strategy, the subsidiarity principle should still prevail. Taxation systems remain national as much as possible, but are unified when necessary; the coexistence of different national taxation systems is run under codes of good conduct allowing countries to decide on the taxation of their residents. Besides, some measures are more efficient if decided at the European level. However this strategy is difficult to implement. It requires international agreements. Harmonisation, even if agreed with partners, restricts states tax autonomy.

The success of such a strategy depends on how easily countries agree on desirable taxation. Co-ordination will be difficult if some countries are very liberal while others are very socio-democrats. Institutional reforms are thus required to allow Member States to preserve their tax revenues. The issue should also be politically debated so that each country, each People are aware of the need to protect and improve the European social model.

Member States and the European Commission should implement tax co-ordination for each tax, possibly leading to unification, forbiddance of unfair practices (aiming at forbidding tax measures targeted to attract tax bases for no good reason), etc. In some cases, minimum rates

could be introduced. What should be done if differences persist after discussion? We think that the countries wishing to remain responsible for domestic taxation should be entitled to it, through refusing to enforce the principles of free movement of people and capital to countries with excessively low taxation and refusing to delegate any power to the ECJ in this respect.

3. Tax structures: where do we stand?

The 1990's have been characterized by successive tax reforms, more or less ambitious all over Europe. Member States have been confronted with the need to raise their tax revenues in order to halt the rise in public deficits and debts entailed by low economic growth in the early 1980's and the early 1990's. The introduction of the single market in 1993 did not affect these trends: contrary to the effects expected from the opening of frontiers in the absence of tax harmonisation, tax to GDP ratios did not decline in EU countries but rather tended to rise, even if less rapidly in the 1990's than in the 1980's: the EU-15 tax burden rose from 38.9% of GDP in 1990 to 39.6% in 2003. In 2003 tax to GDP ratios were 10 percentage points higher in the EU than in Japan or the US (see table 1). Until now, globalisation and tax competition have not deprived European countries from revenues.

Divergences remain strong between EU countries, even if some convergence has been reached. Tax to GDP ratios are the highest in Sweden, Denmark, Finland, Belgium and France and the lowest in the UK, Ireland and Southern countries (Spain, Portugal). The five countries with the highest tax to GDP ratios had a ratio of 46.3% in 1990, which rose to 46.8 in 2003. The five countries with the lowest tax to GDP ratios had a ratio of 31.9 % in 1990, which rose to 34.3% in 2003. Convergence has been limited. Tax burdens have significantly declined – by more than 3 percentage points - in two countries: the Netherlands and Ireland, while they have risen by more than 3 percentage points in 3 countries: Italy, Greece and Portugal.

Table 1 : Tax to GDP ratios, percentage points

	1990	2003
Sweden	53.2	50.6
Denmark	47.7	48.3
Belgium	43.2	45.4
Finland	44.3	44.8
France	42.2	43.4
Austria	39.6	43.1
Italy	38.9	43.1
Luxembourg	40.8	41.3
Netherlands	42.9	38.8
Portugal	29.2	37,1
Greece	29.3	35,7
UK	35.5	35.6
Germany	35.7	35.5
Spain	32.1	34.9
Ireland	33.5	29.7
EU-15	**38.2**	**39.3**
Czech Republic		37.7
Hungary		38.5
Slovak Republic		31.1
Poland		34.2
Japan	29.1	25.6
US	27.3	25.4

Source: OECD, *Revenue Statistics*, 2005

3.1. Changes in the tax structure

The weights of the different taxes have not varied very much between 1990 and 2003 at the EU level (see table 2). The introduction of the CSG (*Contribution sociale généralisée*) in France and of IRAP in Italy did not prevent the increasing of labour taxation, which is harmful in high-unemployment period.

Social contributions and taxes on goods and services have a strong weight in the EU as compared to the US, whereas personal income taxes weigh less (see table 3). Income tax is especially high in Scandinavian countries, contrary to Southern countries keeping a relatively « archaic » tax structure (Portugal, Greece and Spain). Corporate taxation is low in Germany and Austria, while it is particularly high in Finland and Luxemburg. Social contributions weigh heavily on wages in Bismarckian countries (Austria, France, Germany, Sweden, Netherlands), whereas they are relatively low in Denmark, Ireland and the UK. Taxes on

goods and services are particularly high in Denmark (where their weight offsets the absence of employers' social contributions). Two main factors explain the diversity of tax structures: first, the design of social protection systems - Bismarckian (high public spending funded by contributions on wages), Scandinavian (high spending funded by income taxes), Anglo-Saxon (low public spending); second, the contrast between modern systems (high weight of income tax) and archaic systems (high weight of indirect taxes).

Table 2 : Structure of tax in the EU in 1990 and 2003 (*As a percentage of GDP)*

	1990	2003
Personal income tax	9.6	9.4
Corporate income tax	2.6	2.5
Social security contributions	12.7	13.2
Property tax	1.8	2.4
Taxes on goods and services	11.0	11.0
Other taxes	0.5	0.7
Total	**38.2**	**39.3**

Source: OECD, *Revenue Statistic*, 2005.

3.2. Which degree of 'socialisation'?

Primary public spending amounts to 45% of GDP on average in continental European economies, of which 11 percentage points go to pensions, 8 to health, 3 to unemployment allowances, 3 to family/housing/poverty, 6 to education/culture, 3 to economic subsidies; 8 to collective spending; 3 to capital spending. Pension, health, social assistance and education spending are much higher in continental Europe than in Anglo-Saxon countries. Thus, any significant cut in tax-to-GDP ratios implies a similar cut in public expenditure requires privatising and, in a ay or another, lower spending directly benefiting households.

