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AND THE ECONOMIC AND SOCIAL COMMITTEE**

**Tax policy in the European Union -
Priorities for the years ahead**

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1. INTRODUCTION

In recent years, the contribution of tax policy to Community objectives has increasingly been linked to the development of the Internal Market, to EMU and to closer economic integration. In the context of the introduction of the Internal Market, the Community adopted a significant body of legislation on VAT and excise duties in the early 1990s. This however only highlighted the absence of a coherent policy on direct taxation. At the same time, it became clear that, too often, tax proposals were discussed in isolation rather than in the context of wider EU policy.

At the informal ECOFIN meeting at Verona in April 1996, the Commission, contrasting the need for progress in tax co-ordination in the EU with the number of decisions adopted in this area, therefore proposed a new and comprehensive view of taxation policy. Three main, interlinked and mutually reinforcing challenges for the EU were identified:

- the stabilisation of Member States' tax revenues;
- the smooth functioning of the Internal Market; and
- promoting employment.

In developing this approach, the Commission set out the case for greater tax co-ordination within the EU in its Communication of 1 October 1997¹, which paper formed the basis of a debate in the Council on taxation policy on 13 October 1997. Although progress towards greater tax co-ordination has been slow in the three and a half years since then, there have been some important achievements, notably in the direct tax field. In particular, the comprehensive agreement on key elements of the tax package reached at the Council meeting on 26-27 November 2000 was an important step forward towards meeting the above-mentioned challenges.

The efforts to curb harmful tax competition through the Code of Conduct for business taxation and the proposals on the taxation of income from savings will allow Member States to consolidate their tax revenue raising capacities, thus offering scope for reducing the high average tax burden on labour. It is important therefore that the Community sees the various elements of the tax package through to their conclusion. But the Commission believes strongly that there is much more to be done in the area of tax co-ordination. The Community now has the opportunity to put the main addressees of the Internal Market - its citizens and enterprises - centre-stage. Moreover, the world has not stood still since 1996. The increasing globalisation of the economy and the way in which rapid technological developments influence the behaviour of economic operators and the nature of economic activities make a review of EU tax policy even more urgent. The growing gap between the decisions needed in the tax

¹ COM (97) 495 – in particular, paragraphs 3 – 11, which explained the need for tax co-ordination.

field to achieve the goals the Community has set itself and the actual results achieved is therefore worrying.

This Communication sets out the Commission view of the fundamental priorities for tax policy in the European Union in the years ahead. It explains the general approach which, in the Commission's opinion, the Community needs to adopt having regard to wider EU policy objectives, and highlights a number of priorities in specific tax areas. In view of the fact that the legal basis for decisions on taxation will, for the time being, remain unanimity, this Communication also examines whether there are other appropriate instruments that could be used, in addition to legislation, to achieve these priority objectives.

2. THE GENERAL CONTEXT FOR DEVELOPING EU TAX POLICY

The Community is currently facing a number of important challenges, from within - as we complete the existing Internal Market and as Economic and Monetary Union (EMU) is achieved - looking outwards as the EU prepares to enlarge, and as part of the new global economy.

2.1 Recent EU developments

The Lisbon European Council established an ambitious strategic goal for the EU, namely "...to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion". Attaining that goal was a focus of the recent European Council in Stockholm. The tax systems of Member States must be conducive to the necessary market reform: of itself, this requires the Community to place tax policy in a new perspective.

The 2000 Inter-Governmental Conference (IGC) has meanwhile agreed reforms to the Community's institutions that - despite the disappointing outcome of the Treaty negotiations on decision-making for tax issues - will pave the way for enlargement. In the coming years the EU will be welcoming a number of new Member States, each with their own unique tax systems. It is vital that the body of Community tax law is consolidated and stabilised to the largest extent possible before enlargement. Equally, post-enlargement, it will be vital to ensure that taxation does not prevent both existing and new Member States from being able to compete on a level playing field or from extracting the full benefits of the Internal Market.

With the third stage of EMU, the Growth and Stability Pact has increasingly focused the debate on budgetary developments. The Broad Economic Policy Guidelines (BEPGs) have established new challenges for Member States' fiscal policies. A budget that is close-to-balance or in surplus remains a prerequisite for macroeconomic stability. While maintaining these sound budgetary positions, public finances should maximise their contribution to growth and employment. An appropriate balance and sequencing has to be established between reducing public debt, cutting taxes and financing public investment in key areas. Reducing the overall tax burden offers the opportunity to remove disincentives to employment, entrepreneurial activity and growth.

