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New Impetus for EU Taxation Policy

The financial crisis has exposed all EU Member States – to different degrees – with a double economic policy challenge: to foster sustainable economic growth and to consolidate public finances. Can the governments in the EU afford to forego the benefits of targeted tax measures at EU level – tapping the growth potential of the internal market by reducing tax obstacles and improving tax collection on cross-border activities within the EU? This paper provides a short review of the varying tax structures in the EU Member States, discusses the interdependencies as well as the EU dimension of their tax policies and gives an overview on current and future tax initiatives at EU level.

Taxation remains largely a national competency in the European Union; the Lisbon Treaty that entered into force last year did not change anything in that respect. Any EU tax legislation will continue to require unanimity amongst Member States, which is a very high hurdle with 27 Member States and tax sovereignty being so highly guarded by most of them. Therefore it might not be surprising that over the last years taxation was not very high on the political EU agenda. But the situation has changed significantly with the financial and economic crisis. Taxation issues have become an important ingredient of EU policies to boost sustainable growth and consolidate public finances: through the strengthening of the EU's Single Market by reducing the remaining tax barriers[1], recommendations for growth- and employment-friendly tax policies[2] and as part of the Euro Plus Pact approved by the Heads of State and Government to improve economic governance in the EU.[3]

This paper will provide a short review of the varying tax structures in the EU Member States, discuss the interdependencies as well as the EU dimension of their tax policies and give an overview on current and future tax initiatives at EU level.

Structures of Taxation Vary Considerably Among EU Member States

Compared to the USA, Japan or the OECD-average, the EU is a high tax area with an overall tax-to-GDP ratio of more than 39% in 2009 (see Figure 1), which has decreased only slightly since 2001 (cyclically adjusted).[4] One can differentiate Member States across different dimensions; from an institutional and systematic viewpoint, for example, a few Member States, most prominently the Nordic ones, have adopted full-fledged Dual Income tax systems, while the majority of Central and Western European Member States remain closer to tradition; several Eastern Member States have adopted flat tax systems (e.g. Bulgaria, the Czech Republic, Slovakia, Hungary, Romania and the Baltics). Differences are also large among Member States in terms of the level of taxation (including social security contributions – SSC), with the Nordics and the core countries having much higher tax levels than the periphery, and in terms of the structure between direct taxation, indirect taxation and SSC. In that regard, particularly the new Member States tend to raise high shares from indirect taxes (of the twelve countries which raise more than 40% of total revenue from indirect taxes, nine are new Member States), while Social Security contributions are prominent in countries such as France and Germany, but account for a limited share of revenue in the UK and in countries with historical links to it (Ireland, Malta, Cyprus) as well as in Sweden and Denmark, where most social security spending is financed through taxes rather than social contributions (Figure 2).

Generally, however, implicit tax rates on labour are well above those on capital and consumption, although again they vary considerably amongst Member States (Figure 3).

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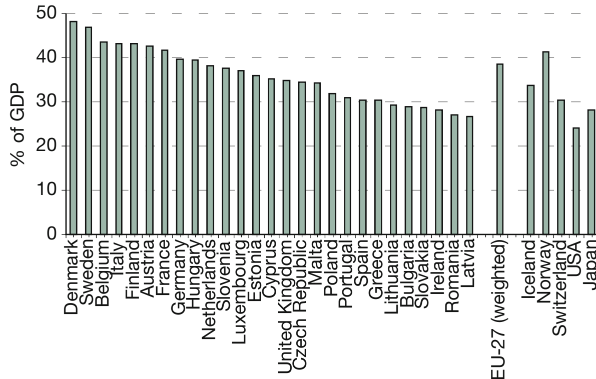
1 European Commission: Single Market Act, Twelve levers to boost growth and strengthen confidence, Working together to create growth, COM/2011/206 final.
2 European Commission: Annual Growth Survey: advancing the EU's response to the crisis, COM/2011/0011 final.
3 European Council 24/25 March 2011 Conclusions, Annex 1, EUCO 10/1/11 REV 1.
4 European Commission: Taxation trends in the European Union, Data for the EU Member States, Iceland and Norway, edition 2011.

Figure 1

Overall Total Tax-to-GDP Ratio (incl. SSC) in EU Member States and Selected Countries, 2009



Source: Commission Services: Taxation Trends in the EU, 2011 edition. Source for CH: OECD revenue statistics, http://stats.oecd.org/Index.aspx?DataSetCode=REV.

Figure 2

Revenue Shares of Indirect Taxes, Direct Taxes, Social Security Contributions, 2009