Table 3 : Tax revenue structures, in terms of tax bases in 2003

As a percentage of GDP

	Ger.	Austria	Belg.	Den.	Spain	Fin.	France	Greece	Ireland	Italy	Lux.	Neth.	Port.	Swe.	UK	EU-15	Japan	USA
Income taxes of which	9.7	13.0	17.7	29.0	9.8	17.3	10.1	8.3	11.7	13.3	15.0	9.9	9.1	18.3	13.0	**11.9**	7.7	11.1
- Households	8.5	9.9	14.3	26.0	6.6	13.9	7.6	4.9	7.9	10.5	7.1	6.9	5.8	15.8	10.2	**9.4**	4.4	9.0
- Companies	1.3	2.2	3.4	3.0	3.2	3.5	2.5	3.3	3.8	2.8	7.9	2.9	3.2	2.5	2.8	**2.5**	3.3	2.1
Wage taxes of which:	14.4	17.0	14.7	1.4	12.3	12.0	17.5	12.9	4.6	12.7	11.5	14.1	11.7	17.2	6.6	**13.2**	9.7	6.7
- Social security contributions	14.4	14.5	14.4	1.2	12.3	12.0	16.4	12.9	4.4	12.7	11.2	14.1	11.7	14.7	6.6	**12.9**	9.7	6.7
- Wage taxes	0.0	2.5	0.0	0.2	0.0	0.0	1.1	0.0	0.2	0.0	0.0	0.0	0.0	2.5	0.0	**0.3**	0.0	0.0
Property taxes	0.8	0.6	1.5	1.8	2.5	1.1	3.2	1.6	1.8	3.4	3.1	2.0	1.5	1.6	4.2	**2.4**	2.6	3.1
Taxes on goods and services	10.4	12.1	11.2	16.0	9.8	14.3	11.1	12.8	11.4	11.1	11.6	12.3	13.6	13.3	11.6	**11.0**	5.1	4.6
Other taxes	0.0	0.3	0.0	0.2	0.2	0.0	1.8*	0.0	0.0	2.6**	0.1	0.2	1.0	0.2	0.0	**0.7**	0.0	0.0
Total	**35.5**	**43.1**	**45.4**	**48.3**	**34.9**	**44.8**	**43.4**	**35.7**	**29.7**	**43.1**	**41.3**	**38.8**	**37.1**	**50.6**	**35.6**	**39.3**	**25.3**	**25.6**

* Mainly professional tax.

** Mainly IRAP.

Source: OECD, *Revenue Statistics*, 2005.

4. Income taxation: the residence principle

According to the subsidiarity principle, each country must decide its level of public spending and degree of redistribution. This requires that the country keeps control of a significant part of its tax revenues. Yet income taxation is one of the taxes that are the less likely to generate direct tax competition, if the residence principle is applied, in other words if each country taxes all its residents' incomes. People are less mobile than capital, companies and products. An individual may chose to more abroad to escape taxation, but will then change its residence and be taxed as a resident in the country where he lives.

However, tax competition plays more and more for higher earnings people, like stars, executives from multinational companies and wealthy people, who may decide to move abroad for taxation purposes. An executive earning euros 30,000 per month will pay an average tax rate of 38% in Switzerland, 44% in the UK, 62% in France (of which 14% are differed wages). Some countries provide specific privileges that induce unfair tax competition. EU Member States should reaffirm the right of each country to tax their residents. This means that derogatory systems allowing for different taxation on permanent, transitory (or newly arrived) residents and non residents should be forbidden.

Incomes earned and kept abroad by foreign people are tax exempt for 15 years when a foreigner settles in the UK and Ireland (*remittance basis system*). This allows foreigners to settle in the UK and pay no personal income tax on income earned in their native countries and transferred anywhere abroad. Such a system attracts people with high financial wealth. In Denmark and Finland, foreign executives benefit from a derogatory tax regime, in the form of an income tax rate lower than for national residents. If such unfair tax competition was to develop, some categories of the population would be exempt from paying public expenditure if they change their residence country, while earning high incomes and having in general benefited from free education spending in their native country. The French government has introduced such dangerous measures in 2003, exempting from income tax extra-earnings paid to executives moving back to France. The only acceptable measure is tax exemption on specific expenses generated by moving abroad.

Table 4 shows average tax rates in several EU countries for a two-earner couple with two children. Column a shows income tax as a percentage of disposable income: this is an indicator of the weight of personal income tax as generally felt by individuals. Column b shows total income tax payments net of family benefits as a share of total wage costs: this ratio is more economic and is not affected by the respective shares of social contributions,

social benefits and taxes. The first indicator shows a larger dispersion than the second. For a two-earner couple on medium wage earnings, the first indicator varies from 7.9% in Spain to 32.5% in Sweden, while the second indicator varies from 25.2 in the UK to 46.4 in Belgium. Countries may be split into two groups: countries where income tax is low (Spain, France, Italy, the UK), countries where it is high (Denmark, Sweden, Belgium). In terms of global tax burden, taxes are relatively low on low wage earnings in France and the UK. Taxes are also low for high incomes in Spain and the UK, whereas they are heavy in Belgium, Denmark and Sweden. All in all, the tax burden is small in the UK, but public pensions are low. Conversely, the tax burden is high in Belgium, Sweden, Italy, Denmark and France. Taxation is especially progressive in France and Belgium, but hardly in Spain and Italy.

Table 4 : Average tax rates in 2001, two-earner married couple, two children, spouse earning 70% of husband's wage

Wage level/APW	0.7		1		2		3		5	
	a	b	a	b	a	b	a	b	a	b
Germany*	0	33.2	9.5	40.2	27.1	48.0	34.6	48.7	40.3	48.6
Austria*	1.6	25.1	13.8	35.7	27.7	43.8	35.6	45.4	41.4	46.9
Belgium*	20.8	39.9	28.2	46.4	39.1	56.4	49.9	62.2	48.9	66.0
Denmark**	28.5	33.1	32.5	37.2	43.9	48.0	49.1	52.9	53.0	56.8
Spain*	3.3	30.6	7.9	33.9	16.9	40.3	21.0	40.2	29.2	40.7
France*	6.6	23.5	11.2	40.0	16.9	47.9	21.5	51.0	27.5	54.9
Italy*	13.4	38.0	16.9	42.8	25.8	49.8	30.3	53.0	34.5	56.0
Netherlands**	12.4	27.1	15.5	32.0	30.1	41.1	37.9	43.6	43.6	46.7
UK**	12.8	19.0	16.1	25.2	21.5	32.2	26.8	36.1	32.2	40.3
Sweden**	26.2	42.8	29.0	46.1	37.0	53.1	41.4	57.4	48.4	63.4

a) Personal income tax/net wage; b) (Personal income tax+social contributions-family benefits)/super gross wage earnings. In France, personal income tax includes CSG/CRDS.

* Entitles to proportional retirement pension; ** Entitles to lump-sum retirement pension.

Source: Author's calculations, based on OECD, *Taxing Wages, 2000-2001*, 2002.

A common trend towards lower tax progressivity can be seen among European countries. The French higher marginal tax rate has declined from 56% in 1988 to 48% in 2004. Since 1988, higher marginal tax rates have been cut by 11 percentage points in Spain and Germany. The introduction of a 2-rate threshold, with the highest rate set at 33% is being considered in Italy. These trends follow the strong cuts of higher marginal income tax rates introduced in the US in the early 1980s as well as in the UK, where the highest marginal tax rate was cut from 98%

in 1979 to 40% in 1988. The highest marginal tax rates currently stand around 50% in the EU (except in Spain: 45% and the UK: 40%, see table 5).