The Commission Communication of 21 December 2000 on the Contribution of Public Finances to Growth and Employment² showed that all in all, the tax reforms implemented over the past three years represent a move in the right direction. Some Member States have made progress in rendering their tax systems more employment-friendly by lowering the fiscal burden on labour, even if overall taxation on labour still remains very high by international standards in many Member States. While the reforms vary in coverage and depth, most Member States are cutting direct taxation on personal and corporate income and in some cases employers' and employees' social security contributions.

The EU policy dialogue has promoted an integrated approach with a greater awareness of policy options and constraints for taxation. Tax cuts should be focused on areas where they have beneficial supply side effects and they should be accompanied by reforms to benefit systems in order to increase growth potential and employment. Emphasis has been put on the need to reduce the fiscal pressure on labour and non-wage labour costs, in particular on relatively unskilled and low-paid labour. This approach is reflected in the BEPGs 2001³ and in the European Employment Strategy⁴, with specific recommendations for each Member State and provision for monitoring at EU level.

It is also essential to get the balance right between cutting taxes, investing in public services and sustaining fiscal consolidation so as to achieve a durable reduction in the overall tax burden.

The Community has not been as successful in promoting common environmentally-friendly tax policies. This is in spite of the political consensus concerning their merit - for example, in many Member States the reductions in direct taxation have taken place in the context of environmental tax reforms, where they have introduced or increased energy or environmental taxes. The recent turmoil following the increase in oil prices demonstrated the need for a coherent Community energy tax policy. The lack of progress risks calling into question the ability of the Community both to meet its commitments under the Kyoto Protocol and, more generally, to take action in this and other politically important policy areas. In this context, the recent Commission Communication, "A Sustainable Europe for a Better World: A European Union Strategy for Sustainable Development"⁵ states that Kyoto is but a first step and that the EU should thereafter aim to reduce greenhouse gases still further, including through the use of ambitious targets for energy taxation. Health and consumer protection concerns also need to be integrated into tax policy – this is already happening in the indirect tax field.

² COM (2000) 846

³ Commission Recommendation for the 2001 Broad Guidelines for Economic Policies of the Member States and the Community. COM (2001) 224, 25.4.2001, pages 11 and 12

⁴ Council Decision of 19.01.2001 on Guidelines for Member States' employment policies for the year 2001, OJ L 22, 24.1.2001

⁵ COM (2001) 264

Lastly, taxation policy has an important part to play in increasing Research & Development (R&D) and innovation within the EU. The Lisbon conclusions call on the Council and the Commission, together with the Member States where appropriate, to improve the environment for private research, R&D partnerships and high technology start-ups by using, among other things, tax policies.

2.2 The global trend towards economic integration and co-operation

At the same time, globalisation and vastly expanded trade and capital flows require Community policies which enhance, not put at risk, the EU's global competitiveness. Technological innovation and, in particular, the development of e-commerce, enhance the mobility of certain forms of economic activity, particularly in the services sector, and the mobility of capital. Businesses in the EU increasingly operate in more than one Member State and there are more international mergers and acquisitions than ever before. In this changing environment, tax barriers to the free movement of capital and tax measures that distort competition must be eliminated. At the same time, EU tax systems must be sufficiently flexible and responsive in order to keep pace with these developments, whilst remaining as simple as possible in order to minimise compliance costs.

Moreover, tax systems must be transparent in order to ensure the right tax is paid at the right time in the right place, and that opportunities for fraud and evasion are minimised. There is a growing international consensus - in the EU and in the OECD - that this can only be achieved through cross-border co-operation and in particular through the exchange of information. Indeed, the last few years have witnessed a move towards closer co-operation between EU Member States, for example in the agreement on principles for exchange of information on savings income and on mutual assistance in recovery of tax claims. In the case of the taxation of savings income, the EU wishes to extend this form of cooperation beyond its borders. To this end, the Commission and the Presidency are currently engaged in discussions with the United States, Switzerland, Liechtenstein, Monaco, Andorra and San Marino about the adoption of equivalent measures to those proposed in the draft Directive.

