

ECO/189

Brussels, 12 December 1995

OPINION
of the Section for Economic, Financial and Monetary Questions
on
Direct and Indirect Taxation

—————
Rapporteur: Mr JANSSEN
—————

Memorized text.

On 22 February 1994 the Economic and Social Committee, acting under Rule 20 of its Rules of Procedure, decided to draw up an Opinion on

Direct and Indirect Taxation.

The Section for Economic, Financial and Monetary Questions, which was responsible for preparing the Committee's work on the subject, adopted its Opinion on 5 December 1995. The Rapporteur was Mr JANSSEN.

At its ... Plenary Session (meeting of...) the Economic and Social Committee adopted the following Opinion ...

INTRODUCTION

Taxation is a very broad subject and the present Own-initiative Opinion deals solely with the most important or urgent issues.

Our yardstick for singling out issues for consideration was whether they involve enough important European aspects and, in particular their interaction with the single market and the principle of free capital movement. It was accordingly decided to focus on indirect taxation on the one hand and on two specific direct taxes (those on savings and company profits).

In addition, a brief look is taken at some other tax issues which have a European aspect (wealth, inheritance and personal income taxes).

Use has also been made, and account taken, of Opinions issued by the ESC in previous years.

The essential challenge for the immediate future is to find at the European level a form of tax harmonization and in the Member States a tax structure which will:

- a) reduce, where appropriate, the burden of fiscal and parafiscal charges on labour;
- b) optimize the burden of taxation in such a way as to stimulate sustained non-inflationary economic growth and employment;
- c) maintain the integrity of the existing European social model and continue to develop it;
- d) facilitate the development of the single market.

1. Introduction

1.1. The power to levy taxes is an essential component of national (Member) States autonomy. At the same time continuing European economic unification reveals the need for a complementary European tax policy.

1.1.1. The European Community has now become the European Union. After many years of having been a free trade area, the EU is now a single market without customs checks which could hamper trade in goods. Citizens from one Member State can live, work and travel anywhere in the Union. Passport checks still exist but they too are to disappear soon. Capital can circulate freely without being hindered by controls.

1.1.2. Far less progress has been made with direct tax harmonization. Each country continues to tax companies and individuals at different rates, under different systems and with different rules of computation. The new freedoms of movement highlight the importance of the persisting differences of tax rules and practices. From the Neumark Report (1962) to the Ruding Report (1992) many groups, committees and individuals have addressed the problems of tax harmonization within the EU but with little evidence of action.

1.1.3. There has been some progress made with indirect taxes, although problems remain, particularly on services; there is a common VAT **system**, albeit at different rates.

1.2. Having a European policy on taxation is justified for three reasons:

1.2.1. If the "single market" is implemented logically, then economic transactions *between* the Member States will have to comply with tax conditions equivalent to those governing transactions *within* a single Member State.

Examples of this are:

- the reform of indirect taxation systems and the attempts to achieve greater convergence between them so as to be able to abolish border checks and so as to be able to give up the checks and formalities with which firms are burdened under the present transitional scheme; and
- the "parent companies/subsidiaries" directive, which specifies that linked companies established in different Member States must be treated in the same way as national companies by being exempted from the withholding tax on dividends under certain conditions.

1.2.2. Following the White Paper on growth, competitiveness and employment, proposals have been made to develop coordinated European tax initiatives to promote employment: for instance, there is talk of a proposal for a European tax on CO₂ emissions and energy which, according to the Commission, should reduce quasi-tax pressure on unskilled labour by 1% of GDP and create an extra 2.5% more jobs.

1.2.3. Dismantling frontiers and freeing capital movement may, in certain cases, lead to a downward spiral of "tax competition" between Member States. This is all the more probable as the tax base becomes more mobile. Such a downward spiral of taxes on unearned income often leads to higher taxes elsewhere, such as those on earned income or certain indirect taxes.

2. Indirect Taxation

2.1. The current situation

2.1.1. Value Added Tax is an essential and distinctive feature of the European Union. All Member States are required to have this tax, and to apply it to the majority of consumer spending, and they are forbidden

to have any other tax or taxes with a similar coverage.

2.1.2. VAT is **designed** to be economically neutral, i.e. to have the least possible effect on the choices made by consumers and businesses. This neutrality operates for transactions inside a single country but, supposedly, also for transactions between different countries and it is this factor which gives VAT its special place in the EU, one of whose principal aims is equal competition between goods and services, regardless of the Member State supplying them.

2.1.3. Despite the recent closer alignment of VAT rates in preparation for the single market on 31 December 1993, there are still some major differences between rates: no less than ten percentage points between the lowest and highest "standard" rates. For the "low" rates the difference is as much as 19½ percentage points. It is known that such differences are due to the lack of agreement between Member States, some of whom have higher rates and want rates to be aligned upwards, while those with lower rates want a low standard rate. Also, countries which apply a zero rate to some goods and products want to continue to do so, considering it as part of their social policy. As tax decisions require unanimity, these differences of opinion have led in the end to the compromise reflected in the table below. They have also prevented the introduction of a definitive taxation scheme based on the country of origin concept, under which VAT accrues to the country of consumption. The stumbling block here was failure to agree on a practicable system of clearing between states which are net payers and those which are net receivers.

TABLE 1 - VAT Rates in the European Union (at 1 April 1995)

	Super-low rate %	Low rate %	Standard rate %	Mid rate %
Belgium	1.0	6.0	20.5	12.0
Denmark	-	-	25.0	-
Germany	-	7.0	15.0	-
Greece	4.0	8.0	18.0	-
Spain	4.0	7.0	16.0	-
France	2.1	5.5	20.6	-
Ireland*	2.5	12.5	21.0	12.5
Italy	4.0	10.0	19.0	16.0
Luxembourg	3.0	6.0	15.0	12.0
Netherlands	-	6.0	17.5	-
Austria	-	10/12	20.0	-
Portugal	-	5.0	17.0	-
Finland	-	6/12	22.0	-
Sweden	-	12/21	25.0	-
United Kingdom*	-	8.0	17.5	-

* Ireland and the UK apply a zero rate with deductibility of taxes upstream.