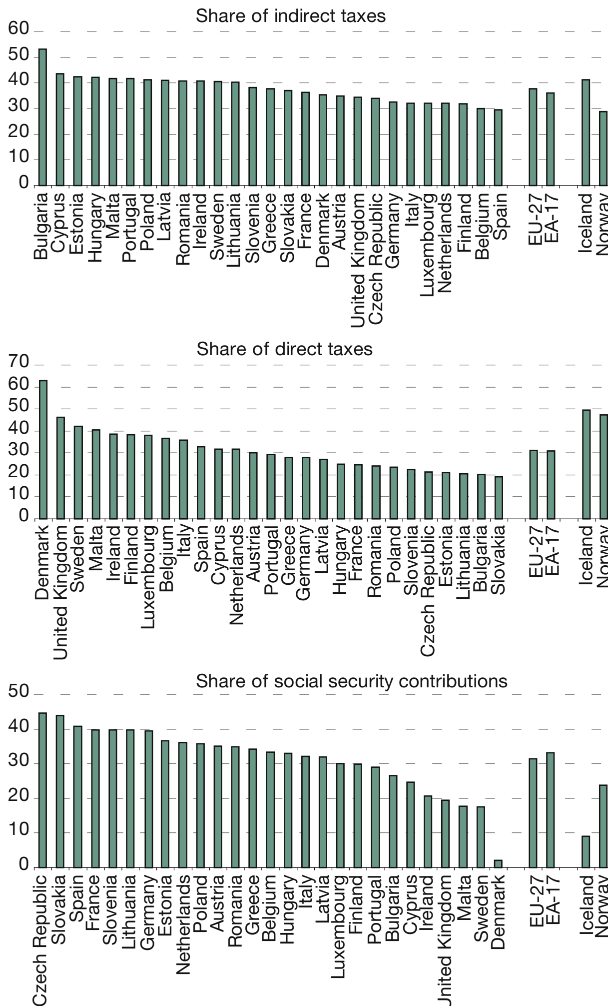
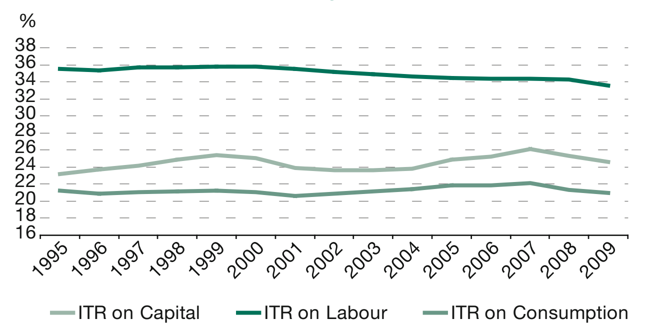


Figure 3

Development of Implicit Tax Rates on Capital, Labour, Consumption; EU-25 Average in %; 1995-2009



Source: Commission Services, Taxation Trends in the EU, 2011 edition.

Especially since the beginning of the financial crisis, there have been several increases in VAT and in excise duty rates, suggesting that European tax systems are moving towards a larger role of indirect taxation. This is however not yet visible in the available revenue data, relating to the year 2009, which was also heavily influenced by the consequences on revenue of the crisis. Compared to 2000, most countries saw revenue contract, but that was generally due to the slump rather than to tax cuts, even though a few countries did adopt some tax stimulus packages in 2009. Overall however, the tax burden in the EU seems to be headed for a rise, owing to the need for budgetary consolidation.

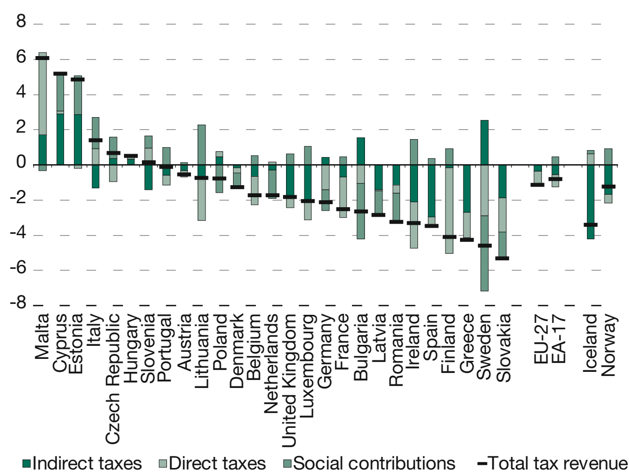
What Is the EU Dimension of National Taxation Policies?

Taxation as National Competency, but in Compliance with the Rules of the Internal Market

The broad variety in levels and structures of taxation demonstrates clearly that taxation is indeed still largely a national competency. This cannot only be explained by the historic fact that tax sovereignty is very much at the heart of parliamentary democracy and national sovereignty. Considering that the bulk of public goods and services are produced by Member States, it is also understandable that Member States want to decide how they are financed. Furthermore, national tax policies also have distributional goals where preferences vary widely within the EU and remain again a national domain. Tax sovereignty is, however, not exercised in splendid isolation. EU economies are highly integrated, above all through the internal market. National tax policies have to obey the basic rules of the internal market, in particular the “four freedoms” for movements of goods, services, people and capital. The European Court of Justice (ECJ) has therefore ruled in many cases that certain national tax rules were not compliant with the Treaty

Figure 4

Evolution by Major Type of Taxes: Indirect, Direct, SSC, Total, Differences in % of GDP, 2000-2009



Source: Commission Services.

rules of the internal market, and Member States had to withdraw or modify them accordingly.

The Effects of Fragmentation of 27 Different Tax Systems in the EU

While reflecting national sovereignty and national preferences, the variety of different tax systems in the EU create:

- *Distortions of the efficient allocation of resources*: 27 different tax systems impact on market conditions in their respective Member States and can therefore create distortions in a single market without physical internal frontiers. This is most evident for taxation on traded goods and services, such as VAT and excises. These distortions result in welfare losses. Therefore the Treaty foresees a certain harmonisation of indirect taxes. VAT and three important excise taxes (energy, alcohol, tobacco) are to a limited extent harmonised (as far as the tax structure and minimum tax rates are concerned).[5]

- *High compliance cost for companies and citizens with cross-border activities*: 27 different tax systems also trigger important compliance costs for businesses and citizens with cross-border activities. Citizens can find it very difficult to cope with more than one set of tax rules and tax authorities; they can in particular have problems in obtaining understandable information on foreign tax rules and claiming tax refunds to which they are entitled from foreign tax authorities.