These are welcome developments. But the potential for co-operation in the field of mutual assistance is far from fully exploited. Increased co-operation would be a major step forward in the fight against tax fraud and result in more efficient tax collection, which in turn would offset any possible losses of revenue from the co-ordinated elimination of tax barriers to the Internal Market. It is precisely for this reason that the Commission considers it important that decisions on proposals in the area of mutual assistance and administrative co-operation are taken in the Council by a qualified majority, as the Treaty already provides (in Article 95), rather than by unanimity (under Article 93 or 94).

2.3 EU tax policy - general objectives

What type of EU tax policy would be compatible with or indeed support Member States' efforts to reform their taxation systems? Clearly, such a policy must, as a priority, serve the interests of citizens and business wishing to avail themselves of the four freedoms of the Internal Market (the free movement of

persons, goods and capital, and the freedom to provide services). It must, therefore, focus on the removal of tax obstacles to the exercise of those four freedoms. Moreover, to the extent that tax systems are used as a tool for allocation, redistribution, and stabilisation objectives, the tax consequences must be clear to the intended economic agents. For both these reasons, tax systems must be made simpler and more transparent. In this context it is important to recognise that, while harmful tax competition must be addressed both at EU level and at the broader international level, notably within the OECD, and the State aid provisions of the Treaty must be respected, some degree of tax competition within the EU may be inevitable and may contribute to lower tax pressure.

Secondly, EU initiatives in the tax field must ensure that tax systems contribute to a higher efficiency in the functioning of the goods, services and capital markets as well as to a properly functioning labour market. This is required to achieve the Lisbon goals. In terms of tax policy, this means that it is necessary to focus on the removal of tax obstacles and distortions, the elimination of inefficiencies linked to the operation of 15 different tax systems within the EU and the simplification of these tax systems to make them more accessible to the taxpayer. It also means ensuring more efficient tax collection, to offset any possible losses of revenue from the co-ordinated elimination of tax obstacles.

Thirdly, as called for in the BEPGs, EU tax policy should continue to facilitate efforts to cut nominal rates while broadening the tax base, thus reducing the economic distortions associated with Member States' tax systems.

These objectives of EU tax policy cannot be sought in isolation and their achievement must be compatible with other general EU policy objectives. In particular, EU tax policy must

- underpin the Lisbon goal for the EU to become the most competitive and dynamic knowledge-based economy in the world;
- support the continued success and development of the Internal Market by allowing, both before and after enlargement, all EU Member States to compete on a level playing field and extract the full benefits of the Internal Market;
- contribute to a durable reduction in the overall tax burden in the EU, by ensuring that a balance between cutting taxes, investing in public services and sustaining fiscal consolidation is preserved;
- reinforce EU economic, employment, innovation, health and consumer protection, sustainable development, environmental and energy policies; and
- support the modernisation of the European Social Model.

2.4 How to achieve these objectives

When discussing the instruments for implementing the general objectives outlined above, one of the questions that is most frequently asked is the extent to which EU tax harmonisation is either necessary or desirable.

It is clear that there is no need for an across the board harmonisation of Member States' tax systems. Provided that they respect Community rules, Member States are free to choose the tax systems that they consider most appropriate and according to their preferences. The level of public expenditure is equally a matter for national preferences as long as this is adequately met by revenues in such a way that budget positions remain close to balance or in surplus. It is essential to underline that in many tax fields harmonisation is neither necessary nor desirable in view of the widely differing characteristics of Member States' tax systems and different national preferences. However, Member States' choices do not take place in isolation and international aspects need to be taken into account. So, for instance, EU tax co-ordination should generally contribute to the coherence of Member States' positions in international fora like the OECD.

But a high degree of harmonisation is essential in the indirect tax field. The Treaty specifically provides for such harmonisation (Article 93), because indirect taxes may create an immediate obstacle to the free movement of goods and the free supply of services within an Internal Market. They may also create distortions of competition. A large number of Directives and Regulations have already been agreed in this area. The Commission's legislative strategy, particularly in respect of VAT as well as environmental and energy taxation, has been clearly established.

As far as taxes on personal income are concerned, the view is that such taxes may be left to Member States even when the European Union achieves a higher level of integration than at present. Nevertheless, Member States must respect the fundamental Treaty principles on non-discrimination and the free movement of workers within the EU. Furthermore, even in this area it may be necessary to co-ordinate national tax systems in order to prevent discrimination in cross-border situations or to remove obstacles to the exercise of the four freedoms (the tax treatment of occupational pensions is a good example of this).

