

The European Union constitution and the development of tax policy

Nigar Hashimzade¹ and Gareth Myles²

Abstract

Taxation is an area of European Union (EU) policy in which the tension between subsidiarity and coordination is acute. This paper reviews recent EU policy alongside an analysis of the underlying economic issues. The governance of tax policy was one of the key issues that the proposed constitution for the EU was intended to resolve. The provisions of the constitution that was proposed in 2004 are assessed to determine whether they provided the powers that the EU requires to ensure efficiency. The changes proposed by the constitution are then compared to subsequent developments.

1. INTRODUCTION

The Constitution for the European Union (EU) proposed in 2004 provided a clear vision for the future. It foresaw the Union as a single market with efficient trade and unhindered movement of capital and labour. Allied to this was the aim of balancing the freedom of competitive economic activity with support for the disadvantaged within a social market economy. The Constitution contained articles that provided a framework for the formulation of tax policy within the EU. The proposed Constitution was rejected in referenda in France and the Netherlands in May 2005, and consequently abandoned. It was replaced instead by the Lisbon Treaty of 2007 but this was far less visionary than the Constitution.

This paper considers recent developments in EU tax policy in the light of the proposed Constitution. We explore what was proposed for tax policy in the Constitution and then consider whether EU tax policy has followed the proposed developments regardless of the fact that the Constitution was not accepted. To explore what was proposed it is necessary to review and interpret individual articles of the Constitution and to describe the issues confronting EU tax policy.

¹ Professor, Durham University and Research Fellow, Institute for Fiscal Studies.

² Corresponding Author. Professor, University of Exeter, Research Fellow, Institute for Fiscal Studies, Director of Tax Administration Research Centre, University of Exeter/Institute of Fiscal Studies.

Acknowledgements: This paper was prepared for the Milan Political Economy Workshop on the European Constitution. We are grateful to Massimo Florio for the invitation to participate in the workshop and to participants for their comments upon the paper.

The major objectives of the Constitution were stated precisely in Article I-3:

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

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

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

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

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

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

The drawback of subsidiarity is that individual Member States may make policy choices which are privately rational but not socially optimal. This is particularly relevant for tax policy given the incentives to engage in tax competition within a single market. To counteract this, the Constitution provided the EU with a coordinating role in policy. As set out in Article I-1:

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

These clauses clearly set out the background against which tax policy was to be designed. Member states would have some subsidiarity but this would be limited by the need for coordination to ensure the efficient functioning of the single market. The rejection of the proposed constitution by voters in France and the Netherlands resulted in the withdrawal of the Constitution and, later, in its replacement by the Lisbon Treaty. What is clear is that if any constitution (or, possibly, any less formal set of new rules) is to be proposed in the future it must provide clear guidelines for trading subsidiarity against coordination. The same tensions between these two will arise in tax policy whatever the form of the final solution for the political structure of the EU. The need to address the divergence between the private and social benefits of the actions of Member States requires rules that permit a coordinating role for the Commission or its successor body.

In the context of tax policy there are a range of conflicts introduced by the multiple objectives of economic efficiency, sustaining a social market economy, and the maintenance of subsidiarity. The special feature that makes issues of governance so central is that tax policy bears directly on the efficiency of the single market and provides the revenue to finance social market activities. Taxation is also symbolic of the freedom of Member States to maintain independent control over a central

component of economic governance. The study of tax policy brings into stark focus how conflict can arise between the coordinating role of the Union and the rights of Member States to pursue their own distinguished policies under the principle of subsidiarity.

The paper begins by reviewing what was proposed in the Constitution about tax policy by assessing a number of its articles. The focus will be on how they could have been applied to provide remedies for the problems created by subsidiarity in a single market. The third section reviews the VAT harmonisation process that was begun by the EU in the late 1980s. This short history provides an illustration of many of the issues involved in tax governance. The remainder of the paper then focuses upon some of the further challenges facing the Union in connection with tax policy. The fourth section studies the taxation of commodities and links the issues surrounding subsidiarity with the principles of international taxation. The fifth section focuses on the taxation of capital as an example of the process of tax competition. The final section provides conclusions.