N.B. Tax exemptions with the right to deduct tax already paid at preceding stage (zero rates) are not included.

Source: EU Commission

2.1.4. A "transitional scheme" for VAT has been prepared so as to prevent the opening-up of frontiers leading to a displacement of trade flows and major tax losses for certain Member States.

2.1.5. Firms engaged in intra-Community trade have adapted to the transitional scheme, thanks to

investments in IT; but it is still complex because of the administrative costs involved and continues to give rise to complaints about certain aspects. Nevertheless, the scheme still has the merit of having made possible the elimination of border checks and halts, and the associated costs.

2.1.6. For deliveries between VAT-registered firms, the transitional scheme applies the principle of "taxation in the country of destination": a firm in country A which orders goods in country B is subject to the VAT rate applying in country A and is responsible for paying the tax while benefiting from the deduction of VAT paid at preceding stages, provided that country A makes the monthly or quarterly VAT declaration subject to clearing arrangements. Under the transitional scheme the firm in country B is obliged to draw up a list of its customers in other EU countries together with their VAT number. This list is sent to the national VAT authority and the information on it is exchanged at Community level between VAT administrations. So, very often VAT is no longer collected by the seller but by the buyer.

2.1.7. Firms which are not allowed to deduct VAT and legal persons who are not liable to VAT may buy goods in the EU up to a certain amount and pay foreign VAT on them.

2.1.8. For final users the basic rule is "taxation in the country of origin". But there are exceptions:

- purchases of new vehicles are taxed at the VAT rate of the country of destination;
- the VAT rate of the country of destination is applied to distance sales of over ECU 100,000. Member States may lower this threshold to ECU 35,000.

2.1.9. The transitional scheme therefore has good and bad points.

2.1.9.1. Good points:

- a big drop in administrative and transport costs caused by customs formalities;
- improved cash flow for firms, due to the abolition of customs bonds and certain advance financing obligations;
- lower prices for goods because of increased international competition.

2.1.9.2. Bad points:

- uncertainty and fear about ultimate tax liability: firms which deliver goods under the "destination country" VAT scheme must prove that the delivery is eligible for VAT exemption in the country of origin. Some Member States require proof that VAT has really been paid in the country of destination, but this causes more red tape and makes firms vulnerable to mistakes or errors by their trading partners;
- appearance and growth of alternative channels: firms buy goods in another Member State where VAT is low without saying that it is an intra-Community purchase. These same goods are then processed and sold at a high VAT rate without the VAT and other taxes due being actually paid to the authorities. However, fraud is always possible in any system, so one cannot say whether the transitional scheme has led to a rise in the number of fraud cases;

With the abolition of border checks, it is possible to set up fictitious movements of goods to dubious and insolvent firms abroad while the goods themselves, in the meantime, "disappear" into the untaxed sector;

- where distance sales thresholds are exceeded, the firm involved must report to the VAT authorities in each country where it delivers goods. As the rules to be followed vary so widely, this costs firms quite a lot of money. So, it is not surprising that firms refuse some EU orders in order to stay below the threshold or work through middlemen in the country of destination;

- smaller firms which in one country may not have to charge VAT on sales below a certain threshold still have to report EU transactions and issue regular lists.

2.2. From a transitional to a final VAT scheme?

2.2.1. The final scheme due to come into force in 1996 would be based on the system of 'taxation in the country of origin' according to present proposals. One of the objectives is to eliminate the zero-rating of 'exports' to other Member States.

2.2.2. But there would also be disadvantages:

- unless a proper clearing scheme between the Member States is introduced, tax revenues would be shifted from the buyer's country to the supplier's country. So, the principle of "taxation in the country of origin", unlike the present system, would benefit exporting countries where the goods were actually bought.

Thus, if the differences in indirect tax rates were too great, trade flows could be diverted: even when VAT actually paid could be claimed back later from the final consumer or the authorities, firms would prefer to buy goods in low-VAT Member States so as to make optimal use of financial flows. Also, firms could use the technique of "distance selling" and (re)locate to low-VAT countries.

2.2.3. All this would have two consequences:

- first, some Member States would no longer collect indirect taxes on intra-Community transactions which otherwise would have been domestic transactions;
- second, all this would lead to distortions of competition and shifts of production and jobs within the Member States.

2.2.4. What is more, relatively low VAT rates do not only bring advantages; they also have a disadvantage, which can be illustrated by the following example:

2.2.5. A given product is VAT-rated at 16% in country X but VAT-exempt in country Y. If a mass merchandiser with its headquarters in Y buys this product in X it has to pay 16% VAT, which ends up in X's treasury. But when the product is resold in Y, the merchandiser will not collect any VAT and will be obliged to claim back VAT from Y. So, Y's treasury finances X's public authorities, which of course causes all sorts of political and economic problems.

2.2.6. However, this problem is much less serious when there is no zero rate. In such cases, and provided that the value added is sufficiently high, it is possible to offset the impact of big differences in tax rates.

2.2.7. Let us take the example of country X, where VAT is 20% and country Y, where it is 10%. Let us imagine that a distribution company in Y buys goods costing 1 million in X and resells them for 1.5 million in its own country: the VAT paid by the firm in X amounts to 200,000 but 150,000 is recovered in VAT on domestic sales. If some goods are bought in Y as well, the problem of lost VAT can be practically eliminated: if the company also buys goods for 1 million in its own country and resells them for 1.5 million, the VAT collected on the transaction is just 50,000 (10% of 1.5 million - 1 million), which completely offsets the VAT paid by the company in X.