5 Art. 113 TFEU (ex Article 93 TEC)

- *Double or higher taxation for cross-border activities*: More importantly, the co-existence of different national tax systems can also lead to double or higher taxation of cross-border activities, despite the attempts of governments to mitigate these effects through double taxation treaties. Examples include not offsetting losses against profits of subsidiaries in different Member States or double inheritance taxation for citizens.[6]

- *Possibilities for tax avoidance and evasion*: The internal market does not only offer business opportunities and potentially additional growth and employment, it also offers possibilities for tax avoidance (legal) and tax evasion (illegal), which cannot be tackled by tax administrations that act on a purely national basis. For instance, cross-border VAT fraud is notorious. Recovery rates of tax claims in other member states are as small as 5%.[7]

Interdependency in Internal Market

All the points mentioned above show how tightly tax policies are interlinked in the EU. The impact of policy measures by one Member State is not limited to that Member State, but can have an impact on tax revenues of other Member States too – and vice versa (cross-border externalities). This has at least two consequences:

- *Tax competition between Member States*: The interdependencies of national tax policies lead to a certain tax competition among Member States, in particular when it comes to mobile tax bases.[8] This might also explain why implicit tax rates for capital (rather mobile) are lower than for labour (rather immobile). The evolution of headline corporate tax rates over the last decades[9] could be revealing in this respect. But the jury is still out on the importance and benefits or costs of tax competition.[10] There is consensus, though, on "harmful" tax competition, i.e. beggar-thy-neighbour policies to attract other Member States' tax bases. This is why the EU has es-

6 Results of public consultations on double taxation and on inheritance taxes: http://ec.europa.eu/taxation_customs/common/consultations/tax/2010_04_doubletax_en.htm and http://ec.europa.eu/taxation_customs/common/consultations/tax/2010_06_inheritance_en.htm.

7 Reckon LLP: Study to quantify and analyse the VAT gap in the EU-25 Member States, Report, 2009.

8 T. Hemmelgarn: Steuerwettbewerb in Europa: Die Rolle multinationaler Unternehmen und Wirkungen einer Koordination, Tübingen, 2007, Mohr Siebeck.

9 European Commission: Taxation trends in the European Union..., op. cit., pp. 31; M.P. Devereux, R. Griffith, A. Klemm: Corporate income tax reforms and international tax competition, 2002.

10 Reviews of the tax competition literature: C. Fuest, B. Bernd Huber, J. Mintz: Capital Mobility and Tax Competition, Foundations and Trends in Microeconomics, Vol. 1, No. 1, 2005; J.D. Wilson: Theories of tax competition, in: National Tax Journal, Vol. 52, 1999, pp. 269-304.

tablished a so-called "Code of Conduct of Business Taxation" that provides for the "roll-back" of harmful tax measures (more than 400 have been examined since 1999) and forbids introducing new ones ("stand-still").[11]

- *Need for cooperation between national tax administrations*: As tax payers (companies and citizens) can benefit from the four freedoms in the internal market, tax administrations will only be effective in tax collection if they cooperate across border in the EU. Recently the Council adopted new legislation to strengthen administrative cooperation among national tax administrations both for establishing tax debts and for their effective recovery.[12]

Governments are faced with a Prisoner's Dilemma type situation: isolated tax policies produce suboptimal results, because they trigger cross-border externalities that are – rationally – not taken into account in the national sovereign decision process. Only co-operative strategies – at least at EU level, where externalities are most pervasive – can improve the effectiveness and efficiency of national tax policies. The so-called Monti Report on the Single Market puts it nicely: "The tax dimension of the single market: working together to safeguard tax sovereignty."[13]

Current Initiatives

Policy Orientations

In the "exit strategy" out of the crisis both for consolidating heavily hit public finances and boosting sustainable growth, tax initiatives at EU level can help to:

- promote sustainable growth and employment through dismantling tax obstacles in the internal market;
- support budget consolidation by ensuring effective and efficient taxation of cross-border activities (fight against cross-border tax evasion and fraud).

The Commission has set out an ambitious tax agenda for the coming years[14] mostly consisting of new legislative initiatives. But there are also still "left-overs" in the legislative process, i.e. proposals tabled by the Commission some time ago where the Council was not able to come to unanimous decisions.

11 Council of the European Union: Code of Conduct (Business Taxation), Brussels 1999.

12 Council Directive 2011/16/EU and Council Directive 2010/24/EU.

13 Mario Monti: Report to the President of the European Commission, José Manuel Barroso, A New Strategy for the Single Market, at the Service of Europe's Economy and Society, 2010.

14 European Commission: Single Market Act..., op. cit., pp. 15-16.

Savings Income Taxation

The Savings Directive[15] (adopted by the Council in 2003 after long and difficult negotiations) aims at ensuring the effective taxation of interest income incurred in another Member State in the resident state of the taxpayer.[16] It provides for the automatic exchange of information between tax administrations of the state of the paying agent of the interest payment and the resident state of the account holder. Financial institutions (paying agents) have to report these data to the tax authorities where they are situated. Only Luxembourg and Austria apply – on a transitional basis – a withholding tax[17] (instead of the automatic exchange of information). First experiences with the application of the directive show that the definition of interest income in the directive and the reporting modalities offer large possibilities to avoid the impact of the Savings Directive and thereby reduce its effectiveness. For instance, interest-linked derivatives or life insurances are presently not covered, nor are interest payments to transparent legal entities (e.g. trusts). Therefore the Commission tabled proposals to revise the Savings Directive in 2008[18], but the Council has not yet been able to agree on these proposals. Progress on this proposal would both increase tax revenue for Member States and improve the fairness of taxation.