2. TAX POLICY UNDER THE PROPOSED CONSTITUTION

The purpose of this section is to review the articles of the proposed Constitution which had significant bearing upon tax policy. In preparing these comments the wording of the Constitution has been taken literally, as opposed to trying to see through the wording to what might be implied.

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

The free movement of persons, services, goods and capital

and that:

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

The need for free movement is fundamental to the development of the EU economy as a single market with a competitive basis and an efficient outcome. With taxation organized as at present, an increase in mobility is not without a cost since it necessarily enhances the incentive for Member States to engage in tax competition. As a consequence the EU will continue to face the prospect of tax competition undermining efficient tax policy if it does not revise its processes as mobility increases.

The articles committing to non-discrimination are interesting if they were applied to products in addition to people. One of the proposals that had been discussed in the EU for many years in connection with revised tax governance is the use of origin rather than destination taxation. However, the basis for the operation of an origin system is that it does discriminate between products on the grounds of nationality. That is, a product that is produced in several different Member States will be taxed at different rates in any country of final consumption.

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

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

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

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

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

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

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

In the field of social security, European laws or framework laws shall establish such measures as are necessary to bring about freedom of movement for workers by making arrangements to secure for employed and self-employed migrant workers and their dependents:

- (a) aggregation, for the purpose of acquiring and retaining the right to benefit and of calculating the amount of benefit, of all periods taken into account under the laws of the different countries;
- (b) payment of benefits to persons resident in the territories of Member States.

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

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

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

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

The implications of these articles for tax policy are clear. Increased mobility exacerbates the problems of tax competition. Increased mobility of capital places downward pressure on the corporate income tax rate. Increased mobility of labour puts similar pressure upon the income tax rate. Furthermore, increased mobility of labour plus entitlements to benefits exerts pressure on the welfare systems of Member States. These are the classic contributors to the race-to-the-bottom. Hence, if these Articles

had been applied here would have been a need for some offsetting policy intervention to control the effects that were likely as a consequence.

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

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

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

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

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

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

The Union shall have exclusive competence in the following areas:

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

These points were developed further in Article III-151:

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

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

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

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

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

The use of 'broad guidelines' opened the possibility for a range of policy interventions at the EU level. The policy of harmonisation, which is discussed in more detail below, envisaged a gradually narrowing band of permissible tax rates until complete harmonisation had been achieved. The same method could be applied under this article to place upper and lower bounds on capital tax rates to lessen tax competition. It could also have been used to re-start the process for harmonisation.

Article III-179 expanded upon the coordination of policies and the fact that the effects of policies must be internalized. The claim to internalization comes from observation of the phrase 'common concern'. If internalized in this way it becomes immediate that some of the consequences of tax externalities between Member States would be reduced:

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

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

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

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

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

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

The final article to be considered dealt with the issue of harmonisation. The article referred to the harmonisation of legislation, not to the harmonisation of tax rates. There is, however, a question of how legislation can be interpreted. Article III-171 stated:

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

Note that this statement explicitly referred to harmonisation to secure the efficient functioning of the market and to avoid distortion of competition. It has already been discussed how tax differentials lead to cross-border shopping which represents a distortion of trade.

With these elements of the proposed Constitution in mind we now discuss some of the major issues in EU tax policy. The articles in the Constitution can be viewed generally as continuing and developing long-standing policies. Even though the Constitution was never adopted it is clear that its intentions in the area of tax policy are slowly being realized.

3. THE SINGLE MARKET AND HARMONISATION

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

Harmonisation refers to the process of bringing about equality in the rate of VAT in Member States. It has been part of EU policy proposals since at least the Neumark Report (1963). The European Commission has understood that the single market implies a need for a degree of harmonisation of indirect taxes because of cross-border shopping and also because of potential protectionist use of national taxes. It is also concerned about the impact of different tax rates on mobile factors such as capital. Finally, certain countries are concerned about the possibility of 'tax evasion' being induced when countries retain autonomy over the setting of tax rates. The variation in

the tax treatment of income from interest on capital is a prime example. Harmonisation can also encourage trade by leading to simplified accounting.