In the case of direct taxation of mobile tax bases, the need for a certain degree of co-ordination has already been recognised, in particular: the exchange of information on savings income; in the Directives in the field of company taxation already adopted (under Article 94 of the Treaty); in the Code of Conduct for business taxation; and in the proposed Directive on interest and royalties. However, it may be necessary to adopt more ambitious approach in the near future. The Treaty (in Article 94) provides for the "approximation" of those direct tax rules that "directly affect the establishment or functioning of the common market". The Commission is examining whether more can be done to tackle direct tax obstacles to the Internal Market, notably in the field of company taxation, while respecting the sovereignty of the Member States. Certainly, further co-ordination of national tax systems in the area of company taxation would help to eliminate situations of double taxation or unintentional

non-taxation as well as the above-mentioned tax obstacles. More analysis is therefore needed, taking into account on the one hand those distortions which could threaten the proper functioning of the Internal Market, and on the other hand the effects of tax competition. The level of taxation in this area is however a matter for the Member States to decide, in accordance with the principle of subsidiarity.

In practice the last few years have seen some progress being made on tax co-ordination at EU level. While the Commission welcomes the trend, it believes further steps can and should be taken along this path. Eight years after the target date for completion of the Internal Market, it is unacceptable that many obstacles remain to the attainment of key Community objectives. Now that the work on the tax package seems to be progressing satisfactorily, increased attention must be paid to the removal of these obstacles. It is high time to put much more emphasis on the concerns of the EU taxpayer. In this respect, a number of specific objectives are outlined in section 3 of this Communication.

Moreover, while it remains the Commission's view that a move to qualified majority voting at least for certain tax issues is indispensable, the legal basis will, for the present, remain unanimity. Given the difficulties in reaching unanimous decisions on legislative proposals, which will be compounded by enlargement, the Community should also consider the use of alternative instruments as a basis for initiatives in the tax field. The full range of possible mechanisms is discussed in section 4 of this Communication.

3. EU TAX POLICY – SPECIFIC OBJECTIVES FOR THE YEARS AHEAD

3.1 Indirect taxation

In the Commission's view a high degree of harmonisation of indirect taxes is necessary, as provided for in the Treaty. The proper functioning of the Internal Market requires VAT and excise systems that are efficient and fully reflect the needs of EU businesses and consumers. The continued existence of a variety of derogations in both the VAT and excise duty fields is unhelpful in this context. In addition, it is important to ensure full consistency between indirect tax systems and the Customs Union for the movement of goods, both in relation to the EU's external border and to the abolition of internal borders. The Commission intends to examine this issue further and, if appropriate suggest legislation.

3.1.1 Value added tax

In the VAT field, the Commission has for a long time been working intensively to try to achieve the improvements in the VAT system which are necessary to adapt it fully to the needs of the Internal Market. The 1987 proposal for an origin based common VAT system was made precisely with the objective of achieving a true "Single Market" in which intra-Community sales and purchases of goods would be treated in the same way as those taking place within the Member States. However, by the time of the abolition of border controls on 1 January 1993, the origin based system had not been achieved and therefore a

transitional system involving taxation in the country of consumption, at the rates and under the conditions applicable in that country, was retained. This transitional system has a number of defects, notably because it is complicated, susceptible to fraud and out of date.

In 1996, the Commission proposed a programme involving a stage by stage movement to the definitive origin system and a number of proposals have been made since in this context. However, it has become evident in the last few years that, because of the importance of VAT for tax revenues, most Member States are reluctant to agree to proposals designed to lead towards the definitive system. They are not prepared, at this stage, to accept any further harmonisation of rates and structures, or the re-distribution of tax receipts, which the definitive system would require, for fear of suffering a loss of tax revenues.

In view of these difficulties, in June 2000 the Commission proposed a new strategy⁶, which was widely welcomed by the Member States when presented in the Council. This current strategy concentrates on bringing about an overall improvement in the operation of the current VAT system that would directly benefit EU taxpayers, although an origin based definitive system remains a long term Community goal. The current strategy focuses on simplification, modernisation and a more uniform application of present arrangements, and closer administrative co-operation. These will both encourage legitimate commercial transactions within the Internal Market and prevent fraud. So long as the present system of VAT-based Community own resources is in existence, closer administrative co-operation and the other measures aimed at preventing fraud will help to maximise the VAT base and thereby ensure that this tax plays the full part in providing income that Community budgetary rules intended.