Common Consolidated Corporate Tax Base

Businesses operating cross-border in the Internal Market face a number of obstacles in corporate taxation:

- high compliance costs due to the existence of 27 different national corporate tax systems;
- high compliance costs due to complicated transfer pricing rules;
- limited possibilities to offset losses incurred in one Member State with profits accrued in another Member State.

15 Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments.

16 The EU concluded five agreements with Switzerland, Liechtenstein, Monaco, Andorra and San Marino providing for measures equivalent to those foreseen by the savings taxation directive.
All Member States entered into bilateral agreements with Anguilla, Aruba, the British Virgin Islands, the Cayman Islands, Guernsey, the Isle of Man, Jersey, Montserrat, the Netherlands Antilles, the Turks and Caicos Islands providing for the same measures as those foreseen by the savings taxation directive.

17 20% from 1 July 2008 to 30 June 2011 and 35% from July 2011 onwards.

18 Proposal for a Council Directive amending Directive 2003/48/EC on taxation of savings income in the form of interest payments, COM/2008/727 final.

To mitigate these difficulties the Commission has proposed a "Common Consolidated Corporate Tax Base".[19] Companies would be offered the option of calculating their taxable income according to the same rules in all Member States. Groups of companies would be allowed to consolidate profits and losses (i.e. consolidated tax base) and to deal primarily with only one tax authority, usually the one where the head office is located ("one-stop-shop" for filing tax returns).

The consolidated tax base would be distributed amongst the Member States where the group is active according to an apportionment key[20], and each Member State would apply its own tax rate on its share of the consolidated tax base. The CCCTB would thereby harmonise the corporate tax base but not tax rates, which would continue to be set under full national sovereignty. For most Member States, the CCCTB base would be broader than the existing national tax base (Figure 5).

Through the introduction of the CCCTB companies could save some €0.7 bn p.a. in compliance costs – savings that could increase to up to €1 bn p.a. if more companies were to set up subsidiaries in other Member States because of the facilitation offered by the CCCTB. In addition, by allowing businesses to offset losses in one Member State against profits elsewhere in the EU for tax purposes (i.e. consolidation), the proposal could result in additional savings of €1.3 bn p.a. for companies across the EU.

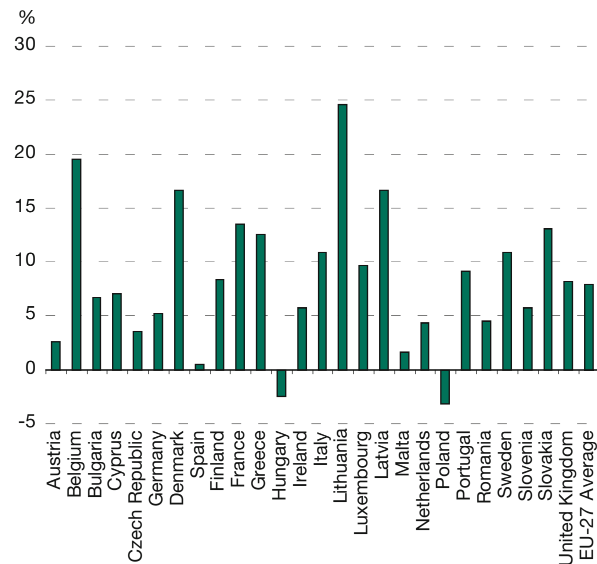
While national tax rates would not be harmonised, possibilities for aggressive tax planning would be reduced. For instance, shifting the taxable profits into low tax jurisdictions would be more difficult as the key apportionment factors would be very hard to manipulate. The factors on which the key apportionment is built represent elements of real business activities.

The CCCTB would provide for more legal certainty to business and tax authorities, since the rules for computing the common base should be subject to fewer changes over time than the current 27 frequently changing systems. Uncertainties linked to action before the ECJ should no longer be relevant, as the CCCTB is designed specifically to comply with the Treaties.

The CCCTB would not only improve the competitiveness of EU business through reduced cost, but also make the EU more attractive for foreign direct investment from third countries – both effects should positively impact on the growth potential of the EU.

Figure 5

CCCTB – Change in the Base, in % of the Present Tax Base



Revision of Energy Taxation Directive

The current Energy Taxation Directive (ETS)[21] was adopted in 2003 but has manifest weaknesses:

- Taxation is based largely on volume (€/1000 litres of fuel) rather than energy content, and minimum rates are determined inconsistently and on a historical basis. For example, when comparing the current minimum rates for motor fuels to their energy content, the energy content of petrol is taxed higher than that of diesel. The same applies for heating oil compared to coal (see Figures 6 and 7).

- CO_2 emissions are not taken into account. Sustainable biofuels which can be regarded as CO_2-free according to the Kyoto Protocol are subject to the same minimum rates as fossil fuels. Again diesel, which per litre triggers more CO_2 emission than petrol, enjoys a lower minimum rate. While it is true that the EU has established the Emissions Trading System (ETS) to cap CO_2 emissions, the ETS covers only 50% of CO_2 emissions in the EU; in particular the transport sector and household heating are not covered.