Table 5 : Higher marginal income tax rates in 2004 (%)

Germany	50.65
Austria	50
Belgium	57
Denmark	59
Spain	45
Finland	52.1
France	53.4
Italy	46.1
Netherlands	52
UK	40
Sweden	56.5
Japan	50
US	41.55

Source: OECD, *Taxing wages*, 2005.

In the future, in a global world, the contradiction between incentive and redistribution policies is likely to grow. It will be easier for the upper classes, who win from globalisation, to choose where to work and pay taxes. The upper classes may refuse to support the part of the population who will be negatively affected by the globalisation process. Governments may have no choice but cut strongly highest marginal income tax rates, and even offer derogatory regimes allowing for tax exemption (like stock options), while at the same time income disparities will grow. One may consider that European countries should resist these changes and agree on a minimum tax rate for high incomes, although this would raise a number of technical issues: should an average or a marginal tax rate be set? How to distinguish taxes and social contributions? What definition for income – including or not financial income and capital gains?

As concerns wealthy people, tax competition applies also to property and inheritance taxation. The weights of these two taxes differ widely in Europe: 1.24 % of GDP in Switzerland, 0.8% in Luxembourg ; 0,6% in France ; 0.5% in Belgium and only 0.2 in the UK, 0.15 in Germany, 0.03 % in Italy (see table 6). In Europe, taxes on wealth remain only in Luxembourg (with a rate of 0.5%), Sweden (rate of 1.5%), France (maximum rate: 1.8%),

Spain (maximum rate: 2.5%), Finland (0.9%), the Netherlands (1.2% on financial wealth, but incomes are tax exempt). En 2001, Italy abolished inheritance taxes.

Table 6 : Taxes on households' wealth

As a percentage of GDP, in 2004

	Taxes on wealth	Inheritance taxes
Germany	0.01	0.16
Austria	0	0.07
Belgium	0	0.48
Denmark	0	0.20
Spain	0.15	0.22
Finland	0.07	0.29
France	0.15	0.47
Greece	0.07	0.14
Ireland	0	0.16
Italy	0	0.03
Luxembourg	0.64	0.19
Netherlands	0.01	0.32
Portugal	0	0.08
Sweden	0.20	0.10
UK	0	0.22
Switzerland	1.02	0.22
Japan	0	0.29
US	0	0.26

Source: OECD, *Revenue Statistics*, 2005.

In 1998, France had introduced an *exit tax*, i.e. French residents settling abroad had to pay 26% on accrued capital gains on financial assets. In 2004, the ECJ judged this measure not conform to the freedom of establishment.

There is thus a high risk that tax competition to attract wealthy people strengthens in Europe, the principle of freedom of establishment depriving countries with heavy taxation to react. Three strategies may then be considered:

- *Race to the bottom*: governments will accept not to tax wealth and inheritance, or at least will cut them sufficiently so that it will not be worth moving abroad. This would mean that the less 'tax demanding' countries will design the tax structure in all European countries, which in not very democratic.

- *Isolated measures*: each country would introduce measures against domestic citizens leaving abroad for tax purposes (deprivation of voting rights, honours,…). However, this may not be accepted by the ECJ.
- *Affirmation of the right to tax*: the countries wishing to keep on taxing their residents reject the principle of freedom of establishment in countries where taxation is too low for high incomes, wealth and inheritance. This strategy would be set by a group of countries wishing to maintain the principle of the European social model, i.e. in favour a redistributive taxation.

The choice between these strategies is a political one, and should be discussed openly.

4.1. Capital income taxation: a model of European taxation?

In most European countries, interest incomes are taxed at a lower rate than other incomes (see table 7). A few countries have maintained personal income taxation on interest income (Denmark, Spain); in the other countries, a withholding tax is levied, at rates ranging from 10 to 30%.

As countries do not tax non-residents incomes, the single Market could have allowed households' financial assets to escape from any taxation if invested abroad. Taxpayers are supposed to assess their incomes to their national tax administration, but the latter have hardly any possibility of checking interest income assessments. Non-taxation of non-residents financial incomes was clearly a typical case of unfair competition.

After long negotiations between EU countries and neighbouring countries (Switzerland, Monaco, etc…) an agreement was reached in 21 January 2003 and a directive came into effect on 1 July 2005. The directive sets out the generalisation of *exchange of information* in Europe. However, Austria, Belgium and Luxembourg have refused it, opting instead for a withholding tax (15% in 2005, 20% in 2007, 35% in 2010; 75% of the tax revenues being paid back to the taxpayer's residence country). Monaco, Andorra, Liechtenstein, Switzerland, San Marin, associate territories of the Member States have agreed to levy a similar withholding tax. This agreement is a compromise, but has the advantage of ensuring that each country may tax their residents and prevents tax competition. The agreement is an incentive for Member States to introduce measures against tax havens, especially when they are nearby. This agreement is a model in terms of tax co-ordination.

Table 7 : Interest income taxation in Europe, in 2003 (excluding derogatory regimes)

Interest incomes included in taxable income, with bank assessment to the administration	
Denmark	Personal income tax (maximum rate: 59%) Withholding tax
Spain	Personal income tax (maximum rate: 45 %) Withholding tax: 18 %
Interest income generally included in taxable income, no bank assessment to the administration requested	
Portugal	Personal income tax (maximum rate: 40%) Withholding tax: 20%.
Luxembourg	Personal income tax (maximum rate: 42 %) No withholding tax.
Germany	Personal income tax (maximum rate: 48.5 %) Withholding tax 25% (bonds) or 30 % (bank deposits).
UK	Personal income tax (maximum rate: 30%) Withholding tax: 20 %
Choice between withholding tax and income tax with bank assessment to the administration	
Belgium	Rate: 15% or personal income tax
France	Rate: 15% (+ 10% of social taxes) or personal income tax (+10%)
Withholding tax	
Austria	Rate: 25%
Finland	Rate: 29%
Greece	Rate: 10% (bonds) or 15% (deposits)
Ireland	Rate: 22 %
Sweden	Rate: 30%.
Italy	Rate: 12.5 % (bonds) or 27% (deposits)
Asset taxation	
Netherlands	Tax base: 4% of market value of financial assets (shares and bonds) Tax rate: 30%

5. The future of social contributions

In most European countries, the ageing of populations and the structural rising trend of health spending can be expected to translate in a rising trend in pensions and health social contributions. At the same time, many countries should increase family benefits in order to rise birth rates, that are currently well below the level at which the population would remain constant. Unemployment allowances and social assistance benefits vary according to the unemployment rate, but until now, there have been hardly any signs that continental European countries will rapidly be back to full employment. Despite all the efforts planned to postpone the effective retirement age, an increase in social contributions seems almost certain.