2.2.8. At its meeting in October 1994 the ECOFIN Council of Ministers proposed that the new VAT system should respect a number of principles:

- reduce administrative charges and costs by simplifying procedures, and limit the number of cases where a firm has to find out abroad about the turnover of a trading partner or appoint a tax representative;
- no tax losses or transfers between Member States;
- the risk of fraud should not rise, and should even fall. This should be assisted by simple and transparent VAT procedures and closer collaboration between authorities.

2.3. The ESC's Recommendations

2.3.1. The ESC considers that the VAT transitional scheme has helped greatly towards implementing the single market, via the abolition of border checks.

2.3.1.1. But the transitional scheme is complex and leads to more insecurity in certain cases.

2.3.2. The ESC is therefore in favour of a simpler and clearer scheme, in which domestic and intra-Community transactions would, as far as possible, receive equal treatment. General use of the principle of "taxation in the country of origin", as planned in the proposed final scheme, can meet these demands.

2.3.3. However, a generalized application of this principle would be incompatible with excessive differences in VAT and other indirect tax rates. The shift in trade flows and distortions of competition which might result should not be underestimated.

2.3.4. Without aiming at complete harmonization of rates (cf. transport costs), it is necessary to bring rates into a narrower band and to make the reduced rates more comparable. The issue of zero rating must be addressed.

2.3.5. Such an alignment of indirect taxation can be either upwards or downwards.

The authorities responsible must strike a balance between the different priorities here:

- the need to put European public finances on a healthy footing and the need for tax revenue in order to implement employment policy;
- the fact that indirect taxes are degressive in nature, as a flat rate hits those with lower incomes proportionally more than those with higher incomes. The ESC would point out that at present the trend is again upwards since certain EU countries, to reduce their high public sector deficits, are tempted to raise VAT, which will make it all the more difficult to bring rates substantially closer together as a precondition for introducing a final scheme;
- the alignment of VAT rates in the EU should lead to lower direct taxes on labour. In Member States where indirect taxes would rise as a result of such alignment, direct taxes on labour should be lowered. In this way total tax revenue would stay constant and jobs would be given a boost. But steps must also be taken to soften the impact of higher indirect taxes on those with low incomes.

2.3.6. When harmonizing tax rates it is important to maintain a reduced rate and a standard rate. For reasons of employment, environmental and incomes policy, consideration can be given to extending the range of goods and services taxed at the reduced rate. The inclusion of local, repair and recycling services in the reduced rate bracket would promote labour-intensive production and a more economical use of raw materials. Goods bearing a European eco-label should also be taxed at the reduced rate so as to encourage environment-friendly production, as should basic necessities, for incomes policy reasons.

2.3.7. Detailed proposals should be worked out in conjunction with the social partners and the business community. Full consultation should take place from the outset on what business needs and on the compliance costs of alternative options, including the additional costs and administrative burdens of anti-avoidance measures.

2.3.8. An adequate timetable should be allowed for full consultation after the proposals have been specified in detail, including the avoidance and evasion counter-measures, and before any political decision in principle to proceed. A definitive system should be introduced **only if clear benefits (both initial and on-going) have been identified which are of sufficient magnitude to warrant the cost of change**. Adequate time must also be allowed between the decision to proceed and the effective date of implementation for changes requiring significant re-programming of computers and modifications of business systems.

2.3.9. The search for a more integrated Europe must not be allowed to stimulate a 'Fortress Europe' mentality; trade with the outside world must not be impeded by protectionism.

2.3.10. Particular account should be taken of the impact of the proposed changes on SMEs and micro-businesses, which is likely to be much greater than in the case of larger companies.

3. Taxes on Savings

3.1. The current situation

3.1.1. Historical background

3.1.1.1. The free movement of capital within the EU has been a reality since 1 July 1990. A citizen of one Member State may now place his savings in another Member State without any restriction. As most Member States have scrapped exchange controls, this in fact means that their citizens can also place their savings outside the EU. At the same time, tax treatment of income from savings varies widely between Member States.

3.1.1.2. During the debate on the 1988 Directive which regulated the liberalization of capital flows, various Member States stressed the danger that such liberalization, if it was not accompanied at the same time by tax measures, might lead to a relocation of savings for purely tax reasons. This is why the Council asked the Commission to prepare a proposal for approximating the different systems of taxing income from savings.

3.1.1.3. In the spring of 1989 the Commission put forward two proposals: a proposal for a directive to introduce throughout the EU a minimum withholding tax of 15% on interest from bonds and bank deposits, and a proposal for a directive on better administrative co-operation. Neither directive has been adopted. Only an agreement on mutual assistance has been concluded between 11 Member States.

3.1.1.4. In the meantime the single market has also become a reality, including the single market in banking services. This has given an extra thrust to the globalization of financial markets while tax systems remain different. A European approach to the differences between tax systems could be based on Article 100 of the Treaty.

3.1.1.5. In 1993 the debate resumed on achieving some degree of harmonization. The Belgian Presidency gave Member States the choice between introducing a minimum withholding tax of 15% or declaring savings income to the Member State where a taxable person was established. The German Presidency also put the question of harmonizing taxes on savings income on the agenda and was able to take account of the Commission's contacts with a number of non-EU countries. But the Essen Council did not take any decision on this.

3.1.2. Comparisons

3.1.2.1. A comparative study reveals one clear trend: while each country seeks to tax the savings of its residents, it also takes care to exempt the savings of non-residents.

