Moving on Up – EU tax harmonisation plans

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Summary

This paper analyses two issues:

- The current moves towards company and savings tax harmonisation in the European Union

- The effect of these developments on the UK's control of its tax policy, and so future levels of UK tax.

High levels of foreign direct investment in the UK, as a result of low corporate taxation and an attractive financial environment, already attract the envy of other EU member states (Figure 3). In short, tax harmonisation offers these states the opportunity to end the UK's self-made advantage.

The Single Market gives the European Court of Justice the means to, and EMU will, end the UK's autonomy in company tax matters. One member of the influential Ruding Committee which investigated company taxation in the EU in 1992, noted that 'There was no doubt in the ... Committee that a common currency requires at least minimum harmonisation of direct taxation'. The result is that other countries will increasingly be able to decide Britain's tax strategy especially if the UK joins EMU. Any of EMU's economic benefits (no exchange rates, lower interest rates) would be cancelled by the significant increase in UK corporation tax to match the continental average of 43.8% (weighted to take account of population).

Whereas recent UK tax policy has lightened the burden and encouraged investment, continental taxes have risen (by the EU's own calculation, 35% — 42% of GDP 1981-1995 — see Figures 1 & 2). Harmonisation of EU member states' tax rates would mean higher taxes for the UK, since other states are unable or unwilling to

reduce the tax burden on their voters (Figure 4) and institutional developments inside EMU would end the need for unanimity among European Union members over tax matters.

Tax harmonisation – in the news

Although not a new issue, tax harmonisation has suddenly hit the news. The Austrians, who hold the EU Presidency until January 1999, immediately declared that harmonisation of corporation tax was an important item on their agenda. Several European countries, notably France, Germany and Belgium have expressed concerns that no action has been taken.

But late in 1997 the UK along with other EU states, signed a code of conduct pledging action on 'harmful tax competition'. The following day, Jean-Claude Juncker, leader of the European Parliament, announced that he expected the harmonisation of EU business taxes 'within two years'.

In March 1998, the European Commission proposed a directive to standardise tax on royalties and interest payments made between related companies operating in different member states.

By early summer, the Commission announced plans for an EU-wide 20% withholding tax on savings. This tax, designed to ensure that all investments in the EU are taxed, immediately attracted criticism, with several banking associations in the UK claiming that it would destroy the profitable Eurobond market by driving savers away from Europe in general and London in particular. In particular, the measure seemed to blur the significant distinction between illegal tax evasion and legitimate tax avoidance, in line with Article L of the 1997 code of conduct which lumped evasion and

avoidance together. On 26th September, the Commission announced that harmonisation of the withholding tax on savings should be achieved by the end of June 1999 at the latest.

What is direct tax harmonisation?

Harmonisation is a key tool in creating the Single Market. It involves standardising the rules for product standards, competition and law across the European Union to allow companies to trade as freely as possible within the Single Market.

There are degrees of harmonisation. 'Full' harmonisation requires national governments to implement identical standards be they in product design or taxation. 'Partial' harmonisation implies a level of common ground achieved through minimum or maximum legal requirements or through an assessment that different systems have a similar, harmonious effect on the Single Market.

Direct tax harmonisation involves standardising income and company taxation across the whole European Union. On Day One of the Austrian Presidency, Austria's finance minister, Rudolf Edlinger, summarised the issue simply: 'If the EU established minimum taxes, the countries where the level is lower than that will have to raise them. That is a problem' (Electronic Telegraph 2nd July 1998). An effort to set an EU business tax rate would constitute an attempt to change the political philosophy of many national governments, especially in the UK.

Harmonising tax in the EU would therefore involve the knotty problem of bridging the considerable gap between 'Anglo-Saxon' and 'continental' beliefs of the role of the state in society.

Moreover tax levels reflect the ability of governments to collect taxation: the vicious circle of high taxation and a flourishing black economy in several European countries should be noted. A rate that reflected other governments' problems would discriminate against British taxpayers who have a good record of payment of tax. Higher taxes would drive business and investment out of Britain, especially in financial services industry, where labour is highly mobile. Heavier industry on the continent would be less affected.

The story of VAT (indirect tax) harmonisation reveals the Commission's current strategy on tax. Although proponents of business tax harmonisation deny that harmonisation requires a single fiscal policy (and so, to all intents and purposes, a single European state) exactly this proposal is being developed in VAT standardisation. A Commission publication, A common system of VAT (XXI/1156/96, 24th October 1996), insisted that 'the introduction of a single rate [of VAT] should not be set aside since this would be the only way of guaranteeing that the tax is entirely neutral'. One sign that the Commission fully intends to set a single rate came when the status of its VAT Committee abruptly changed from being 'advisory' to 'regulatory' on 21st January 1998.