The rise in social contributions could be avoided if people resorted more to private insurance, but the development of private pension funds would be costly for the intermediate generation and pension funds premiums hardly differ from social contributions. The US experience does not give any evidence that private health insurance is more efficient and cheaper than public social insurance. Privatising partly pensions systems would allow for a stabilisation in tax to GDP ratios, but the counterpart would be a rise in pension funds and private insurance premiums that would need to be made compulsory so that all people remain covered under satisfactory conditions. A system combining public insurance for the poorest and private insurance for middle and higher incomes would make it possible to cut the tax to GDP ratio but would not solve the problem, since the middle class would have to pay taxes for the poorest and premiums for themselves.

Do social contributions raise a tax competition issue? Not in principle, as concerns the social security contributions that finance more or less social benefits (pensions, unemployment, workplace injuries, and maternity allowances). These systems are not fully contributory since these have a redistributive element (for instance, executives with a low probability of being unemployed pay for workers who have a higher risk of being unemployed; men pay for women, as concerns pensions). But the contributory element is probably high enough for employees to realise that social benefits are part of their earnings. A rise in pension contributions to finance pension benefits will be accepted more easily by contributors than a rise in taxes. However, employees' contributions only should be increased so that company competitiveness is not directly affected. The competitiveness of public pension benefits as compared to private pension funds should be ensured, i.e. public pension rights should be reaffirmed, tax incentives for pension funds should be restricted to a EET type system for the income tax, with no social contributions rebates.

Besides, only contributions financing contributory benefits should be based on the 'wage bill' while other benefits should be financed by taxes. This logic is not always applied in Europe. Family benefits are financed by social contributions in several countries (Belgium, France, Italy for instance), this can also be the case for health benefits (Germany, Austria, Belgium, France). This way of financing benefits is neither socially fair, nor economically justified in times of mass unemployment.

Two examples show how the issue could be tackled: CSG in France and IRAP in Italy. The CSG was introduced in 1991 and extended in 1997, which has allowed for the abolition of employees' health contributions. The CSG allows for financing part of family and health benefits on the basis of all households' incomes instead of wages only. Hence, employees'

social contributions now finance insurance benefits only. Conversely, employers still finance family and health benefits. None of the successive governments have dared introduce the logic reform that would have consisted in basing family and health expenditure on total value added. Governments stepped back due to the huge size of inter-company transfers it would have entailed. They also feared that such a reform would have had a negative impact on the more capitalistic branches, assumed to be the more modern ones.

In 1998, Italy substituted health contributions based on labour only (at the rate of 11.46%, however with many rebates), with IRAP (regional tax on productive activities), taxing all net value added components at the rate of 4.25%. This taxation ensures tax neutrality, whatever production technique is chosen by companies and, relatively to wage-based contributions, should be an incentive for companies to use more labour and fewer machines and to favour labour intensive activities. However, IRAP was forbidden by the ECJ, on the motive that VAT is the only taxation that may be applied to value added. This decision paralyses unfairly tax reforms. It has no justification because a tax that does not hit imports and is not reimbursed on exports has no competitive advantage as compared with social contributions.

VAT weighs on imports but not on exports, contrary to social contributions. Hence trading-off percentage points of social contributions with percentage points of VAT provides competitiveness gains, similarly with currency devaluation. But these gains will persist only if the rise in imported consumer goods prices generated by the rise in VAT has no impact on wages, i.e. if employees accept purchasing power losses. Let us assume that consumers consume 20 of imported products and 80 of domestic products. Domestic production is 100, 20 is exported. Labour is the only production factor. Initially, prices and wages are worth 1, wages 80, the employers' contribution rate is 25%. These contributions are replaced by a VAT of 25%. The following day, import prices are 1.2; domestic production prices on the domestic market are 1, export prices are 0.8 (since VAT is not paid on exports). The domestic economy has benefited from competitiveness gains (+20%). A tax of 4 has been shifted from production to imports. But these gains have been obtained thanks to a loss of 4% in workers' purchasing power. If workers get a pay rise compensating for this loss, and if this pay rise impacts prices, then wages again, prices and wages will rise until prices have risen by 20%. Competitiveness gains will have been transitory. No tax reform may by miracle provide competitiveness gains without employees losing purchasing power.

In Germany, environmental taxes have been raised (by 0.8% of GDP) in order to finance old-age benefits and to avoid any rise in employers' and employees' contributions (which would have needed to rise by 0.85 percentage point each). The contributory principle has been lost.

In Sweden, a similar reform has been introduced, aiming at rising environmental taxation by 1.4% of GDP from 2001 to 2010, in order to cut personal income taxation and employers' contributions.

These measures are part of the 'double dividend' logic: environmental taxes would have two advantages. They would be an incentive for reducing the use of polluting products and the revenues they would generate would allow for lower labour taxation. In fact, three strategies can be considered. The rise in environmental taxation may be counterbalanced by subsidies for the production of each type of products; by a subsidy to each producer depending on its past polluting activity; last at the level of all companies by lower employers' contributions. The first two reforms have the advantage of not penalising directly polluting companies, but they are difficult to implement. They require an accurate knowledge of production processes. How would new companies be considered? How to account in permanence for technical progress? If polluting companies are given an incentive for changing their production techniques, households have no incentive for not buying goods produced with polluting techniques. The third strategy hits directly polluting companies, raising their production costs. The rise in prices is an incentive for households to buy other products. This strategy does not require any microeconomic analysis and allows subsidising labour.

The combination of environmental taxation and of cuts in employers' social contributions may generate, at no cost for public finances, lower pollution and less unemployment. This is more likely to occur if the country concerned is initially far from full employment. However environmental taxation revenues are all the more high that the price elasticity of demand for taxed products is low. A contradiction may thus arise, between ecological aims (strong and targeted taxation will be efficient only if it generates *ex post* limited revenues) and aims for profitable taxation in terms of tax revenues. Last a fiscal reform affecting significantly the structure of company costs implies costly reallocations of activities: some activities will not be profitable anymore and will have to be stopped. Some other activities will become profitable, but will require new investments. In any case, such reforms should be co-ordinated at the European level in order to avoid some countries becoming the preferred production site of polluting companies.