TABLE 2 - Withholding Taxes On Interest From Bank Deposits (in %)

Source country

Country of residence	Source country											
	B	DK	F	D	GR*	IRL	IT	L	NL	P	ESP	UK
B	10	-	-	-	10	-	15	-	-	15	-	-
DK	-	Bar	-	-	10	-	15	-	-	15	-	-
F	-	-	15	-	10	-	10	-	-	15	-	-
D	-	-	-	30	10	-	-	-	-	15	-	-
GR	-	-	-	-	15	-	10	-	-	20	-	-
IRL	-	-	-	-	10	27	10	-	-	20	-	-
IT	-	-	-	-	10	-	30	-	-	15	-	-
L	-	-	-	-	10	-	30	Bar	-	20	-	-
NL	-	-	-	-	10	-	30	-	Bar	20	-	-
P	-	-	-	-	10	-	-	-	-	25	-	-
ESP	-	-	-	-	10	-	12	-	-	15	25	-
UK	-	-	-	-	-	-	15	-	-	20	-	25

* Withholding tax not levied on foreign currency deposits.

The figures in bold on the diagonal constitute full discharge of tax liability; the others are chargeable (and refundable) according to the progressive income-tax bracket of the person concerned. The word "Bar" in bold means that tax is levied at the appropriate rate on the basis of an exchange of information.

3.1.2.2. The ESC considers this to be an anomalous position and recommends the introduction of the concept of 'European Resident' to correct it; it is no longer defensible to abolish internal frontiers and, at the same time, keep the distinction between 'residents' and 'non-residents' (which is based on the existence of frontiers) where these terms apply to citizens of Member States. In the Single Market of Europe the only non-residents are the citizens of non-EU states.

3.1.2.3. Totally free capital movement with maintenance of the differences between tax rates and of the principle of different treatment for residents and non-residents therefore also leads to competitive tax exemption. It is the saver's interest to deposit money abroad so as to avoid taxes. This forces Member

States to reduce withholding taxes on the savings of their own residents. The risks of such a scenario occurring increase further when there is little or no exchange risk.

3.1.3. Competitive tax exemption: the situation in brief

3.1.3.1. The following table summarizes the changes in taxes on residents' income from savings between 1989 and 1993.

TABLE 3 - Main Changes in Withholding Taxes On Interest From Residents' Savings Between 1989 and 1993

Belgium	<ul style="list-style-type: none"> - Withholding tax on interest cut from 25 to 10% in January 1990 - Introduction of unit trusts (SICAV) - Withholding tax raised to 13.39% for 1993-1994
Denmark	<ul style="list-style-type: none"> - Income from capital exempted from 12% surtax from DKK 231,800 upwards
France	<ul style="list-style-type: none"> - Levy on gilts cut from 25 to 15% and that on other securities and bank deposits cut from 45 to 15% - Introduction of unit trusts - Introduction of special levy on growth bonds - Introduction of a "solidarity levy" on income from securities
Germany	<ul style="list-style-type: none"> - Withholding tax of 10% on income from sight and term deposits, bonds, gilts and other securities introduced in January 1989 and abolished in May 1989 - Withholding tax described in Table 2 introduced in November 1991 by decision of the Constitutional Court
Italy	<ul style="list-style-type: none"> - Withholding taxes able to be set off against income tax - Withholding tax on interest from bank deposits and bonds other than gilts and company debentures raised from 25 to 30%
Luxembourg	<ul style="list-style-type: none"> - Raising of threshold for freedom from taxes on interest income
Netherlands	<ul style="list-style-type: none"> - Raising of threshold for freedom from taxes on interest income
Spain	<ul style="list-style-type: none"> - Withholding tax raised from 20 to 25%

Source: Christian VALDUC "Harmonisation fiscale et construction européenne" in the *Courrier hebdomadaire du centre de recherche et d'information socio-politiques* no. 94/14-41.

3.1.3.2. It is worth noting that it is those countries which are most advanced as regards economic and monetary integration that have been obliged, among other things under the pressure of "tax competition" from others, to cut taxes on residents' savings.

3.1.4. Consequences

3.1.4.1. Such a situation has the important consequence that the mix of production factors is distorted at the expense of labour and jobs. Taxes have a greater impact on labour than on capital. On the other hand, the profits tax to be paid may also influence the further investment of companies.

3.2. What approach to adopt?

3.2.1. The problem of competition in the field of taxes on income from savings may be solved by introducing a minimum withholding tax at European and OECD level: Member States would thus remain free to apply higher rates than the agreed minimum, but not lower rates. The "tax-cutting war" would certainly not be stopped, but it would be kept within certain limits.

3.2.2. Priority must also be given to abolishing the distinction between residents and non-residents.

3.2.3. However, if the above principles are to be implemented successfully, account must be taken of a number of practical problems and inconveniences.

3.2.4. The first problem is linked to the introduction of a withholding tax in systems where income from savings is declared to the tax authorities: countries which tax income from savings on the basis of obligation to declare (which is generally based on a compulsory exchange of data with financial institutions) have no immediate interest in introducing a withholding tax. Moreover, the introduction of a withholding tax would probably raise the question of knowing whether payment of such a tax would free the taxpayer from any further tax liability.

3.2.5. In addition, each Member State must remain free to decide whether or not to lump together all incomes or grant certain exemptions for income from savings (e.g. for small savers).

3.2.6. The second problem is the risk of capital flight to non-EU countries. Given the high degree of capital mobility at world level, such a flight of capital may translate into a shortage of the very capital which Europe needs so much (e.g. for large infrastructure projects) and a fall in the expected tax revenue. This risk is all the more real where the withholding tax is high and exceeds a certain "threshold of indifference", which probably lies at around 10 to 15%.

3.2.6.1. The risk of capital flight from small and medium-sized investors is relatively small:

- the distance separating them from the financial institution will certainly dissuade very many from investing their savings outside Europe;
- because of the exchange risk, investments in other currencies do not always offer comparable security.

3.2.6.2. For this reason the harmonization of taxes on savings income must not be limited to the EU; a solution must be negotiated which can be applied to a wider international area, such as all the OECD member countries.