19 Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM/2011/121 final.

20 The consolidated tax base is shared out on the basis of a fixed apportionment formula based on three equally weighted factors: assets, labour and sales.

21 Council Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity.

Figure 6

Current Minimum Rates for Motor Fuels on Energy Content (GJ), EUR/GJ

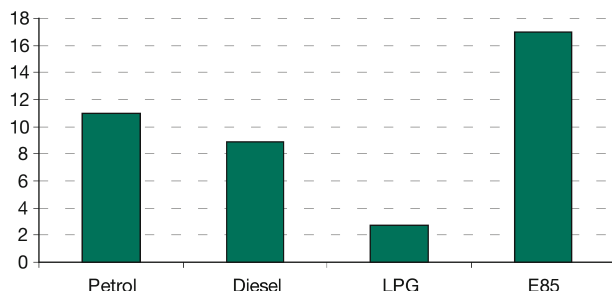
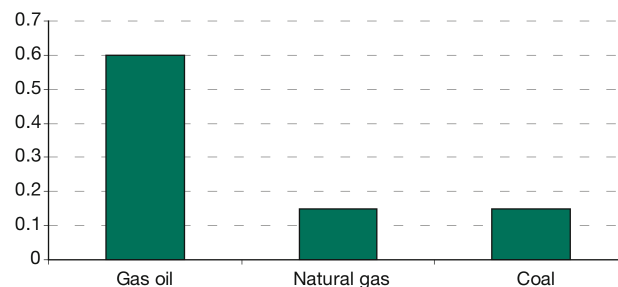


Figure 7

Current Minimum Rates for Heating Fuels on Energy Content (GJ), EUR/GJ



In order to mitigate these weaknesses, the Commission has proposed a revision of the Energy Taxation Directive[22] in April 2011. The basic thrust of the proposal is a two-tier tax base:

- The first part would be based on the CO_2 emissions, with a minimum rate of €20/tCO_2 for all uses of energy products not covered by the ETS.
- The second part would be based on energy content measured in gigajoules (GJ), with a minimum rate of €9.6 for motor fuels and €0.15 for heating fuels.

With the new approach, any distortions between fuels would be removed and a price for CO_2 emissions would be introduced, complementing the Emissions Trading System. Sustainable biofuels would not be subject to the CO_2-related part of the tax and would only be subject to the energy content part, based on their own – lower – energy content, and thereby receive an incentive as less polluting fuels.

With the proposal, the minimum tax rate for (non-bio) petrol expressed in € per 1000 litres would remain at the current level (€359/1000 l), while the minimum rate for (non-bio) diesel expressed in € per 1000 litres would have to increase from the current €330/1000 l to €390/1000 l in 2018, as a litre of diesel contains both more energy and emits more CO_2 than a litre of petrol. Minimum rates for household heating would also increase, as they would for industry use in small installations not covered by the ETS (see Table 1). The minimum rates for ETS installations would go down for both heavy fuel and gas oil. Member States with tax rates above the minima would have to align the taxation of energy products accordingly, i.e. apply the same rates per GJ and tCO_2 respectively for all fuels in the respective categories: motor fuels used for transport and heating fuel (business and non-business use). As these modifications can trigger rather important changes in tax rates, the Commission proposal provides for generous transitional periods for motor fuels, both for the respect of the minimum rates and for the alignment of rates among different fuels (minimum rates will increase gradually until 2018 and the alignment can be postponed until 2023). This will allow economic actors – producers and consumers – enough time to adapt to a changed tax environment, which will be less distortive and better reflective of environmental externalities. It will also provide a technology-neutral tax treatment. As the taxation of the household sector is less likely to create distortions in the EU internal market, Member States have the possibility to exempt heating fuels for the household sector. This gives Member States the possibility to take into account social policy considerations or achieve more rational energy use for household heating by other means, e.g. construction standards, targeted investment grants, etc.

As the revised directive fixes only minimum rates, its actual impact will depend on how Member States adapt their tax rates.[23] Under the assumption that Member States were to put the CO_2 element (€20/tCO_2) on top of current rates for all non-ETS emissions from 2013 onwards, tax revenue would *ceteris paribus* increase by some €40 bn p.a. in 2020. CO_2 emissions outside the ETS would decrease by some 4%, which represents more than one-third of the reductions needed outside the ETS in order to achieve the 20% reduction target of the EU's energy and climate change strategy.[24] If the additional tax revenue was used to reduce labour cost (employers' social security contributions), employment would increase by some 700 000 jobs (+0.3%) and GDP by 0.2% compared to the 2020 baseline. As to the diesel/petrol balance which is very much in the focus of public discussion, the impact assessment shows

22 European Commission: Smarter energy taxation for the EU: proposal for a revision of the Energy Taxation Directive, COM/2011/168 final.