Existing proposals have been reviewed in line with this new strategy and new proposals have been and will be made. This has resulted in the recent adoption by the Council of two proposals (concerning the abolition of fiscal representatives⁷ and the minimum level for the VAT standard rate⁸), and also in a political agreement by the Council on the proposal concerning the improvement of mutual assistance on the recovery of claims⁹. Of particular importance is the first proposal made after the new strategy was announced - the proposal to modify the rules applying VAT to certain services supplied by electronic means¹⁰. This proposal has the principal objective of protecting EU competitiveness by eliminating a major disadvantage for EU service providers relative to their non-EU competitors. Linked to this is the proposal recently presented by the Commission on invoicing¹¹, which is designed to cut red tape

⁶ COM(2000) 348

⁷ Council Directive 2000/65/EC of 17 October 2000 amending Directive 77/388/EEC as regards the determination of the person liable for payment of value added tax

⁸ Council Directive 2001/41/EC of 19 January 2001 amending Directive 77/388/EEC as regards the length of time during which the minimum standard rate is to be applied.

⁹ COM (1998)364

¹⁰ COM(2000)349

¹¹ COM(2000)650

for European traders and to make it possible to use electronic invoicing and storage so as to improve competitiveness and promote electronic commerce.

An action programme has been put in place in relation to the above proposals. Following that programme, the Commission intends to carry on with the work on existing proposals (change of status of the VAT Committee¹², the right of deduction and the 8th Directive¹³, e-commerce and invoicing) as well as to present new proposals, focusing on the recasting of the Sixth Directive, the place of supply of goods, and on travel agents. Some of this work is already under way. Further work is also being undertaken in respect of financial services and in the field of subsidies/activities of public authorities/services as well as co-ordination of customs and taxation policies. It is important that the proposals made and those planned take effect rapidly and that the Commission monitors progress in the implementation of this new strategy. As for VAT rates, a review and rationalisation of the rules and derogations applying to the definition of reduced VAT rates should be considered in the medium term, but not before the end of 2002. This will be after the evaluation of the pilot project introduced by the Directive (1999/85/EC) on labour intensive services¹⁴. Particular attention will be paid to the rates applying to virtual products compared with traditional products and the use of reduced VAT rates in Community policies (e.g. to help protect the environment and promote employment).

3.1.2 Excise duties

In the field of excises, general definitive arrangements govern the holding, movement and monitoring of products subject to excise duty. The arrangements apply to alcoholic beverages, manufactured tobacco and mineral oils, and allow goods to be moved with suspension of excise duty and without checks at intra-Community frontiers. Minimum rates of taxation have existed since 1992 for these products¹⁵. However, there are highly differentiated excise duties between Member States above these minimum rates, a situation which creates serious obstacles to cross-border trade in the case of a number of goods.

Energy and environmental taxation

Generally, taxation has proved to be an efficient economic instrument for tackling environmental problems. It is a crucial instrument in meeting the commitments of the Kyoto Protocol and has the potential for providing an effective stimulus for policies to dissociate energy use from economic growth, to improve energy consumption patterns and to develop renewable energy sources, like biofuels, as pointed out in the Green Paper on the security of

¹² COM (1997)325

¹³ COM (1998)377

¹⁴ Council Directive 1999/85/EC of 22 October 1999 amending Directive 77/388/EEC as regards the possibility of applying on an experiment basis a reduced VAT rate on labour-intensive services

¹⁵ Council Directive 92/12/EEC of 25 February 1992 on the general arrangements for products subject to excise duty and on the holding, movement and monitoring of such products

energy supply in Europe¹⁶. Currently, the taxation of energy builds on three pillars: (i) excise duties, (ii) VAT and (iii) specific levies. Whereas excise duties on mineral oils and VAT constitute Community systems of taxation, no EU-wide framework is applicable to energy products other than mineral oils.

As regards mineral oil products, since 1992 a unanimously agreed Community system provides for a minimum excise rate for each product according to its use (propellant, industrial and commercial uses, heating purposes). Today, however, excise duties are often levied at rates that are significantly higher than the minimum rates, which have not been updated since 1992. Effective excise rates thus differ substantially between Member States. Zero taxation is compulsory for some activities (international air traffic) and national derogations can also be granted for specific policy reasons in favour of, for instance, environmentally-friendly products or economic sectors (agriculture, public transport, road haulage). In many cases, the above-mentioned derogations are granted in order to maintain the competitiveness of local companies when higher energy/environmental taxation schemes are implemented. Moreover the multiplication of national taxes that differ in their scope, methods of calculation, rates, etc. jeopardises the unity of the Internal Market and might negatively affect the functioning of the liberalised gas and electricity markets.