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

Table 1³ provides some data on the evolution of VAT rates in the Union since 1970. It can be seen from this data that little progress have been towards convergence until recently, when the Member States increased the rates in the last five years, which helped to overturn the falling trend in revenues during the global economic crisis. According to the Eurostat (2013), six Member States increased their standard VAT rates in 2009, eight in 2010, four in 2012, and nine in 2013, some after a temporary cut to boost demand.

Table 1: VAT rates of EU member countries

		Germany	France	Italy	UK	Denmark
1970-1974	Standard (normal)	11	23	12	10	15
	Reduced (essential)	5.5	7.5	6	-	-
	Increased (luxury)	-	33	18	-	-
1985-1990	Standard (normal)	14	18.6	19	15	22
	Reduced (essential)	7	2/7	4/9	0	-
	Increased (luxury)	-	23	38	-	-
2000	Standard (normal)	16	20.6	20	17.5	25
	Reduced (essential)	7	2.1/5.5	10	5	0

³ Sources: Molle (2001); Eurostat (2013)

2013	Standard (normal)	19	19.6	22	20	25
	Reduced (essential)	7	5.5/7(2.1)	10/4	5	0

Variations in levels of excise duty and capital taxation in different EU Member States have also caused concern. As part of its internal market programme, the Commission also proposed the harmonisation of excise duties on mineral oils, tobacco products and alcoholic beverages. This was rejected by Member States, and a system of minimum rates was introduced in 1993. Despite this, as shown in Table 2⁴ the dispersion of rates remains significant giving rise to substantial cross-border shopping flows.

Table 2: Excise Taxes in euro, 1 July 2013

	Cigarettes (per 100)	Wine (per litre)	Petrol (per litre)
Belgium	2.20	0.53	0.64
France	4.58	0.04	0.64
Germany	9.44	0.00	0.72
Spain	2.41	0.00	0.46
Sweden	16.64	2.55	0.76
UK	22.07	3.34	0.79

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

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

⁴ Source: EC Excise Duty Tables, Ref. 1038, rev. 1, available at http://ec.europa.eu/taxation_customs/index_en.htm#

has been shown over differences in personal income taxation. This is, perhaps, surprising since, together with social security contributions, personal income tax yields more than 40% of total tax receipts in the EU. The explanation can probably be found in the considerably lower mobility of labour compared to capital.

The EU position on harmonisation is captured in the following series of quotations. First, from the European Commission:

Member States have shown little enthusiasm for the proposals in Council meetings and [...] have been reluctant to accept the greater harmonisation of VAT rates and tax structures. (European Commission 2000, p18)

Second, from the 2003 Draft Report of the Committee on Monetary and Economic Affairs:

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

Third, from the Council Directive of 2006:

It is ... necessary to achieve ... harmonisation of legislation on turnover taxes by means of a system of value added tax (VAT), such as will eliminate, as far as possible, factors which may distort conditions of competition, whether at national or Community level. ... It is necessary to proceed by stages, since the harmonisation of turnover taxes leads in Member States to alterations in tax structure and appreciable consequences in the budgetary, economic and social fields. The common system of VAT should, even if rates and exemptions are not fully harmonised, result in neutrality in competition. ... It is vital to provide for a transitional period to allow national laws in specified fields to be gradually adapted. (Council Directive 2006/12/EC)

And, finally, from the Council Communication of 2011:

There is a general feeling amongst stakeholders that the fragmentation of the common EU VAT system into 27 national VAT systems is the main obstacle to efficient intra-EU trade and thus prevents citizens from reaping the benefits of a genuine single market. ... Divergent practices at national level are increasingly being highlighted as a frustrating burden. ... The economic evaluation concludes that compliance costs for businesses are high, with estimates ranging from 2% to as much as 8% of VAT collection. ... Reducing by 50% the dissimilarity of the VAT rates structure between Member States could yield a rise of 9.8% in intra-EU trade and an increase in real GDP of 1.1%. ... The application of the standard rate remains the basic principle and the VAT Directive does not compel Member States to make use of reduced rates. The Member States are therefore primarily responsible for limiting as far as possible the scope of such rates where they constitute an unjustified tax break. The current economic and financial context, which demands a strong fiscal consolidation of national budgets, is a further reason for limiting their use as compared to increasing the standard rates. (European Commission 2011)