23 European Commission: Commission Staff Working Paper Impact Assessment, Annex 5, 6 and 9, SEC/2011/0409 final.

24 European Council 13-14 March 2008, Presidency Conclusions, 7652/1/08 REV 1, 20/05/2008.

Table 1

ETD: Minimum Tax Rates (Old and New), by l or kg, Motor and Heating Fuels (Business and Non-business Use)

Energy product	Unit	Minima in current ETD	New minima in proposal
Motor fuel use		2011	By 2018
Petrol	€/1000 l	359	359
Gas oil	€/1000 l	330	390
Kerosene	€/1000 l	330	392
LPG	€/1000 kg	125	500
Natural gas	€/GJ	2.6	10.7
Heating use (non-business use)		2011	By 2013
Gas oil	€/1000 l	21	57.4
Heavy fuel oil	€/1000 kg	15	67.8
Kerosene	€/1000 l	0	56.3
LPG	€/1000 kg	0	64.9
Natural gas	€/GJ	0.3	1.27
Coal	€/GJ	0.3	2.04
Electricity	€/MWh	1.0	0.5
Heating use (business use)			
Gas oil	€/1000 l	21	57.4
Heavy fuel oil	€/1000 kg	15	67.8
Kerosene	€/1000 l	0	56.3
LPG	€/1000 kg	0	64.9
Natural gas	€/GJ	0.15	1.27
Coal	€/GJ	0.15	2.04
Electricity	€/MWh	0.5	0.5

that an alignment of tax rates even with petrol rates unchanged (i.e. a substantial increase of tax on diesel) would only slow down the increase of sales of diesel cars compared to the baseline, while absolute numbers would still go up. Removing the price advantage for diesel would also rebalance the supply and demand on the fuel market where currently the EU has to import diesel and export petrol.

Taxation of the Financial Sector

In the aftermath of the financial crisis, the discussion on taxing the financial sector more has gained momentum. The Tobin tax – on foreign currency transactions – had already been proposed in 1972, in particular to finance development policies. The political logic of the current discussion is rather straightforward: the financial sector was at the origin of the financial crisis and received massive support from taxpayers, so in turn it has to contribute to footing the bill for crisis repair. Major studies on the causes of the financial crisis show[25] that there were a series of factors contributing to the crisis: the macroeconomic environment in particular in the USA with low interest rates and global imbalances, the sub-prime crisis in the USA, failures in banking regulation and surveillance, but last and surely not least also excessive risk taking and wrong incentive systems in the financial sector. During the financial crisis, the financial sector in the EU benefitted from massive public support. Some €4.6 trillion were committed during the last three years (some 40% of GDP), of which about half was drawn down by financial institutions. In the meantime some of them have been paying back assistance received, so that the final cost of the support is not yet known. But the cost of the crisis goes far beyond. As the financial crisis unfolded and had a major negative impact on the real economy, many countries implemented major fiscal stimuli in order to prevent the crisis from turning into a worldwide economic depression. This fiscal stance and the downturn following the financial crisis left traces in increased public debt. EU-wide public debt stood at less than 60% of GDP in 2007 and will reach nearly 85% in 2012. Servicing this additional debt amounts to nearly 1% of GDP annually, assuming an interest rate of around 4% p.a. Therefore there is a clear case for making the financial sector, as one of the actors responsible for the crisis, contribute to the lasting crisis costs, which go well beyond the cost for bailing out banks.

Furthermore, there at least two other arguments in favour of increasing the tax burden of the financial sector. First, the financial sector is largely exempted from VAT, as the classical transaction based VAT system (charging VAT to the full amount invoiced and allowing for deduction of input VAT) is technically very difficult to apply to financial services, which are largely margin based. The scope of this VAT exemption can be estimated to an equivalent of 0.15% of GDP or close to €18 bn per year in the EU.[26] Second, large parts of the financial sector benefit from implicit state guarantees ("too big to fail") implying de facto subsidies to the financial sector[27] that could be compensated by

25 Bank for International Settlements: 80th Annual Report, June 2010; http://www.bis.org/publ/arpdf/ar2010e.pdf; Financial Services Authority: The Turner Review: A regulatory response to the global banking crisis, March 2009, http://www.fsa.gov.uk/pubs/other/turner_review.pdf; T. Hemmelgarn, G. Nicodeme: The 2008 Financial Crisis and Taxation Policy, Taxation Paper, January 2010, http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_20_en.pdf.

26 Professor H. Huizinga: Brussels Tax Forum, March 2011, http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/conferences/taxforum2011/huizinga_ppt.pdf.

27 K. Ueda and B. Weder di Mauro estimate subsidies equivalent to 10 to 50 basis points for the refinancing cost of these financial institutions. See: The Value of the Too-Big-to-Fail Subsidy to Financial Institutions in: S. Claessens, M. Keen, C. Pazarbasioglu (eds.): Financial Sector Taxation: The IMF's Report to the G-20 and Background Material, 2010, pp. 106-16.

higher taxation. The same applies to other economic rents in the financial sector, for instance in remunerations and profits.[28] Excessive risk taking by financial institutions can present negative externalities that could also be compensated through specific taxes. Therefore an argument can be made for a Pigouvian type of tax on the financial sector correcting certain negative externalities. There is, however, broad consensus that regulatory measures are the most appropriate way to address the root causes of market failure in the financial markets at the origin of the financial crisis. It is difficult to envisage that any additional tax on the financial sector would have prevented the financial crisis.

As to concrete additional taxes or levies on the financial sector, there are two types of taxes (with sub-variants) under discussion[29]: the Financial Transaction Tax (FTT) and the Financial Activities Tax (FAT). So-called bank levies (on parts of the liabilities or assets of banks) are not included here, as they normally serve a more limited purpose, i.e. financing bank resolution funds, in order to avoid taxpayers having to again bail out banks in difficulties.