The current mechanisms at both national and Community level thus lead to possible distortions in the consumer choices between energy sources or products and in the conditions of competition. A Community framework for facilitating the approximation of the taxation schemes of Member States would offer the most efficient remedy to these difficulties.

Against this background in 1997 the Commission proposed a Council Directive for restructuring the Community Framework for the taxation of Energy Products¹⁷, with a view to extending the scope of the Directives on mineral oils to a number of other energy sources, e.g. coal, electricity and natural gas, and to increasing the Community minimum excise duties on energy products. In aiming at the gradual introduction of the “polluter pays” principle, this proposal would make it possible to both restructure national tax systems, achieve certain policy objectives in the field of employment, environment, transport and energy, and improve the functioning of the Internal Market. One key element of the proposal is the recommendation that Member States, when implementing the Directive, should avoid any increase in their overall tax burden. Macroeconomic research suggests that a structured reform, involving the introduction of “green taxes” and reducing the tax burden on labour can, under certain circumstances, lead to a double dividend, conferring benefits on both employment and the environment.

After a four-year stalemate in the Council, it is essential that progress is now made on the above-mentioned proposal, even if unanimity cannot be obtained.

¹⁶ COM(2000)769

¹⁷ COM(1997)30

The weaknesses of the current situation have once again been exposed by the range of different measures adopted by Member States, in particular in the road haulage sector, in response to the increased oil prices in 2000. It demonstrates once again that a common framework for the taxation of energy products should be established, not only on the structure of such taxes but also in relation to tax rates. This will prevent distortions in the Internal Market, ensure that prices of energy products reflect their external environmental costs and assist the Community to meet its international environmental commitments.

The shift towards environmental taxes has clearly been a very slow one. A common framework including differentiated rates according to environmental objectives could be very useful. The aforementioned Commission Communication on an EU Strategy for Sustainable Development calls on the Energy Products Directive to be adopted by 2002. An agreed Community framework for energy taxation could help to pave the way for more ambitious environmental targets for energy taxation within two years of the adoption of the Directive, aiming at the full internalisation of external costs.

Vehicle taxation

In accordance with the Commission's 2001 work programme, it is intended to present towards the end of this year a Communication on vehicle taxation in the EU. The intention in so doing is to launch a discussion on future options for action at Community level in the field of vehicle taxation. Recommendations will also be made concerning the problems of double taxation in this area. At present, for example, there is no co-ordination concerning registration taxes for passenger cars. In eleven Member States, a person who purchases a car will be required to pay a registration tax. If that person then moves to live and work in another Member State, it is necessary to re-register the car on local number plates and, in at least eleven of the Member States, to pay a further registration tax there, with no system of refunds or reliefs for registration taxes paid in the first country. In addition to the registration tax, highly differentiated systems of vehicle taxation also cause several problems from the perspective of the free movement of goods. The Commission will examine whether any of these problems constitute breaches of the provisions of the Treaty, and take steps as necessary. Approximation of vehicle taxes should in any event be encouraged, especially in view of the enhanced transparency of vehicle prices following the introduction of the Euro.

The possibility of restructuring registration and circulation taxes in an environmental direction will also be examined. This restructuring could be made in a way, which would promote vehicle taxation differentiation, based on the CO₂ polluting effect of each new passenger car put in circulation. The Commission's work in this area will be based notably on input from other Community Programmes, and in particular the Community strategy on CO₂ Emissions from Cars, the Auto Oil II Programme and the European Climate Change Programme. It should contain a number of options for future action, which would take into account the Community's environmental objectives, and in particular those included in the Kyoto Protocol.