It is unlikely that the VAT Committee will settle on a low standard VAT rate as it suits the European Commission to allow VAT to increase since a large part of the EU budget depends on VAT receipts, 42% of which go to the EU. The larger the VAT receipt, the more money the EU can spend independently. Since the end customer pays VAT, businesses have not opposed the increase.

The impetus for direct tax harmonisation

There are two major causes of tax harmonisation:

- The European Court of Justice
- Economic and Monetary Union.

The European Court of Justice

Since the early 1980s the work of the European Court of Justice (ECJ) has crossed into the field of direct taxation in supporting the freedoms of movement within the European Communities. Its activity has led KPMG's David Evans and Alastair Munro to conclude that 'The possible impact of European Community law on United Kingdom direct taxation cannot be underestimated' (Taxation, 6th August 1998). Professor Frans Vanistendael of Leuven University explains the matter simply:

Increasingly the ECJ [European Court of Justice] is applying the non-discrimination principle, that has fully been accepted and implemented in the area of indirect taxation, to the area of income tax. This is only a logical extension of the basic principles on which the single market is based in the EC Treaty. A single market in which non-resident competitors from other member states would be treated less favourably for income tax purposes is in effect not a single market.

(*EC Tax Review* 1998/2 p.77)

The remit of the European Court of Justice has increased for two reasons, in line with its mandate to achieve the 'ever closer union' of Europe. As the Single Market has developed, to include greater freedom of movement, loop-holes have been revealed in many EU member states' tax laws. Article 234 of the Treaty on European Union empowers the ECJ to judge these doubtful cases in the first instance. The Court also has jurisdiction in a final appeal (Article K7). David Southern, a tax barrister writing in Taxation, 16th October 1997, has commented that 'Effectively the European Court of Justice has become a United Kingdom tax court', since the national courts are

unwilling to pass judgements that might later be overturned by the ECJ.

The British Government has assured MPs on numerous occasions that the unanimity principle for matters of tax is 'sacrosanct' (the Prime Minister's words) but the evidence suggests otherwise. The European Court of Justice has just used a Single Market provision, Article 59 which prohibits restrictions on freedom to provide services in the EU, to attack Sweden's insurance company tax legislation (the *Safir* case, judgement delivered on 28th April 1998). Legislation on the Single Market requires only simple majority, not unanimity. The British Government is therefore wrong because the Single Market has moved on, and now that varying levels of tax are deemed to obstruct its further development, the ECJ can apply Single Market law to end distortions. Inside EMU, experts are agreed that a faster decision-making process will be necessary. This would involve majority voting on tax issues. In 1997 the European Parliament's Economic and Monetary Affairs Committee called for majority voting on tax matters three times. It noted that 'harmonisation ... will ultimately render the principle of unanimity superfluous'.

Economic and Monetary Union

Once EMU has begun, it will remove one more barrier to international trade inside the euro-zone: variable exchange rates. The wide difference in corporation tax levels around Europe will become more obvious and there is likely to be political pressure within the EU's Council of finance ministers to harmonise tax at a single European rate so that no member of EMU can profit from lower taxation.

Thus Onno Ruding, the former Netherlands finance minister and now vice-Chairman of Citicorp, explained in the September 1998 issue of EC Tax Review that 'There are clear links between corporate taxation, the

EMU and the Single Market'. He went on to say that 'A successful EMU requires a high degree of policy co-ordination, on economic as well as political matters, and will unavoidably reduce remaining national autonomy, including on tax policies. It is unrealistic to assume differently'. This almost exactly mirrors the opinion of the current president of the Bundesbank, Hans Tietmeyer, that 'it is an illusion to believe that the States will retain their independence in fiscal policy' (Press Conference, 18th October 1995).

It has therefore become clear that the European Central Bank's sphere of interest will not stop at setting interest rates and broad economic policy. There are two reasons for this:

- Effective control of economic and monetary policy
- Stabilisation of the EMU zone

EMU will centralise some powers of taxation with the ECB. Evidence of governmental reforms in Europe (in Belgium and Spain) shows that when competence for policy has shifted from one level of government to another, spending power logically follows. Scottish devolution revolves around the promise that the Scottish parliament will be able to vary the rate of tax by as much as 3% either side of the UK rate. Tax also forms an important economic lever to which the ECB will need to have access to co-ordinate an EU-wide single economic and monetary policy. This is why economic experts like Ruding, Tietmeyer and Vanistendael all believe that ECB control of tax policy is inevitable. Politically, the move will centralise significant powers in Brussels and Frankfurt, conforming to the EU's goal of 'ever closer union'.