It does not seem possible, in the current state of European integration to unify or even have a convergence of national social protection systems, while at the same time market unification in Europe makes it more and more difficult for different systems to coexist. A European company located in seven European countries has to handle seven social protection systems. Will this mosaic resist the increase in labour mobility in Europe and the increase in the

number of trans-national companies? There is a major risk that tax competition operates through social contributions, i.e. through lower benefits or their privatisation. This would be in opposition with the European social model.

Social protection should remain purely national as long as social life, trade unions and social negotiations are done at the domestic level. The systems today have extremely high disparities across Europe, in terms of pensions, unemployment and health benefits. The risk is that, under the principles of free competition and establishment, private insurance companies become entitled to compete with public pensions and their redistributive element. Hence, countries concerned should clearly state that the principle of free competition should not apply to social insurance regimes, with social or redistributive aims. Each country remains responsible for implementing a sufficiently attractive system at the European level, while remaining sufficiently redistributive. The task would of course be easier if social standards were set at the European level: minimum income, old-age income, family benefits (as a percentage of average income in each country), universal health insurance; minimum pension income (as a percentage of wages in the country). Deciding if such issues are part of the European social model is a political choice. Adopting such standards would reduce the risk of social competition.

6. Corporate taxation coordination

The company tax burden is not easy to estimate precisely because it is difficult to breakdown accurately taxation affecting companies, workers and households: in which category are employers' social security contributions or the Italian IRAP? For a company deciding to settle in a country or another, all taxation measures may have their importance, including personal income tax to be paid by their executives while public expenditure and transfers benefiting their workers will also need to be taken account.

According to a relatively arbitrary definition (corporate taxation + wage tax + property firm tax+ taxes on company capital + local taxes), the company tax burden generally varies from 3 to 5% of GDP in Europe, but is higher in France, Italy and Sweden (more than 5.5%) and well below in Germany (1.7%, see table 8).

Table 8 : Company taxes, in % of GDP in 2003

	Corporate tax	Tax on wages	Others	Total	Employers' social contributions
Austria	2.2	2.7	0.2	5.1	6.8
Belgium	3.4	0	0.3	3.7	8.7
Denmark	3.0	0.2	0.3	3.5	0.0
Finland	3.5	0	0.5	4.0	9.0
France	2.5	1.1	2.1	5.7	11.1
Germany	1.3	0	0.4	1.7	7.1
Greece	3.3	0	0.6	3.9	5.9
Ireland	3.8	0.2	0.4	4.4	2.7
Italy	2.9	0	2.6	5.5	8.9
Luxembourg	7.9	0	1.6	9.5	5.1
Netherlands	2.9	0	0.6	3.5	4.5
Portugal	3.2	0	1.0	4.2	7.0
Spain	3.2	0	0.1	3.3	8.7
Sweden	2.5	2.5	0.6	5.6	11.8
UK	2.8	0	1.7	4.5	3.7
Czech Republic	4.6	0	0.2	4.8	10.6
Hungary	2.2	1.0	0.3	3.5	9.3
Poland	1.8	0.2	0.4	2.4	4.8
Slovak Republic	2.8	0	0.2	3.0	8.8
Japan	3.3	0	0.9	4.2	4.4
USA	2.1	0	1.5	3.6	3.4

Source: OECD (2005).

Let us consider a company aiming at profit rate of π after taxes. Its production cost is thus:

$$c = (1 + c_c)wn + (\rho\theta + (1 - \theta\ \pi/(1 - s))\ k$$

where θ is its borrowing ratio ; s, the corporate tax rate ; c_c, the employers' social contribution rate. The wage is:

$w = (1 + t)(1 + c_s)\omega$ where t is the VAT rate, c_s: the employers' contribution rate and ω the real disposable wage. So :

$$c = (1 + c_c)(1 + t)(1 + c_s)\ \omega\ n + (r\ \theta + (1 - \theta)\ \pi/(1 - s))k$$

Thus, the total cost depends on the whole taxation, the ratio between disposable wage and labour productivity, finally on the corporate tax rate. Social security contributions and the VAT play entirely symmetrical roles.

The analysis of companies' financial situation shows that, almost everywhere in Europe, the wage share in value added was lower in 2004 than in 1990 and 1973, while the profitability index was higher (see table 9). It is thus currently unnecessary to consider introducing tax reforms increasing company profits at the expense or workers or public revenues.

Table 9 : Indicators of companies' situation

	Wage share in value added			Profitability index*
	1970	1990	2004	2005*
Germany	72.1	66.8	65.6	100.9
Austria	73.2	77.2	69.6	141.9
Belgium	66,6	70,1	70,7	96.7
Denmark	74,5	70.6	68.1	139.2
Spain	72.5	68.3	65.3	104.7
Finland	71.7	73.5	63.0	154.3
France	73.7	69.6	66.3	122.5
Greece	78.1	72.2	64.6	100.5
Ireland	79.4	67.4	55.2	177.3
Italy	79.4	69.9	64.1	120.6
Netherlands	70.8	66.4	69.2	96.1
Portugal	72.9	67.0	76.4	70.7
UK	74.1	75.4	74.2	133.6
Sweden	70.9	70.7	69.4	136.5
Japan	68.5	69.3	66.2	83.8
USA	72.5	68.1	65.9	134.7

* 100 in 1970-73.
Source: EU.

6.1. Local taxes on firms

Companies are subject to local taxation in all European countries, except in Sweden and the UK. Local taxation raises four problems: the tax base must be located, which necessarily implies taxing production factors (labour, fixed assets, buildings) rather than company benefits; local taxation may come in contradiction with national policy orientations, in particular as regards tax relief; it generates inequalities between local administrations due to the discrepancies in tax potential and these inequalities are cumulative; it generates tax competition between local administrations, at the detriment of deprived areas. European countries have tackled these problems in different ways, also varying from time to time, ranging from the abolishment of local company taxation in the UK to autonomous local taxation of productive activities in most countries. In term of tax competition, a choice has to be made between these two models, since maintaining local taxation may require the introduction of a minimum rate at the European level.

All European countries, except Sweden and the United Kingdom, have a taxation of company's property. Seven Member States - Germany, Belgium, Spain, France, Italy, Luxembourg and Portugal - use specific local company taxation, levied on several bases

(fixed assets, wage bill or number of employees, profits, value added, etc). Several countries introduced reforms of local company taxation in the 1990's, either to reduce tax competition on these taxes, or to ensure a better adequacy with national taxation policy objectives. Thus, in Germany, the 'professional tax', previously set on fixed assets and wage bills, is now based on profits. In France, the reform of the professional tax, undertaken from 1999, led to the progressive suppression of the wage bill from the base, in order to reduce labour costs. Moreover, the ceiling of the professional tax as a percentage of value added implies that many companies pay local taxes as a proportion of their value added. In Italy, IRAP directly is based on value added. Each of these tax bases has specific advantages or disadvantages (se table 10).