It is clear from these quotes that the harmonisation of tax rates within the EU has returned to the policy agenda. The quotes show an acceptance of the fact that the process had reached a hiatus in the early 2000s, and the beginning of a new drive for harmonisation from the middle of the decade. It is also noteworthy that the basis of the argument has shifted over time. The final quote shows a change in focus from the rather tenuous concept of 'neutrality in competition' to a more concrete argument on compliance costs for businesses.

4. THE TAXATION OF COMMODITIES

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

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

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

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

As an example of the final point, the UK government has long pursued a policy of imposing a high tax upon cigarettes to discourage consumption for health reasons. But if cigarettes can be purchased elsewhere in the EU with a lower rate of tax and personally imported back into the UK then, at best, the policy is only partially effective.

At worst, it simply becomes irrelevant.⁵ In such cases, the perfectly acceptable objective of one Member State is undermined by cross-border shopping exploiting the tax choices of other Member States that do not subscribe to the same set of objectives.

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

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

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

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

The fact that the destination principle is not a suitable system of taxation for a single market was recognized at a very early point in the development of the EU. The

⁵ In 2005, in conjunction with HM Customs and Excise, a football club collected discarded cigarette packets after a match. 22% were found to have been unofficially imported.

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

The alternative system of taxation proposed by Tinbergen (1953) was the origin principle which taxes goods in the country of production. In brief, under the origin principle a good is taxed by the country in which final production takes place prior to supply to consumers. When applied to the Union, the origin principle would require each Member State to tax the production occurring within its borders. Products produced by one Member State would bear the same rate of tax regardless of where they were consumed in the EU. The advantage of the origin principle is that no border tax adjustments are required so that it is consistent with the operation of a single market (in that tax differentials do not induce cross-border shopping) and it leaves each Member State free to pursue its own tax objectives.

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

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

The Council Directive 2006/112/EC mentions the destination principle as the one that should be used during the transition to the harmonised system of VAT. More recently, however, the Communication on the future of VAT (European Commission 2011) has admitted that the origin principle

remains politically unachievable. This deadlock is even recognized by the European Parliament - until now a fierce defender of the principle of origin - which has called for a move towards the destination principle.

Many economists since Tinbergen have argued for a switch to the origin principle (for example, Lockwood et al., 1994, 1995) in preference to remaining with a destination system that is inappropriate. One argument that might be thought to have held back the EU in making the change is that a transition in the basis of taxation, from taxing consumption to taxation production, would cause a major disruption in revenues. This need not be so. Support for this statement is derived from the equivalence results which demonstrate (with uniform taxation of commodities) that the destination principle with border controls leads exactly to the same economic outcome as the origin principle without.

In a closed economy this result is easy to understand. The levels of production and consumption in equilibrium must be equal, so the change in the principle has no effect upon the size of the tax base. If the tax rates are the same under the two principles they must lead to the same relative prices and, hence, to the same equilibrium. In an open economy the change in the principle must cause the relative tax rates on different goods

to change. For example, if the one country has a lower rate of VAT than a trading partner then imported goods will bear a higher rate of tax after the switch. However, this change in relative taxes between the two principles is compensated for by adjustment in the relative wage rates in the trading countries. Even more surprising, if tax rates are not uniform within each country then the origin principle may even lead to higher economic welfare than the destination principle (Keen and Lahiri 1998; Hashimzade et al. 2005).

This literature suggests that a switch from destination taxation to origin taxation is feasible without major changes in tax revenues and more than likely would be beneficial. In particular, the effects of the switch would be minimized if undertaken once the labour market is liberalized.