If the UK joined EMU, crucial powers of decision-making on tax would be exercised either in the ECB or

the Euro-committee of financial ministers. Both operate using majority voting — simple majority in the European Central Bank, qualified majority in the Committee. This is a substantial change from the current requirement for unanimity on all tax issues discussed at European Union level.

It is credible that the European Central Bank (using a simple majority to make decisions) and the Euro-11 committee of EMU-zone finance ministers (using qualified majority voting) would control taxation so that a dissenting member, or minority can be outvoted and forced to accept the majority decision.

The expanding influence of both the European Court of Justice (made supreme under Article 35 of the Amsterdam Treaty) and the European Central Bank will reduce the British electorate's control of UK tax policy.

Will direct tax harmonisation push British tax up?

Since EMU would lead to remote control of British tax policy, if the UK joined, it is vital to know to what level UK tax would be harmonised. Some supporters of tax harmonisation believe that it would lead to lower tax, stimulating higher inward investment. In theory tax could be harmonised at any level, but the practical situation in Europe means that the benchmark is most likely to be higher rather than lower than UK tax at present. The benchmark could fall in one of three broad areas.

- It could, if the UK joined EMU, reflect Britain's deregulated and low spending policy on tax. This is recommended by UNICE, Europe's federation of employers. **UK tax would stay the same.**

- It could find a middle way between the bulk of higher taxing and spending continental economies and the British model. **UK tax would rise (by about 5%).**

- Alternatively it could reflect the European average. This is the easiest option. **UK tax would rise significantly (10 – 15%).**

On the law of averages, it is unlikely that the current rate of British corporation tax, which is exceptional in Europe, would form the benchmark (Figure 2). This mathematical calculation is supported by investigation of states' political attitudes to the varying corporation tax rates around the EU.

'Harmful tax competition'

EU states have been preoccupied with the issue of 'harmful tax competition' which has been highlighted by EMU. Taxation deemed 'harmful', under a code of conduct published late in 1997 and agreed by the UK, concerns 'those measures which affect, or may affect in a significant way the location of business activity in the Community' (Article A).

Also defined as harmful are 'Tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the member states in question' (Article B). Parliament debated the code in late 1997, when questions were raised about the exact definition of 'harmful'. When an assessment of whether a country's system of tax is 'harmful' can be initiated by another member state, as the code allows, clearly whether Britain's low tax regime is deemed harmful depends on the political opinion of other EU members. It is a relative concept, as the German ex finance minister, Theo Waigel, showed when he described London as a tax

haven in late 1996, because low personal income tax in the UK had encouraged German financiers to move there.

Foreign Direct Investment

The UK benefits significantly from foreign direct investment. According to the OECD, in 1994 the UK received 34% of all inward investment into the EU; corresponding figures for France, Germany and Italy were 11%, 20% and 7% respectively. (Figure 3)

One reason for the UK's success seems to lie in the significant difference between the tax regime in the UK and that on the continent. Overall British taxation dropped from 35.3% to 33.6% of GDP during the period 1980 to 1993 and continues to do so. By contrast, overall EU tax increased from 36.7% to 41.4% of GDP, 1980-1993 (*Wall Street Journal Europe*, 10th May 1996). This has made the UK increasingly popular to foreign investors.

There is a close relationship between low corporation tax and investment, although the European Commission has tried to separate the two. It has claimed that varying tax rates obscure the 'intrinsic merits' of various 'investment alternatives' (Withholding tax proposal, 20th May 1998), when clearly the returns on investment are inextricably linked to the level of corporation tax. In October 1998, the telecommunications company Ericsson explained that its decision to move part of its business to London followed difficulties persuading executives to work in Sweden, because of high taxes.

Tax havens

Tax havens in Jersey, Guernsey and the Isle of Man also encourage investors to deal through London institutions with specific expertise in the opportunities available. These tax havens would fall foul of the Code of Conduct, because Article M requires that 'Member States with

dependent or associated territories…commit themselves…to ensuring that these principles are applied in those territories'. The islands' future position is also precarious because of the blurring of tax 'evasion' and 'avoidance'. 'Avoidance' is defined in national terms as the manipulation of tax law against Parliament's intent, yet clearly the code of conduct and the aim to curb tax avoidance and evasion give this legal issue an international, political significance.

It is entirely possible, given the widespread recognition of the need to attract foreign direct investment, that other member states will attack current British arrangements as 'harmful' or encouraging evasion or avoidance, since they could be portrayed as drawing investment away from other European countries. The Ruding Committee, reporting in 1992, concluded that variations in member states' company tax demands were distorting the Single Market. In a note on tax harmonisation a British MEP, Graham Mather, has written, that 'the impending attack on tax havens is common knowledge in Brussels'. By March 1998 the UK Government had already begun a review of financial regulation in all offshore centres in line with European political developments.