Table 10 : The choice of local taxation base

Base	Location	Economic effect	Revenue Volatility	Profit volatility
Wage bill	Easy	Negative on employment		Increase
Fixed assets	Easy	Negative on investment and industry		Increase
Value added	Difficult			
Gross surplus	Very difficult		High	Reduction
Profits	Very difficult	Negative on retained earnings	Very high	Strong reduction

Local taxation on companies raises problems similar to tax competition between countries. There seems to be a trend towards taxing value added. Rates should be relatively uniform in each country, but could possibly be slightly modified depending on specific advantages provided by the local administration or specific disadvantages generated by the company: a minimum rate could be settled. Tax competition should be regulated by the State, with lower rates being allowed for local administration suffering from high unemployment and revenue losses being offset through state funding. This would require that the State transfers revenues between local administration, in order to compensate for their different tax potentials. Incorporating local taxation in corporate taxation co-ordination would remain a difficult issue at the European level.

6.2. Will corporate taxation survive?

Although corporate taxes amount only to a small share of tax revenues, they are a very sensitive issue for companies. For the last twenty years, governments have convinced

themselves that company profitability was crucial for investment and therefore employment. Besides, tax competition has strengthened: with the opening of frontiers implied by globalisation, large companies put domestic tax systems into competition when making their location decisions. So, almost all EU Member States have reduced their corporate tax rates in the 1990's.

Corporation tax revenues are highly volatile since they are based, in a non-linear way and with variable delays, on company profits that fluctuate with the economic cycle (see table 11). Corporation tax revenues rose from 2.3% of GDP in 1995 to 3% in 2000, following the improvement of companies' accounts (rise in mark-ups, lower interest rates) before falling down to 2.6% in 2002. Corporation tax revenues are relatively similar in all European countries, about 3% of the GDP. However Austrian and even more German revenues are dramatically lower than in the average EU, many entrepreneurs choosing to set individual companies. Revenues are much higher in Finland (since 1997, owing to new technology activities), Netherlands and even more Luxembourg (owing to high profits in the banking sector).

Table 11 : Corporate taxes, % of GDP

	1980	1990	1995	2000	2003	2003*
Austria	1.4	1.4	1.5	2.0	2.2	5.1
Belgium	2.2	2.4	2.8	3.6	3.4	3.7
Denmark	1.4	1.5	2.0	2.4	3.0	3.5
Spain	1.2	2.9	1.8	3.0	3.2	3.3
Finland	1.4	2.1	1.8	6.0	3.5	4.0
France	2.1	2.3	2.1	3.1	2.5	5.7
Germany	2.0	1.7	1.1	1.8	1.3	1.7
Greece	0.9	1.6	2.0	4.6	3.3	3.9
Ireland	1.4	1.7	2.8	3.8	3.8	4.4
Italy	2.4	3.9	3.6	2.9	2.9	5.5
Luxembourg	6.6	6.4	7.4	7.2	7.9	9.5
The Netherlands	2.9	3.2	3.1	4.2	2.9	3.5
Portugal	0.9	2.3	2.6	4.1	3.2	4.2
UK	2.9	4.1	3.3	3.6	2.8	4.5
Sweden	1.2	1.7	2.9	4.0	2.5	5.6
EU15	2.1	2.7	2.3	3.0	2.5	4.0
Hungary			1.9	2.2	2.2	3.5
Poland			2.8	2.5	1.8	2.4
Czech Republic			4.9	3.8	4.6	4.8
Japan	5.5	6.5	4.2	3.6	3.3	4.2
USA	2.9	2.1	2 .6	2.6	2.1	3.6

* With local wages and property taxes

Source: OECD, *Revenue Statistics*, 2005.

Most EU Member States have cut their corporate tax rates in the 1990's (see table 12). Germany had two tax rates: 36 and 50% (for respectively distributed and retained profits, the latter being more heavily taxed because they were exempt from dividend taxation), which were cut down to a single rate of 25% by the reform introduced in 2000. The French rates (42% on distributed profits, 37% on retained earnings, less taxed in order to support investment) were cut down to 34.33%. In Denmark and Sweden, rates declined from 50 to 30%. Taxation is dramatically low in Ireland (12.5% in general, but 10% for industrial sectors). Except Ireland, rates range from 28 to 35%. However, the comparison is made difficult by the existence of local taxation that may be levied on profits (Germany), value added (Italy), capital (France) and even more by substantial differences in the assessment of the tax base (in particular depreciation rules). In the 1990's many countries have widened the tax base while cutting their tax rates, in order to design a more neutral system.

Table 12 : Corporate tax rates in 1990 and 2005

	1990	2005
Austria	30	25
Belgium	43	35.54
Denmark	50	28
Finland	33	26
France	42 distributed profit 37 retained profit	34.94 (34.43 in 2006)
Germany	36 distributed profit 50 retained profit	39.3
Greece	46/ 40 industry	32 (25 in 2007)
Ireland	43/ 10 industry	12.5
Italy	36	33 (37.25% with IRAP)
Luxembourg	34	30.4
The Netherlands	35	31.5 (30.5 en 2006)
Portugal	34	27.5 (22.5 en 2006)
Spain	35	35
Sweden	52	28
United Kingdom	35	30
EU15 (average)	41.8	34.1

Source: *European Tax Handbook* (2005)

New Member States have generally lower rates than the old Member States (see table 13) and they consider cutting further their rates so as to compensate for the abolition of state aid to companies, changes in basis determination rules and to attract foreign direct investment.

In a report on company taxation in Europe, the Commission (2002) measured the extent of the divergences between tax systems. It calculated an average effective tax rate, i.e. the tax rate levied on a standard investment with a return of 20% before tax (see table 14). The charges levied on companies for domestic investments are relatively disparate in Europe. However, rates range from 28% to 32% in most countries, except Ireland (10% only) and Sweden 23%, whereas Belgium, France and Germany have tax rates of 35%. Apart from Ireland, these disparities are not likely to generate substantial capital movements. However, the risk exists that the downward trend in tax rates turns into excessive tax competition.