The FTT is levied on financial transactions whenever a financial instrument is issued or exchanged. Most proposals provide for taxing the trade of shares, bonds and derivatives; some include currency transactions as well.

The FAT is based on a different approach: the tax base is – in its basic form – defined as the value added in a given period, i.e. profits and remunerations.

As to their economic effects, the FTT can reduce certain trading activities, such as high frequency trading which is often criticised for destabilising financial markets. However, it can also create certain distortions through its cumulative impact – the higher the number of transactions, the higher the final tax burden. Therefore low tax rates and broad tax bases could mitigate certain risks of this highly popular tax. The FAT is from an economic point of view rather neutral but has hardly piqued any interest politically. The incidence of both taxes is not clear cut; it is highly probable that the final tax burden for both can be shifted at least to a certain extent to the buyers of financial services. Tax avoidance is another important issue for both taxes, if not introduced worldwide. This also impacts on the sustainability of the tax revenue. In the highly globalised and mobile financial markets, operators will be able to react to the tax and try to minimise its impact on them, either by avoiding certain transactions, by relocating into non-taxing constituencies or by utilising primarily untaxed products. International experience has shown that the design of an FTT can be decisive for its success and revenue potential.[30]

The European Commission announced in July 2011 that it continues to support an FTT worldwide and that it will table a proposal for an FTT at EU level as a first step after the summer. Part of the revenue should become an EU own resource to finance the EU budget from 2018.

Towards an Overhauled VAT System

The current VAT system in the EU was created in 1967 and is the most important harmonised tax system in the EU. On average VAT accounts for more than 20% of all tax revenues (including social security contributions – see Table 2) and represents a very important, if not the most important, revenue source in all Member States – and its importance continues to increase.

Therefore it is very important to make sure that this revenue source remains robust and sustainable in the future. There are, however, indications that there is room for improving the VAT system, in particular in three areas: effectiveness of tax collection, efficiency and neutrality, as well as compliance and administrative costs.

The effectiveness of the tax collection addresses the problem that not all VAT that is due is actually collected. Tax fraud and evasion as well as tax avoidance and irrecoverable VAT because of insolvent companies, etc. are the factors underlying the so-called VAT gap. Mistakes due to the complexity of the system are another cause. Estimates of the VAT gap in the EU amount to more than €100 bn p.a. or to some 12%. There are large differences between Member States – the VAT gap ranges from single figures to 30% in Greece (see Table 3).

As to VAT fraud, the intra-EU supplies are particularly exposed to fraud (missing trader and carousel fraud), as with the current system (exemption at export and taxation at acquisition or cross-border reverse charge) the chain of fractioned VAT collection is interrupted at the internal EU borders.

28 P. H. Egger, M. von Ehrlich, D. Radulescu: Comparison of Different Compensation Components and Levels Among Different Sectors of the Economy, mimeo, 2011.

29 European Commission: Taxation of the Financial Sector, COM(2010)549; and Commission Staff Working Document SEC(2010)1166; International Monetary Fund: A Fair and Substantial Contribution by the Financial Sector, Final report to the G-20, June 2010.

30 European Commission: Taxation of the Financial Sector... op. cit.; and Commission Staff Working Document, op. cit.; J.Y. Campbell, K.A. Froot: International Experiences with Securities Transaction Taxes, in: Jeffrey A. Frankel (ed.): The Internationalization of Equity Markets, 1994, pp. 277-308, National Bureau of Economic Research, University of Chicago Press.

Table 2
Share of VAT in Total Taxation, 2009

	2009		2009
BE	16.0	LU	16.7
BG	31.2	HU	21.3
CZ	20.7	MT	22.9
DK	21.0	NL	18.4
DE	18.7	AT	18.9
EE	25.2	PL	23.4
IE	22.7	PT	23.0
EL	21.1	RO	24.8
ES	13.5	SI	22.4
FR	16.3	SK	23.3
IT	13.2	FI	20.3
CY	26.0	SE	20.7
LV	22.5	UK	16.6
LT	25.2		
EU27*	17.3	EA-17*	16.8
Convergence indicators			
St. dev/mean	19.2	Max-min	18.0

* Weighted average.

Source: Commission services.

Table 3
VAT Gap as a Share of Theoretical Liability, EU25*, in %, 2006

	2006		2006
EU25	12	IT	22
AT	14	LT	22
BE	11	LU	1
CZ	18	LV	22
DE	10	MT	11
DK	4	NL	3
EE	8	PL	7
ES	2	PT	4
FI	5	SE	3
FR	7	SI	4
EL	30	SK	28
HU	23	UK	17
IE	2		

* EU25 excluding Cyprus.

Source: http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_cooperation/combating_tax_fraud/reckon_report_sep2009.pdf.

Next to the question of the effectiveness of tax collection stands the question of the design of VAT as a consumption tax – both in terms of efficiency and neutrality. The theoretically optimal VAT would be a tax on all goods and services (in a VAT system taxing consumption) with a single (standard) rate. On the basis of this concept, the OECD is calculating a so-called VAT Revenue Ratio[31], which compares actual VAT revenues to the potential tax base multiplied by the standard rate. The EU scores a disappointing average of around 55%, whereas countries like Canada, Switzerland and Chile lie over 70% and New Zealand ranks highest with nearly 100%. Besides the degree of taxpayer compliance and the capacity of the tax authorities to administer the tax, the low EU score is due to a multitude of exemptions (e.g. for postal services, financial services, public authorities), the numerous specific or temporary derogations concerning the VAT rates (e.g. zero and super-reduced rates) and the many possibilities to apply reduced rates that are amply used by many Member States (e.g. for food, restaurant, hotel, passenger transport, cultural goods and services, etc.) but that at the same time reduce the efficiency and neutrality of VAT.