3.2.7. If, after the step recommended in point 3.2.6.2 has been taken, the introduction of a standard withholding tax did lead to an increase in taxation on income from savings, savers and the financial institutions might try to pass this increase on to borrowers through a rise in interest rates. Such a rise could badly affect private investment - and hence growth and jobs - and lead to extra spending on servicing national debts.

3.2.7.1. The size and probability of this risk depends on the following factors:

- the elasticity of the supply of savings. Traditional economic analysis teaches us that a tax is borne almost entirely by the supply side (in this case, savers) when this is virtually, or fully insensitive to changes in interest rates. Even when the supply of savings reacts "normally" to an increase in taxation, both parties are affected: savers (higher gross interest rate) and investors (lower net interest rate);

- this elasticity is in its turn determined in part by the possibility of moving invested capital abroad.

3.2.7.2. Applying a withholding tax throughout the OECD countries will minimize any impact of the tax on the supply of capital.

3.3. ESC guidelines

3.3.1. To keep tax competition within certain limits, gather the resources needed for employment initiatives and ensure that the EU is not placed at a disadvantage on the global capital market, the ESC recommends the following measures. When implementing these measures, account must always be taken of international limitations.

3.3.2. Introduce the concept of "European resident": it is no longer defensible to abolish internal frontiers and at the same time keep the distinction between "residents" and "non-residents", which is based on the existence of frontiers.

3.3.3. Adopt a European and international approach to taxation. Such a policy must respect the existing differences between the Member States as regards the taxing of income from savings (withholding tax or compulsory declaration) and should not prejudice one system to the detriment of the other. Member States which levy taxes on the basis of a compulsory declaration must receive assurances about the reporting of interest income by their citizens in another Member State.

3.3.3.1. In return, Member States which apply a withholding tax must receive assurances regarding:

- either the retention of a minimum withholding tax on the income from savings of their citizens in another Member State;
- or the systematic reporting of the interest income received by their citizens in the other Member States.

3.3.3.2. What this boils down to is that the Member States can choose between the introduction of a withholding tax of say 15% (cf. the threshold of indifference) or the systematic reporting of interest and dividend payments to the government of the saver's Member State of origin.

3.3.4. Steps must be taken to encourage small savers irrespective of the type of savings, e.g. by fixing a capital threshold below which savings income would be tax-exempt or by introducing a threshold for non-taxable interest.

3.3.5. Within the EU, tax havens belonging to the territory of Member States should be abolished. There will also have to be negotiations on sorting out the situation of other European enclaves outside the EU and that of exotic off-shore centres.

3.3.6. Bearing in mind the fact that savings may be held in non-EU countries, a solution based on conclusions reached at European level must also be sought at OECD level, in the form of a withholding tax or an exchange of information.

3.3.7. Uniform taxation of savings should be extended to cover income from financial instruments which are closely related to fixed-income savings.

4. Company Taxation

4.1. The current situation

4.1.1. Tax policy towards companies has so far concentrated in the EU on abolishing the double taxation of

cross-border income flows ("parent companies/subsidiaries" directive and draft directives on taking account of the losses of branches and subsidiaries established in other Member States and on the payment of interests and royalties within groups of companies). This policy is justified by the aim of eliminating tax barriers in the European single market.

4.1.2. The right approach, surely, to company tax harmonization is to start with problems and look for solutions. **Why** cannot a French company merge with a German company across the border? **Why** must a Birmingham business, wishing to open a sales office in Milan, find itself caught in the cross-fire between the claims of two rival tax authorities? **Why** is there so much paperwork involved in a Finnish company purchasing goods from a Spanish supplier within what is supposed to be a Single Market? **Why** does a Dutch company with a subsidiary in Greece have so many problems with transfer pricing? What can be done to remove or alleviate the "ACT problem"?

4.1.3. Europe's taxation policy does not yet include the aim of harmonizing systems, rates and the basis of assessment for company taxation. The European Parliament has pointed out, correctly, that it is pointless to standardize rates without also standardizing the tax "base" i.e. the method by which the liability is calculated.

4.1.4. The Ruding report has shown that:

- taxation, as well as the political, economic and social situation, is a factor in decisions on setting up activities, especially financial and, to a lesser extent, industrial activities;
- completion of the single market has made corporate decision-making more sensitive to differences in company taxation;
- the most "decisive" aspects of taxation are, in descending order, the overall rate of company taxation and taxation on natural persons (unincorporated businesses), cross-border withholding taxes on income from dividends and interests, depreciation schemes and tax incentives for investments, other factors determining the basis of assessment and, finally, the "costs" of complying with the obligations laid down by tax legislation;
- tax competition may lead to lower taxation on mobile factors and an increase in the difference between this taxation and that on fixed factors of production. This distorts the allocation of production factors.

4.1.5. Serious differences in tax rates and base between countries within a free market area are unlikely to exist for very long, except for valid economic reasons. Provided there is freedom of movement of people and capital as well as goods, no Member State can afford to impose taxes at levels which drive away capital, discourage inward investment, create unemployment and erode the tax base itself.

4.1.6. Tax competition is particularly pronounced in the area of special exemptions. Many Member States have special tax schemes for financial service centres. These centres may or may not be linked to "offshore" territories and are used to siphon off profits from the rest of the economy (e.g. manufacturing industry) to companies which are exempted from tax or taxed at a much lower rate.

4.1.6.1. The following table gives an incomplete summary. It should also be pointed out that most countries also have a special system for "headquarters", where taxation is based not on profits but on the "cost-plus" method.