Table 13 : Corporate tax rates in the New Member States

	2005
Cyprus	10
Estonia	0 (retained profit)/24 (20 in 2007)
Hungary	16
Latvia	15
Lithuania	15
Malta	35
Poland	19
Slovak Republic	19
Slovenia	25
Czech Republic	26 (24 in 2006)

Source: *European Tax Handbook* (2005)

Table 14 : Effective corporate taxation in the EU

In 2001	Nominal corporate tax rate	Rate used for the calculation*	Average effective taxation rate
Austria	34	34	27.9
Belgium	39	40.17	34.5
Denmark	30	30	27.3
Finland	29	29	26.6
France	33.33	36.43	34.7
Germany	25	39.35	34.9
Greece	37.5	37.50	28.0
Ireland	10	10	10.5
Italy	36	40.25	27.6
Luxembourg	30	37.45	32.2
The Netherlands	35	35	31.0
Spain	35	35	31.0
Portugal	32	35.20	30.7
Sweden	28	28	22.9
United Kingdom	30	30	28.3

* It includes corporate and local taxes.

Source: European Commission, 2002.

6.3. The basic principles for corporate taxation

Corporate taxation can be considered as a tax on companies' shareholders or as a tax on companies themselves, as a counterpart of the advantages companies draw from the infrastructures of the country where they have located their production (from this point of view, taxation should also be levied on borrowed capital). Benefit taxation may rely on two principles. According to the **source principle**, a country may tax all benefits generated at home, either by residents or non-residents. Thus, in a country applying the source principle, domestic benefits of foreign groups entities will be taxed and national companies will not incorporate their profits earned abroad in their taxable profits (as a counterpart, foreign losses will not be deducted). According to the source principle, corporation tax is a tax on companies, and corporate tax rates may differ between countries to reflect differences in the services provided to companies.

A country applying the **residence principle** must tax all incomes earned by national residents, whether earned in the country or abroad. Foreign losses can be deducted from profits. According to this principle, corporate taxation is levied on company owners.

At the international level, the source principle should apply. Residence is an ambiguous concept for companies. The residence principle would allow firms to escape taxation if they locate in a tax haven. So in a given country foreign firms could benefit from an unfair competitiveness advantage by escaping to taxation. With the source principle, all firms operating in a given country are subject to the same tax rate: this ensures neutrality for capital imports. But it may be feared that a company from a given country is encouraged to invest in countries with low tax rates: there is no neutrality for capital exports. This fear is not justified if low rates only compensate for a lack of infrastructure, geographical distance, political risks… The other problem is profit shifting: firms could try to localise their profits in countries with low tax rates by manipulating transfer prices, royalties and interest payments.

Some countries accept that their international companies produce consolidated benefits, in other words, the principle of residence: these companies can consolidate all losses and benefits of their subsidiaries or branches world-wide, deducting the taxes paid abroad from their domestic taxes.

6.4. Corporate taxation and the single market

The current system is unsatisfactory. Two kinds of critics can be made. For companies (and for the Commission), the main problem is that countries have different rules for assessing tax bases, which complicates the operating of trans-national companies. Discriminations according to the nationality of parent companies and subsidiaries remain. Some incomes are subject to double taxation. Transfers between parent companies and their subsidiaries are managed under a disparate set of bilateral conventions that must be re-examined when one of the partner countries modifies its legislation.

For Member States, the main problem is tax rates disparities. Large companies are incited to optimise their taxation by carefully choosing the location of their headquarters, of their subsidiaries, of their financial transactions. They can use transfer prices, intra-group borrowing and royalties to locate their profits in the countries where tax rates are the lower. This generates costly surveillance policies for governments and exerts pressure on Member States to decrease their taxation rate. The need to avoid costly tax competition, the European single market, the rising number of European companies (settled in several European countries) make it increasingly necessary to co-ordinate corporate taxation at a European level.

The Commission tries mainly to ensure tax neutrality for trans-national investments: firms should be able to invest anywhere in Europe without taxation being a source of economic

distortion. Directives have been implemented in order to avoid double taxation and to limit tax optimisation practices. The Commission has also introduced procedures to fight harmful tax competition among European countries. However, corporate taxation co-ordination at the European level can only be limited because of Member States' taxation autonomy.

An option would be to generate a progressive convergence of the tax systems in the EU. This convergence would suppose agreements on taxation principles, tax base harmonisations and minimal tax rates. This would raise difficult issues: how to account for local taxation? Should reduced rates for less-developed countries, areas or sectors in difficult economic situations be authorised? Who, between the Member States and the Commission, would have the initiative of introducing measures aiming at reducing taxes temporarily (in bad times) or permanently (to boost R&D spending, for example)? Accounting for the subsidiarity principle in taxation, the Commission gave up pursuing this strategy.

On December 1, 1997, the Ecofin council adopted a *Code of Conduct*, i.e. a set of measures aiming at fighting harmful tax competition. 230 regimes were pointed at as potentially likely to generate unfair competition, i.e. at impacting the location of activities within the European Union on artificial grounds. Derogatory tax regimes where Member States offer preferential tax treatment, i.e. support a category of companies (for example non residents) to the detriment of the others (for example residents) are contrary to the *Code of Conduct*. But low taxation – applied to everyone- is not considered unfair and is seen as a sign of good management of public finances. The *Code of Conduct* made it possible to remove a certain number of preferential tax systems. But the core issue remains: what global tax competition is acceptable?

6.5. On tax base harmonization

The Commission (2002) suggested a reform of the tax base, with four alternative possibilities. Two suppose a compulsory system:

- A European Union company Income Taxation (EUCIT) will unify corporate taxation all around Europe. In the long run, it is the best solution, but it supposes that countries agree to lose all autonomy in that field. Countries with low tax rates will have to raise them. They can agree only if their possibilities to subsidize their firms are increased. So, Member States should agree to leave all industrial policies at the European level. It is not realistic nowadays.
- A harmonised Tax base (HTB) unifies the bases, but lets each country free to choose

their tax rate. But a common basis main would exacerbate tax rate competition.

Two introduce an optional system for European firms:

- In the Common Tax base system (CTB), a European firm could chose to compute its whole profits according to some specific European rule.
- In the Home State Taxation system (HST), a European firm could chose to compute its whole profit according to the rules of the country of the parent company.

In both cases, the profits of a group would be shared between the various Member States in which it operates, according to some allocation keys (added value, wage bill, etc), each State taxing the profits returning to their country. The principle of profit sharing, already used in the US and Canada, according to appropriate allocation keys impedes profit shifting practices. However, these proposals raise many difficulties:

- In the HST system, companies would have the possibility to choose between 25 rules. Some countries may choose very favourable regulations to attract headquarters. The system would be incontrollable by national administrations. Tax competition will not be totally avoided.
- Even in the CTB system multinational firms would be taxed differently (and, in fact, less) than national firms.
- It seems difficult that subsidiaries of a multinational corporation make a tax assessment only to the tax administration of the country of the head office. How would the coherence of the subsidiaries' tax assessment be ensured in the host country? Profit assessment allows national administration to check the consistency of value added and wage bill assessment. The simplification at firms' level has a counterpart, which is the loss of control for national administrations.