Why don't other EU members lower their taxes?

There are six major reasons why British tax would rise because other EU states will prove unwilling or unable to reduce their tax rates.

- The Maastricht Treaty imposed deflationary policies and many European Union countries have no appetite for further spending cuts, now that they have qualified for EMU. Many experts, including Adair Turner at the CBI fear that EMU may increase unemployment, making welfare cost-cutting less

attractive to governments. It would be easier to raise British tax, than to reduce continental taxes.

- Many other countries would like a more equal share of Foreign Direct Investment without having to make the tax savings Britain has. Few other countries have tax havens like the Channel Islands: ironing out the UK's advantage would be attractive.

- The monopoly of Social Democratic governments now controlling the EU makes tax cuts unlikely. Although deregulation and reform of the welfare state are long overdue, governments committed to old-style social protection are unlikely to support a reform of tax downwards. The Green Party/SPD coalition in Germany has agreed to increase taxes on energy as a means of financing growing pension liabilities (FT, 19th October 1998). The overall burden of tax, however, remains the same.

- Large unfunded pension liabilities shared by most European governments (but not the UK) make continued higher taxes to fund the mounting debt inevitable (Figure 4).

- The stability pact may also have an unforeseen impact on tax as well, making it imperative for governments to safeguard tax levels to avoid contravening the pact, which sets a maximum budget deficit for EMU members, and being fined as a consequence.

- Germany and France have already implied that they could not tolerate the British low tax regime inside EMU, as continental business would migrate to the UK. Already, some companies are taking advantage of the Single Market's Freedom of Establishment provisions to register their businesses in the UK —

paying lower tax as a result. This is bound to enflame opposition to the UK's fiscal regime, when other governments lose tax revenue as a result.

The unspoken solution – lower government spending

Both the Ruding (1992) and Monti (1996) Reports to the Commission on taxation identified what appeared to be an intractable problem. Broadly, tax could either be raised from mobile (business, investment) areas of the economy, or immobile bases (labour, land, housing). Tax mobile elements and they leave, reducing revenue. Tax the immobile, and the effect is to reduce consumer spending and increase unemployment. Tax competition was identified in totally negative terms: it 'eroded' the tax base, was a 'beggar thy neighbour policy' or 'undermined' governments. Neither report addressed the possibility of reducing overall taxation.

Harmonisation would be an easy way of removing Britain's advantage, relying on the size of the European market as a means to guarantee continued investment despite higher average taxation. However it is just as likely that higher taxes would drive investment which might have gone to the UK to other locations outside the European Union.

Besides the threat to business, investment and private savings, harmonising taxes throughout the EU is profoundly undemocratic. Democracy developed in Britain as the government's reliance on its tax payers increased; the vote was the concession for taxpayers' increasing role. Today tax levels in Britain broadly represent what the British electorate and businesses in the UK are willing to pay. Yet if UK tax increased due to cross-European harmonisation, the government would

be powerless to do anything. Voters would have no ability to influence the level of tax they pay.

At present the Government supports joining EMU when the time is right. It also supports international action to tackle tax evasion. It maintains that the UK will remain in full control of direct tax policy in the UK. The mounting legal evidence detailed above shows that the basis for the last argument is very unsound. As Ruding has made explicitly clear, 'Monetary Union requires ... a willingness to reduce national sovereignty over taxation as well'. The role of the European Court of Justice and the European Central Bank will make British control over tax policy, and therefore low British taxation, a thing of the past.

Joining EMU is central to the issue of tax harmonisation since it would make the British advantage transparently obvious. Contrary to government claims, it would also give Europe power to determine Britain's tax in its collective interest. It is likely that the level of tax harmonisation agreed by the Central Bank or in the European Council would cancel out any of the marginal benefits EMU could offer the UK.

Tax harmonisation inside EMU would mean a net deterioration in the attractiveness of the UK as a place to site business and investment. British jobs and prosperity would suffer as businesses and international investment migrate elsewhere.

Suggested Further Reading:

Christopher Arkell, 'Another Hard Lesson', *European Journal* 1997 Vol.4 No.9

Christopher Arkell, 'Time for another tilt at the ECJ', *EJ* Vol.6 No.2 (forthcoming)

European Commission, *Taxation in the European Union, Report on the Development of Tax systems*, 22.10.96

Parliamentary Debates, European Standing Committee B, 'Harmful Tax Competition', 26th November 1997

Onno Ruding, 'After the euro: corporation tax harmonisation?', *EC Tax Review* 1998 Vol.7 No.2

Frans Vanistendael, 'Redistribution of tax law-making power in EMU?', *EC Tax Review* 1998 Vol.7 No.2

UNICE, *Benchmarking Europe's Competitiveness: from analysis to action*, 1998

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