TABLE 4 - Main Special Tax Schemes Which Directly Or Indirectly Offer Advantages To Financial Service Centres

Belgium	- "centres de coordination"
Luxembourg	- holding companies - "centres de coordination" - "sociétés de financement" - "sociétés de participation financière"
France	- Monaco and Andorra
Italy	- campione d'Italia - San Marino
Ireland	- international financial services centre - off-shore companies and customs-free zones
Netherlands	- Netherlands Antilles holding companies legislation
Portugal	- island of Madeira
United Kingdom	- Channel Islands: corporation tax companies and exempted companies - Sark: no taxes at all - Isle of Man: exempted companies - Gibraltar: certificate of exemption

Source: European Commission

4.1.6.2. Small and medium-sized firms which take the legal form of a one-man business or a partnership are faced in some Member States with the discouraging effect of progressive personal taxes. The Commission recently published a recommendation that, as regards the reinvestment of profits, the Member States give such firms a right to opt for corporation tax and/or limit taxation to a rate comparable with corporation tax.

4.2. Assessment of possible proposals

4.2.1. Bearing in mind the principle of subsidiarity, the problem described above may be resolved by an approximation of certain rules and parts of the corporation tax code.

Particularly worth thinking about are:

- the introduction of a minimum tax base; and
- harmonization of the main parameters for establishing the tax base.

4.2 .1.1. Such an approach would undoubtedly benefit the tax balance as far as companies are concerned and would increase the financial capacity of certain Member States. On the other hand, it could also lead to problems for regional policy with the consequence that, with the planned introduction of EMU, Member States would lose a second means of adjustment (currency devaluation and the use of tax incentives would no longer be possible. Account would also have to be taken of relations with non-EU countries).

4.2.2. So, the regional policy dimension must also be included in a minimum harmonization of company taxation. The system of direct aid for investment may serve here as an example: as much greater advantages can be offered to disadvantaged regions in the way of investment aid, arrangements can be made to provide them with special exemptions and a wider range of tax advantages.

4.2.3. As with tax rates, tax **bases** differ between Member States for a number of reasons. These may be accidental, or historical or result from specific incentives (or penalties) to encourage (or discourage) particular types of investment or corporate activity. They may be designed to encourage investment in a particular, and otherwise unfavoured, part of a Member State or to encourage investment in the State as a whole. Such tax incentives are an essential part of the regional and industrial policy of the EU and are not inherently incompatible with the adoption of a market-led approach to harmonization.

4.2.4. The loss of the devaluation tool within the framework of the debate on EMU. If an asymmetrical shock should happen in a future Monetary Union, the authorities could, despite the proposed harmonization, still play an important role: a reduction of company taxation would mean that the Member State concerned has a certain tax margin. This margin could also be used to improve other components of competitiveness and thus attract new investments (e.g. lowering of social-security contributions or provision of cheap industrial land).

4.2.5. In the event of the Member States reaching unanimous agreement on the introduction of a minimum rate, one must consider the policy of non-EU countries.

4.2.6. Differences of base may also result from the effects of inflation. No Member State yet imposes tax on a 'monetary correction' or even 'current cost accounting' basis, although the UK has gone a little way in this direction by the indexation of capital gains. Unless and until all Member States adopt a harmonized system taking account of inflation (or, until unrealistically, inflation disappears) the tax base will continue to be distorted both by the effects of inflation itself and by any national measures taken to mitigate these effects. The problem would be made even worse by foreign exchange movements, particularly where these do not reflect purchasing power parity. This aspect has not been addressed by the Commission papers.

4.3. The ESC's position

4.4. The ESC regrets that European tax policy does not yet include the aim of a minimum harmonization of company taxation systems, rates and tax bases.

4.4.1. The ESC feels that a certain harmonization of company taxation is a desirable aim and very useful in the long term. Since capital mobility is a reality, the influence of tax factors on the location of economic activities can only increase. For the single market, it is particularly important that the terms of competition are not excessively disturbed by internal differences in Member States' tax systems and that any use of these systems for a tax-exemption war is avoided.

4.4.2. The ESC is not in favour of a complete standardization of company taxation, even in the medium or long term. This is not desirable because the Member States must be able to continue using economic policy instruments.

4.4.3. But the ESC is in favour of minimum standards for the company taxation rate and the main parameters determining the tax base. This minimum rate must be sufficiently flexible and take account of the tax pressure in non-EU countries.

4.4.4. Bearing in mind the principle of subsidiarity, the ESC wants a policy identical to that on direct subsidies: Member States remain responsible for direct aid, but the Commission checks compliance with rules of competition. The same checks should be carried out in the field of taxation. Existing checks on tax

aid are not achieving the desired objective because they are limited to exemptions from the general schemes in force in the Member States. One forgets that, in the present situation, differences between general schemes generate competition distortions which are sometimes greater than those created by certain tax incentives.

4.4.5. Bearing in mind that a number of smaller firms are short of capital and that such firms provide a large proportion of jobs, the ESC supports the Commission's recommendation that the rate of taxes on profits which are reinvested in job-creating projects should be made comparable with the tax rate generally applied to company profits.

4.4.6. The ESC thinks that existing bilateral double taxation agreements between the different Member States must be replaced by a single European double taxation agreement.

5. Other Types of Taxation

5.1. Personal taxation

5.1.1. Personal taxation too differs greatly within the EU. The table below shows personal taxation as a percentage of GDP. Although the figures disregard the fact that the relative tax base for personal taxation may differ from one Member State to another, the technique used still provides some idea of differences in personal taxation. Percentages vary from 4 to 26% of GDP, or a ratio of more than 6:1.

TABLE 5 - Personal taxation as a percentage of GDP

Austria	9%
Belgium	14%
Denmark	26%
Finland	17%
France	6%
Germany	11%
Greece	4%
Ireland	12%
Italy	10%
Luxembourg	11%
Netherlands	12%
Portugal	6%
Spain	8%
Sweden	18%
United Kingdom	10%

Source: OECD

5.1.2. Despite these big differences, the ESC does not think that the Community should do anything to reduce them or seek a minimum basis of harmonization, like those for indirect taxes and taxes on savings. Labour is a lot less mobile within the EU than "capital" or certain components of consumer demand. Even with further progress on the free movement of persons, cultural differences and language barriers will hamper labour mobility within the EU. So, a differing level of personal taxation in a Member State will have little or no influence on the other Member States.