As was discussed above, the Constitution that was proposed did not explicitly enter into a prescription of the future system of taxation. What it did provide was a statement of what the EU wished to achieve and the powers that it would have to achieve it. Until a Constitution is adopted, or other set of definitive rules implemented, the EU will remain in the current unsatisfactory position. For now, however, the switch to the origin principle appears to have been removed from the agenda, in favour of a 'simpler, more efficient and robust VAT system' based on the destination principle. As stated in the Communication of the European Commission on the future of VAT,

The Commission has come to the conclusion that there are no longer any valid reasons for keeping this objective, and will propose that it should be abandoned. ... Abandoning the origin principle makes it possible to launch substantial efforts to devise alternative concepts for a properly functioning destination-based EU system of VAT. (European Commission 2011)

5. CAPITAL TAXATION AND TAX COMPETITION

The discussion of commodity taxation has focussed upon the choice of the tax principle and whether tax rates should be harmonised. In contrast, the discussion of capital taxation in the context of the Union has emphasized the consequences of jurisdictions competing for mobile capital by strategically setting their tax rates. Such competition can lead to inefficiently low tax rates and can even culminate in the 'race-to-the-bottom'.

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

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

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

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

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

Evidence on the extent of tax competition is contained in the OECD report of 1998. It can also be witnessed in the data on corporate tax rates of EU Member States. A sample of this evidence is reported in Table 3⁶ which details the statutory corporate income tax rate in 1982, 2001, and 2013. In all countries, with the exception of Italy and Ireland, the statutory tax rate has fallen, in some cases dramatically. These reductions are usually interpreted as being driven by the success of the low rate of corporate tax introduced in Ireland.

⁶ Sources: Devereux et al. (2002); Taxation Trends (2013).

Table 3: Adjusted top statutory tax rate on corporate income, in per cent

	1995	2001	2013
Austria	61	34	25
Belgium	45	40	34
Finland	50	35	36
Germany	62	38	30
Greece	42	38	26
Ireland	12.5	12.5	12.5
Italy	38	40	31
Netherlands	48	35	25
Portugal	55	36	32
Sweden	61	28	22
UK	53	30	23

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

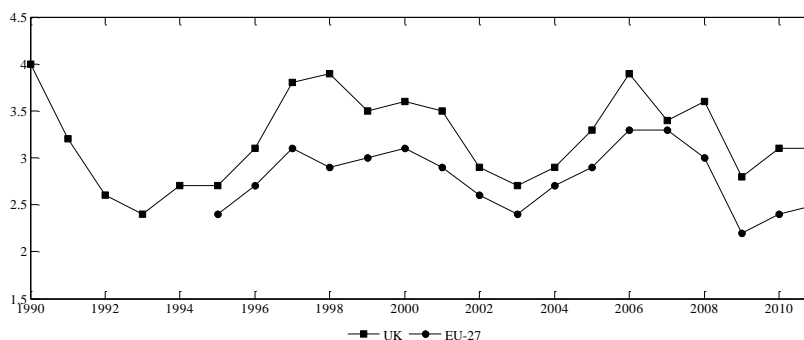
Some evidence of the net effect of rate reduction and base broadening is presented in Figure 1.⁷ This figure graphs the revenue from corporate taxation as a percentage of GDP for 27 EU member economies and separately for the UK. The reason why the UK data may be particularly interesting is the argument that tax competition in the Union has been driven by the aggressively low rate of tax in Ireland. The UK is Ireland's closest geographical neighbour and shares a common language. It is natural to expect that if the low tax rate has benefited Ireland then it will have done so at the expense of lost capital for the UK. For the aggregate curve the percentage value for each country is weighted by GDP, so that the effect in small countries cannot dominate the overall picture.

Contrary to the evidence from looking at the statutory rate, revenue from the corporate income tax remained mostly constant until the early 1990s and has shown a strong growth trend over the following 10 years. While an increase in corporate profitability

⁷ Data source: Taxation Trends (2013).

may explain at least some of this increase, the fact remains that revenues from the corporate income tax are not being adversely affected by the effects of tax competition.