The European VAT system was a pioneer more then 40 years ago at its inception; unfortunately nowadays it is no longer considered international best practice. Its basic system has hardly changed over the years, but after the completion of the internal market in 1993 has been incrementally amended to meet the challenges of increasing fraud as well as the requests for Member State specific options. This has resulted in higher compliance costs for businesses – which are the main tax collectors for VAT – through more reporting requirements and increasing fragmentation of the internal market.

Against this backdrop the Commission has launched a major project to fundamentally overhaul the EU's VAT system. In December last year[32], it published a Green Paper with the apt title "Towards a simpler, more robust and efficient VAT system" that was followed by a wider public consultation. More than 1700 contributions, some of them very substantial, demonstrate the high interest from public authorities, business, and other stakeholders in a fundamental VAT reform.

This reform will have to address technically complex and politically controversial subjects, like:

31 OECD: Consumption Tax Trends 2010 – VAT/GST and Excise Rates, Trends and Administrative Issues, Paris 2011.

32 European Commission: Green Paper on the Future of the VAT: Towards a simpler, more robust and efficient VAT system, COM/2010/0695 final.

- How to tax intra-EU supplies? The current transitional system poses two problems. First, it is exposed to fraud; anti-fraud measures have made this system already so complicated that for EU business it can seem easier to export to third countries than within the EU, because of high compliance costs, risks and legal uncertainty. Second, given the trend to more destination-based rules for the place of supply and the persistent resistance of Member States to accept a clearing mechanism to share tax receipts, to move towards a closer harmonisation of VAT rates and to rely on each other to collect a part of their VAT revenue, the following question seem to be legitimate: Does it make sense to maintain the “origin principle” as the vision of the definitive system that will succeed the current transitional one? If the origin principle were abandoned, what would the alternative be? And what could be a destination-based system? The current system, with its well-known pros and cons? What about alternative systems, such as abandoning the current distinction between supplies of goods and supplies of services and setting the place of taxation for both where the customer is established (as is already the case for services)? How about a more general use of the “reverse charge” approach or, on the contrary, taxing those intra-EU supplies with a one-stop-shop allowing the supplier to transfer tax receipts directly to the Member State of destination?

- How can we improve the neutrality and efficiency of the EU VAT system? This is linked to the degree of harmonisation necessary in the internal market as regards in particular the exemptions, the reduced rates and the restrictions on the right of deduction in order to avoid distortions of competition and not least to reduce compliance costs for operators. Those requirements have to be balanced against the subsidiarity principle and the wish of Member States to preserve their tax sovereignty.

- For all these issues that are linked to the effectiveness and efficiency of tax collection (both for business and tax administration), the possibilities of technological progress, in particular in IT, have to be exploited. A study[33] has shown for instance that there are new options for collecting VAT:
  - by using financial intermediaries in the so-called “split payment model”;
  - by developing the possibilities of e-auditing or e-monitoring (central VAT monitoring data base within tax authorities to be fed data by taxable persons with electronic invoices or data warehouses to be set up by the taxable persons but accessible to the tax authorities);
  - via risk management approaches using the concept of a “certified taxable person”, allowing tax administrations to rely more on internal control systems of “reliable” tax payers (who in turn would save on compliance costs) and thereby freeing scarce public resources to fight tax evasion and fraud.

On the basis of the public consultation in the first half of 2011 and the outcome of the economic evaluation of the current VAT system that the Commission is carrying out in the meantime, the Commission will come out with a Strategic Communication on the way forward for EU VAT at the end of this year.

Conclusion

The financial crisis has presented all EU Member States – to different degrees – with a double economic policy challenge: to foster sustainable economic growth and to consolidate public finances. Can the governments in the EU afford to forego the benefits of targeted tax measures at EU level – tapping the growth potential of the internal market by reducing tax obstacles and improving tax collection on cross-border activities within the EU? The European Commission has proposed or announced concrete initiatives in areas such as taxation on capital income, corporate taxation, energy taxation, VAT and a Financial Transaction Tax. The unanimity requirement in the Council remains a very high hurdle to make these proposals a reality. For some projects such as the CCCTB, if unanimity is not achievable, an alternative could be enhanced cooperation[34], where not all Member States but at least nine of them would have to agree to apply the measure. Where legislative initiatives may not be achievable, increased tax policy coordination, for instance in the recently revived Tax Policy Group[35], could sustain the momentum. While the focus is on EU internal tax coordination, coordinated policy positions with third countries – some like Switzerland being closely linked to the EU – could leverage the weight of the EU as a whole to achieve a level playing field for EU businesses and fight tax evasion, tax avoidance and beggar-thy-neighbour policies. To ensure that cross-border mobile tax bases – such as capital income – are effectively taxed is also crucial for the credibility of our tax systems and their perceived fairness.

33 PWC: Study on the feasibility of alternative methods for improving and simplifying the collection of VAT throughout the means of modern technologies and/or financial intermediaries, 2010.

34 Title IV of the Treaty on European Union and Title III of Part VI of the TFEU.

35 The TPG group was re-established in 2010 by the Commissioner A. Šemeta with personal representatives of the EU Finance Ministers to discuss key tax policy issues.