5.1.3. However, differences in personal taxation may have unexpected and undesirable effects on certain categories of workers.

5.1.4. Highly-trained workers are more mobile and less bothered by language or cultural barriers. So they are more sensitive to big tax differences between Member States.

5.1.4.1. The ESC therefore recommends that a more detailed analysis be carried out of the effects of major

differences in taxation on highly-skilled workers. Particular attention should be paid to checking whether such differences cause serious problems in practice.

5.1.5. A second category is that of frontier workers. As such workers pay taxes on their wages and social-security contributions in accordance with the laws of the host Member State, but are still subject overall to the income tax rates of their country of residence when making their annual declaration, financial problems may be caused by true tax revenue being converted into quasi-tax revenue for the country where the worker is employed. For such cases the ESC recommends a form of "right of verification". When tax and quasi-tax decisions are taken, Member States should systematically be obliged to assess the impact of their decisions on cross-border workers.

5.2. Wealth taxes

5.2.1. Macroeconomic statistics also show big differences in wealth taxes: in some countries wealth taxes bring in little or nothing, but in others they bring in substantial revenue. It is more than probable that "tax competition" processes are also involved here, since a large proportion of wealth (capital) is extremely mobile and can be shifted without too many problems to neighbouring Member States where wealth taxes are much lower.

6. Taxes on Labour and Jobs

Introductory remark

As the ESC considers jobs a priority issue, this Opinion goes further into the relationship between jobs and taxes. The ESC is aware that jobs and unemployment are influenced through various channels by tax and quasi-tax policy. But in view of the importance assumed by the "tax on labour" in the present discussion, this Opinion will only consider this specific aspect. The ESC reserves the right to come back to this matter in more detail in future Opinions and investigate the impact of other tax systems and their mutual connection with jobs and unemployment.

6.1. A critical assessment of the European social model

6.1.1. In many EU countries taxes on labour are high. According to the European White Paper they represent around 23.5% of the EU's GDP. This figure is higher than in, for example, the USA (19.4%) or Japan (16.6%). Within the EU itself there are big differences. Figures range from 16% in the UK to 29% in Belgium, 14% in Greece to 32% in Sweden.

TABLE 6

Taxes on Labour in 1992
(personal income tax + employers' and employees' welfare contributions)

Austria	22
Belgium	29
Denmark	27.3
Finland	30
France	24
Germany	26
Greece	14
Ireland	17
Italy	24
Luxembourg	23
Netherlands	27
Portugal	15
Spain	19
Sweden	32
United Kingdom	16

Source: OECD

6.1.2. Although these taxes, in conjunction with others, help to finance the European welfare state, one wonders to what extent higher taxes on labour destroy jobs and create unemployment.

6.1.2.1. Some maintain that taxes on labour produce a vicious circle: higher taxes on labour push up gross wages, these higher wages destroy jobs, the loss of jobs leads to a fall in revenue from contributions and a government deficit ... which in turn leads to new taxes being imposed on labour in order to eliminate the deficit.

6.2. Criticism of the critical assessment

6.2.1. Before concluding that the European type of welfare state is a direct threat to jobs, one should first check if the bases of the above argument are correct:

- do higher taxes on labour automatically lead to proportionally higher wages?
- do higher wages destroy large numbers of jobs?

6.2.2. Higher taxes on labour not only cause a fall in net salary; they also mean that workers are granted welfare protection against sickness, unemployment and old age, with the result that the working population must pay less for private sickness insurance, pensions and other savings plans. In this way the pressure towards higher wages can be countered.

6.2.2.1. The Belgian economy is a good example of this: Belgium has an extensive system of **state** social security and devotes a relatively high percentage of its GDP to it. So, taxes on labour are rather high. But this picture changes completely when one considers social security spending in the broad sense of the term (public and private sector insurance). Such spending as a percentage of GDP is a lot lower than in the rest of the EU. In other words, despite the advanced stage of development of the welfare state financed by higher taxes on labour, **total** spending on social security is low in relation to that of other comparable countries.

TABLE 7
Welfare transfers and social protection spending
(% GDP 1988 figures)

	Welfare transfers by the state	Total spending on social protection
Belgium	23.8	27.7
Denmark	16.8	29.3
Germany	22.9	28.3
France	21.7	28.2
Italy	17.3	23.1
Netherlands	25.7	30.9

Source: European Commission

6.2.3. If, despite everything, financing the social model should lead to higher wages, one must ask what is the exact link between wage levels and jobs.

6.2.4. Under no circumstances can the negative link between high wages and low employment be denied. But at the same time one must recognize that experiences regarding the impact of a linear wages policy on jobs do not give grounds for much optimism. Many econometric models and studies reach the conclusion that the statistical link between jobs and wage trends is fairly weak: elasticity is said to be on average 0.2 in the short and 0.5 in the long term. This means that 1% wage moderation would only create jobs in the long term and only then to the tune of 0.5%.

TABLE 8 - Wages-jobs elasticity

	Short term	Medium term	Long term
Belgian Planning Bureau		- 0.27	- 0.3 to - 0.4
Commission DG V (for the whole EU)		- 0.30	
French Planning Bureau	- 0.11		- 0.4
Dutch Planning Bureau			- 0.4 to - 0.5

6.2.4.1. More over, these figures are calculated on the supposition that the wages policy of other countries does not change. If it does, and different Member States together adopt the same policy, one should not, bearing in mind the way in which the single market is interwoven, place too much hope in an improvement of the mutual competitive position of Europe. And one must also take into account certain deflationary effects. The impact of an across-the-board wage cut on jobs in Europe would be even less than that suggested by the elasticities mentioned earlier.