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



There has been a weak trend for a decrease in revenue through the late 1990s and early 2000s, but this has been clearly driven by changes in corporate profitability. From 2003 revenues were on a rising trend which has resumed after a short dip during the economic and financial crisis in 2007-8. It might be expected that if tax competition is driving down capital tax rates, the process would have accelerated since the completion of the single market in December 1992. To test this idea, consider the data in Figure 1: it can be seen that the effective burden on capital has actually risen very slightly since 1993 – the converse of what the tax competition argument would suggest. If the Member States are engaged in tax competition then it is not necessarily leading to the collapse of revenues even for the countries that may be expected to suffer the most.

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

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

Economists have identified tax competition as harmful because it leads to equilibrium rates of tax which are below the efficient level. In turn, the low tax rates lead to reduced government revenues, thus limiting the scope for redistributive social policies. The mobility of labour can also undermine an attempt to conduct redistributive policy. Observation of the fall in statutory corporate income tax rates is usually given as evidence of tax competition within the EU. A review of the data shows that corporate tax revenues as a percentage of GDP have not fallen. This can occur through the tax-base broadening and through an increase in corporate profitability. More recently, however, concerns about decreasing competitiveness in the wake of the economic and financial crisis led to a trend in the tax reforms in the EU Member States mostly introducing tax-base-narrowing measures. At the same time some Member States have broadened their corporate tax bases by limiting interest deductibility and by restricting loss relief (Tax Reforms in the EU Member States 2013). The EU has a voluntary Code of Conduct designed to lessen tax competition. As was noted above, the proposed Constitution granted the EU powers to coordinate the policies of individual Member States. Coordination is the natural policy to combat tax competition.

6. CONCLUSIONS

The central economic aspirations of the European Union are to attain the objective of a highly competitive social market economy. At the same time it also wishes to respect subsidiarity and allow Member States to pursue independent policies. In the area of tax policy these two aims come into conflict as exemplified by the race-to-the-bottom that has often been predicted as the inevitable consequence of tax competition. The paper has explored how the proposed Constitution for the EU planned to deal with these difficulties. The articles of the Constitution suggest an intention to restart the process of harmonisation and to enhance coordination of tax policy.

The history of tax harmonisation in the EU reveals a policy that has gradually eroded the ability of individual Member States to set their own tax rates. Although harmonisation would have removed many of the problems brought about by tax differentials between Member States it was eventually abandoned because of opposition caused by the perception that harmonisation was threatening subsidiarity. Even without an explicit process for harmonisation the data reveal that it has nonetheless happened with the differential between the lowest and highest standard VAT rates diminishing over time. The choice of a tax principle for the EU has made even less progress than that of harmonisation. If the EU cannot harmonise the rates then an alternative would be to switch to origin taxation. This possibility has been discussed in EU policy debate since the time of the Treaty of Rome. Origin taxation has also been adopted as a proposal for the EU, although there is considerable debate about the precise form the system will take. However, there appears to have been no progress on this issue at all since the Constitution was proposed. Competition between member states in the setting of tax rates on corporate income has led to a fall in statutory tax rates but also to changes in the tax base. The policy to counter this has so far been restricted to the adoption of a Code of Conduct rather than a set of formal policy regulations. This is unlikely to prove sufficient to control the competition if the gains from violation are sufficiently large.

The proposed Constitution reaffirmed the commitment of the EU to the freedom of movement for capital and labour with an absence of discrimination. The Constitution also perceived a role for the EU to play in the coordination of the policies of Member States. Given that the aims of efficiency, freedom of movement, and subsidiarity lead

to the problems outlined above, the EU clearly needs to exercise a coordinating role in the area of taxation. Although the Constitution also required Member States to take account of the effect of their policies on others, thereby internalizing, at least partially, some of the externalities, it still left an important role for the Commission to play.