6.6. On tax rate harmonisation

So we do not see how Europe could escape painful negotiations on convergence of corporate taxation. Corporate taxation is not the most appropriate tool to attract firms to locate in less developed countries or deprived areas, due to risks of profit shifting (companies may benefit from low tax rates in a country while producing mainly elsewhere). Our preferred strategy would be to exchange the corporate taxation convergence against more freedom given to Member States to subsidize their companies. This could be done in four steps:

- Some convergence of the tax bases.

- Clear recognition of the source principle. In fact, the logic would be to tax the 'net operating surplus' rather than profits. European taxation could progressively move in this direction with the introduction of taxes like the Italian IRAP.
- Introduction of minimum rates, depending on the level of development reached by the country, for instance 20% for New Member States and 30% for the old Member States. The lower minimum rate will increase as countries converge. Countries providing specific advantages to companies could of course set a rate higher than 30%, at their own risk.
- Less developed countries would be allowed to subsidise their companies (possibly *via* the EU structural funds), with value added or wage bill bases, rather than through low corporate tax rates, so as to minimise the risks of profit shifting. Company subsidies could also be allowed more easily for regions or economic sectors in difficulty, aid for innovation and research.

In any case, the fight against tax havens should be strengthened, at the European or world levels. Companies and financial institutions should not be allowed to have subsidiaries or to transfer funds in these countries. European countries should subordinate bilateral agreements authorizing the transfer of dividends without taxation to the existence of a minimum rate of the profit taxation.

6.7. On dividends taxation

Value added goes to wages, interest, dividend incomes and non distributed profits. Fair taxation would ensure that all these elements are similarly taxed. This would suppose, in particular, that social contributions (for pensions, unemployment benefits, etc.) are well differentiated from taxes. For interest income, taxation should apply only to real interests. Similarly, the logic would be that real capital gains are taxed like dividends. Then, the question of corporate taxation arises. Can this tax be considered as a tax on the owners of the company, which would justify taxation under the residence principle or like a tax on the company (but in this case, why not tax interests)?

Let us consider a country where the corporate tax rate is 33.3%; the maximum income tax rate is 50%; the tax rate on bond interest income is 25%. Effective taxation is 50% on high wages; 42% on real bonds income (for an interest rate of 5% and an inflation rate of 2%). The tax rate on dividends is 33.3% (if dividends are completely tax exempt), 50% (if dividends benefit from an imputation system), 50% (if they benefit from a rebate of 50%), 66.7% in the event of double taxation. The tax rate on capital gains is 33.3% if they are exempt from income tax

(and if capital gains equal retained profits); 50% if they are taxed at 25%. On the whole, the coherence of taxation is not automatically guaranteed.

The imputation system is logical if corporate tax is considered to be a tax on company owners. The double taxation system could be justified if corporate tax is a specific tax on firms. But this would suppose that the corporate tax is also levied on interests and that its rate is strongly reduced. The schedular tax system is a compromise that makes it possible to adapt income tax and corporate tax rates.

The ECJ requests that the same system is applied to domestic and foreign dividends. In practice, this forces countries to adopt an income-tax scheduled system. The fairness of this system is arguable. Let us imagine for example a country A where the corporate tax rate is 33.3 % and with a scheduled taxation of dividends at 25%. The income tax rate is 50% (see table 16). In the neighbouring country, B or C, the corporate tax rate is 20%. The total tax rate for savers in A, who invest in B, is 40%. This is not justified since profitability is the same in B and A. But if the low tax rate compensates for some economic disadvantages, as in C, such a discrepancy can be justified. However, this compensation would not exist in an imputation system. The imputation system reduces the impact of tax competition. So, switching from an imputation system to a schedular system supposes an overall agreement on tax rates levels, countries with high rates accepting lower rates in less developed countries or having natural disadvantages. Another option would be to standardize corporate tax rates, to maintain the imputation system while allowing countries to give direct subsidies to their companies.

Table 15 : Savings' profitability for a resident of country A

	Country A	Country B	Country C
Profitability *ex-ante*	15%	15%	12%
Corporate tax rate	33.3%	20%	16.7%
Profitability after CT.	10%	12%	10%
Prof. with imputation	7.5%	7.5%	6%
Prof. with 25% taxation	7.5%	9%	7.5%

7. Conclusion

Can one conceive a common European tax? He would represent a significant step towards the construction of a common citizenship. But, at the present time, it raises questions of redistribution between rich and poor countries, of equity and tax coherence. The natural candidates are the environmental taxation (but its Europeanization would be contradictory

with the idea to use its revenue to reduce the social security contributions and to support employment), the tax on the incomes of the capital of the households (but, the countries should give up any autonomy on the matter, which raises the issue of the placements with privileged taxation), the tax on profits (but it is central in the organization of the tax systems that its Europeanization is hardly possible).

Unfortunately, there are no simple solutions in the field of tax harmonization. Until now, European countries seem to have more or less succeeded in maintaining their desired level of redistribution and public expenditure. However, it is difficult to say if lower taxation on the richest and companies results from globalisation constraints or reflects rising trends of liberal ideas.

Europe will have to live for a long time in a contradiction between capital and goods markets where unification is rapid, and taxation (and more generally budgetary, social and political institutions) that remain national. In far as taxation is concerned, the problem is *institutional*: Community authorities and the States should care for maintaining the ability of countries to tax their residents, and *political:* tax co-ordination will be easier if all governments agree explicitly to maintain the European social model, *i.e.* significant and redistributive taxation to finance public expenditure and transfers.

Basically, Europe can choose between two strategies. The first consists in maintaining the European social model, characterized by a significant level of transfers, public expenditure and thus of taxation. The system will have to be preserved from tax competition by harmonisation in Europe that will have to include the prohibition of unfair competition, the introduction of minima rates in certain cases, and by tough measures against tax havens at a worldwide scale. The European Social Model will have to rely on its comparative advantages (free education and health for all, public infrastructures, social security benefits) to remain competitive in spite of globalisation. The second strategy consists on the contrary in moving towards a more liberal model, where privatisation of welfare will allow for cuts in tax rates that are assumed to promote employment, education and vocational training, savings and investment. This strategy supposes that Europeans agree to live in a Society with rising inequalities. Tax competition would then a tool to support this trend. But what should be done at the European level if European countries wish to make different choices?