6.2.5. In other words, economic reality suggests that the effects of the European welfare state on jobs is not so widespread as seems at first sight. The statistics confirm this: The table below shows that the correlation between taxes on labour and unemployment is not obvious. High-tax countries have relatively low unemployment, while other countries with low taxation may have high unemployment.

TABLE 9 - Unemployment and Tax Pressure in 1992

	Unemployment	Taxes on labour
Australia	10.7	12
Austria	5.9	22
Belgium	7.9	29
Canada	11.2	20
Finland	13	30
France	10.4	24
Germany	4.6	26
Greece	8.7	14
Ireland	15.5	17
Italy	10.5	24
Japan	2.2	16
Netherlands	6.7	27
New Zealand	10.3	16
Norway	5.9	24
Portugal	4.1	15
Spain	18.1	19
Sweden	4.8	32
United Kingdom	10	16
USA	7.3	18

Source: OECD

6.3. Correct analysis of the "social Europe" problem

6.3.1. However, the organization of the European social model through major quasitax pressure on labour may pose a problem for certain categories of workers. The first category which comes to mind is that of unskilled labour, which may be hard hit by high taxes on labour:

- for the unskilled (especially women), the labour supply curve would be fairly elastic, so that higher taxes and quasitax charges would lead to relatively higher gross wage demands without net wages falling significantly (moreover, the existence of ceilings for contributions in many Member States leads to proportionally higher social-security contributions for unskilled labour than for highly skilled labour);
- in addition, higher wages for unskilled labour would have a greater impact on jobs: according to the White Paper, wage-job elasticity is twice as high for lower wage groups. This can partially be explained by the fact that unskilled labour is homogenous and does not have specific labour qualifications, which means that the "price" (wages) plays a more important role in defining demand for unskilled labour, and also by the fact that the use of unskilled labour is relatively high in the labour-intensive services sector;
- these developments must also be examined against the background of the globalization of the economy and progress in the field of technological innovation, both of which lead to a further fall in demand for unskilled labour.

6.3.2. This unconscious "conspiracy" against the use of unskilled labour is reflected in the unemployment statistics: the unemployment rate among the unskilled is several times higher than that among the highly skilled or the average unemployment rate. This is one factor which reveals the existence of structural problems concerning unemployment among the unskilled.

TABLE 10
Male working population 25-64 years in 1991

	Total unemployment	Unemployment among the unskilled
Belgium	4.7	14.4
Denmark	8.8	13
Netherlands	3.4	12.4
France	6	7.3
Germany	5	10
United Kingdom	7.8	13.4
Austria	3.2	4.7

Source: OECD, Jobs Study

6.4. Towards an efficient social model

6.4.1. Against this background, the ESC therefore advocates making the employment position of unskilled labour one of the central foci of a European job-creation strategy. Priority must be given to improving the qualifications of the unskilled through more sustained efforts at training and an active jobs market policy.

6.4.2. However, such an approach must be backed up by an economic policy in which taxes and quasitaxes are harnessed to providing better job prospects for unskilled workers.

6.4.3. Compared with across-the-board measures for **all** worker categories, such a policy will have a more lasting impact on jobs:

- the chance that a lowering of quasitaxes will lead to a **net rise in wages** is limited compared with a package of across-the-board measures (figures analysed above);
- the jobs created in this way will basically be the result of an improved competitive position in relation to cheap-labour countries, less substitution of labour by capital and an extension of the services sector. There is no danger that the initial impact on jobs will disappear with time, give that a European wage moderation policy has hardly any influence on the **internal** competitive position.

6.4.4. The following sources may be used to finance a reduction in charges geared towards the unskilled:

6.4.4.1. **Compensatory gains.** Although such compensatory gains (more contributions and less spending because of more jobs) will be real, they will not be enough to offset **completely** the fall in quasitax charges. For example, the White Paper estimates compensatory gains as being one-third of the total reduction of charges. Additional measures must therefore be taken to preserve the financial equilibrium of social security schemes.

6.4.4.2. **Shifting of the tax burden.** The basis for social security contributions and revenue must be extended. Social security schemes must aim less at the labour factor (which already bears a fairly heavy burden) and turn more towards alternative financing.

6.4.4.3. **Controls on spending.** A third and final source of financing concerns spending itself. Without touching the essence of social cohesion, as guaranteed by a number of social security schemes in the EU, an attempt must be made to better control real increases in spending. This may be done, for instance, through a systematic analysis of points where systems efficiency can be improved.

6.4.5. **Illustration.** According to the Commission's estimates² an energy tax of 1% of GDP would eventually (after 7 years) lead to no less than 3% more jobs throughout the EU, provided that this cost reduction is neutral in budget terms and specifically channelled to the unskilled and low-paid. Such estimates are, of course, subject to some uncertainty and based on econometric models, but even if the real result is only half that estimated, it would be a big step towards reducing unemployment in the EU. Where taxes on labour hit the workers themselves directly, they have the effect of reducing net disposable income and, with it, purchasing power. In this way private consumption falls and, as a result, economic growth itself is slowed down.

7. Final remark

7.1. This Opinion finishes where it began, with the assertion that the level of unemployment is the most important, most critical and most urgent problem facing the EU today; it is one which threatens not only its prosperity and its unity but its very survival. In this situation, taxation policy and everything else that the EU does must be devoted primarily to the solution of this problem.

7.2. Unless the European Community finds an adequate solution for the tremendous problem of unemployment, its existing social model will be endangered.

Brussels, 5 December 1995.

The President The Secretary-General

of the of the
Section for Economic, Financial Economic and Social Committee
and Monetary Questions

Jean PARDON Simon-Pierre NOTHOMB

² See Study No. 3 "Taxation, Employment and Environment: Fiscal Reform for Reducing Unemployment" in European Economy No. 56, 1994.

.../...

CES 1421/95 fin NL/GW/CH/pm/hm