In principle, the articles of the proposed Constitution would have granted to the EU the powers required to control tax policy and to achieve the economic efficiency it pursues. Whether this would have been the case in practice depends on how arguments over subsidiarity and coordination would have been resolved. The proposed Constitution sought to provide the necessary balance between subsidiarity and coordination but, as is often the case with the EU, the actual outcome would have emerged as a compromise from political negotiation. From the perspective of tax policy the proposed Constitution can be judged to have reached many of the correct conclusions. Any future set of rules for the EU must achieve a very similar compromise.

REFERENCES

- Council Directive 2006/12/EC ‘On the common system of value added tax’, *Official Journal of the European Union*, L347/1, 11.12.2006.
- Devereux, M., Griffith, R. and Lemma, A. (2002) ‘Corporate income tax reforms and international tax competition’, *Economic Policy*, 17, 450 – 495.
- European Commission (2000) *Tax Policy in the European Union*. Luxembourg: Office for Official Publications of the European Communities.
- European Commission (2011) ‘On the future of VAT: Towards a simpler, more robust and efficient VAT system tailored to the single market’, Communication 851.
- European Communities, July 1967 to October 1993: Commission Second Report from the Commission to the Council and the European Parliament on the implementation of the Commission's White Paper on completing the internal market. COM (87) 203, 11 May 1987.
- Hashimzade, N., Khodavaisi, H. and Myles, G.D. (2005) ‘Tax principles, product differentiation and the nature of competition’, *International Tax and Public Finance*, 12, 695 -- 712.
- Hindriks, J. (1999) ‘The consequences of labor mobility for redistribution: tax versus transfer competition’, *Journal of Public Economics*, 74, 215 - 234.
- Hindriks, J. and Myles G.D. (2003) ‘Strategic inter-regional transfers’, *Journal of Public Economic Theory*, 5, 229 -- 248.
- Keen, M. and Lahiri, S. (1998). ‘The comparison between destination and origin principles under imperfect competition’, *Journal of International Economics*, 45, 323 -- 350.
- Lockwood, B., de Meza, D. and Myles G.D. (1994) ‘When are origin and destination regimes equivalent?’, *International Tax and Public Finance*, 1, 5 -- 24.
- Lockwood, B., de Meza, D. and Myles G.D. (1995) ‘On the European Union VAT proposals: the superiority of origin over destination taxation’, *Fiscal Studies*, 16, 1 -- 17.
- Mintz, J. and Tulkens, H. (1986) ‘Commodity tax competition between member states of a federation: equilibrium and efficiency’, *Journal of Public Economics*, 29, 133 -- 172.
- Molle, W. (2001) *The Economics of European Integration*. Aldershot: Ashgate Publishing Company.
- Neumark Report (1963) ‘Report of the Fiscal and Financial Committee’, in *The EEC Reports on Tax Harmonisation*. Amsterdam: International Bureau of Fiscal Documentation.
- OECD (1998) *Harmful Tax Competition: An Emerging Global Issue*. Paris: OECD.
- Rhode, P. and Strumpf, K. (2003) ‘Assessing the importance of the Tiebout hypothesis: local heterogeneity from 1850 to 1990’, *American Economic Review*, 93, 1648--1677.
- Sinn, H.W. (2002) ‘The new systems competition’, in *Competition of Regions and Integration in EMU*. Vienna: Oesterreichische Nationalbank.
- Tax Reforms (2013) ‘Tax reforms in the EU Member States: Tax policy challenges for economic growth and fiscal sustainability. 2013 Report’, European Commission Taxation Papers, Working Paper N. 38 -- 2013.

Taxation Trends (2013) 'Taxation trends on the European Union: Data for the EU Member States, Iceland and Norway.' Eurostat Statistical Books, European Commission.

Tiebout, C. (1956) 'A pure theory of local expenditures', *Journal of Political Economy*, 64, 416 -- 424.

Tinbergen, J. (1953) Report on the Problems Raised by Value Added Taxation in the Common Market. European Coal and Steel Community -- High Authority.

Wildasin, D. (1988) 'Nash equilibria in models of fiscal competition', *Journal of Public Economics*, 35, 229 -- 240.

Wilson, J.D. (1999) 'Theories of tax competition', *National Tax Journal*, 52, 269 -- 304.