In line with the objective of ensuring the smoother functioning of the Internal Market and the wider objectives of the Treaty, the Commission services have to prepare reports and proposals concerning the Community's minimum levels of excises on alcohol and tobacco. A report and proposal on tobacco taxation has been adopted recently by the Commission. At present, prices and excise rates for tobacco products in the EU still vary considerably between Member States (e.g. for cigarettes, the excise duty in the highest taxing Member State is four times the amount charged by the lowest taxing Member State). The measures proposed should enhance convergence between the tax levels of the different Member States and restrict fraud and smuggling within the Internal Market. Particular attention is also given to health protection aspects and to the relationship between such protection and the price of these products. As regards the report on excise duty levied on alcohol and alcoholic beverages, the Commission services are in the process of consulting Member States and trade associations concerned on the issues to be dealt with in the report. These issues are the proper functioning of the internal market, competition between the different categories of alcoholic drinks, the real value of the rates of duty and the wider objectives of the Treaty (such as health and agricultural policy). The Commission intends to adopt the report on alcohol taxation later this year.

3.2 Direct Taxation

3.2.1 The international framework

Section 2.2 of this Communication highlighted the importance of the international dimension in considering the development of EU tax policy. This is particularly relevant in relation to direct taxes, where globalisation has had the most significant impact. To work effectively, a global economy needs some acceptable ground rules to guide governments and business. The overall aim of the major world economies, including those of the EU Member States, has been to work towards a fiscal climate which promotes free and fair competition and is conducive to cross-border business activity, while at the same time ensuring that national tax bases are not eroded. The work on tackling harmful tax competition, both in the OECD and also in the EU through the tax package, has been central to this aim in the last few years.

Considerable progress has been made in identifying harmful tax practices and agreeing timetables for their elimination. It is also becoming clearer which non-EU jurisdictions are prepared to co-operate with the international consensus on fair tax competition, and which are not. In the coming months, OECD members will be examining what co-ordinated defensive measures might be taken against non-cooperative jurisdictions. The Community should play a leading role in taking forward this work, notwithstanding that the United States is reviewing its position. However, in the case of EU Member States, any such measures must be compatible with the Treaty. Beyond the question of agreeing appropriate defensive measures, the Community also needs to consider the coherence of all its policies towards both cooperative and non-cooperative jurisdictions. For example, Community policies on development aid and on access to EU markets should have the effect of encouraging and rewarding co-operation with the fair

tax competition agenda. The Commission intends to study how such coherence can be achieved.

Of course, the work of the OECD in the direct tax field extends far beyond the harmful tax competition agenda – it has pioneered work on eliminating double taxation, developed guidelines on transfer pricing, and there is also emerging work on the company taxation of e-business. The Community has a special status at the OECD, as a full member but without voting rights, and in that capacity the Commission represents the Community's interests as a whole. At the same time, however, Member States often do not exchange views on tax issues discussed within the OECD before taking a position. This sometimes leads to unsatisfactory results, as the Community is unable to take a coherent position or to exploit its full potential where it has a common interest. Therefore, in the Commission's view, it should be explored whether, without making any changes to the institutional framework, including Member States voting rights, co-ordinated views in OECD tax debates might be established across the Member States. Such an approach would be desirable given that EC law and the jurisprudence of the European Court of Justice inevitably affects what positions the Member States are able to take.

3.2.2 Company taxation

An important objective for the Commission in the direct tax field is to ensure that EU company tax systems cater for the increased cross-border activity and modern organisational structures of companies. To this end, the Commission services are currently in the process of preparing a study of company taxation in the EU. The intention is to present a Communication on the results of the study and the related tax policy implications shortly. As requested by the Council on 22 July 1999, the study: "will be undertaken in the general context of the Vienna European Council conclusions emphasising the need to combat harmful tax competition whilst taking into account that co-operation in the tax policy area is not aiming at uniform tax rates and is not inconsistent with fair tax competition, but is called for to reduce the continuing distortions in the Single Market also in view of stimulating economic growth and enhancing the international competitiveness of the Community, to prevent excessive losses of tax revenue or to get tax structures to develop in a more employment-friendly way. This study will also be undertaken on the basis of the ECOFIN Council conclusions asking to illuminate existing differences in effective corporate taxation in the Community and the policy issues that such differences may give rise to. The study should also highlight remaining tax obstacles to cross-border economic activity in the Internal Market.

"The study will analyse differences in effective levels of corporate tax in Member States, taking into account, inter alia, the results of the report of the Ruding Committee (1992). Attention should be given to the influence of corporate tax bases on effective levels of taxation. Moreover, the study should also identify the main tax provisions that may hamper cross-border economic activity in the Single Market. On this basis, an assessment should be undertaken of the effects on the location of economic activity and investment. The Commission should highlight the tax policy issues involved in reducing tax-induced distortions and examine possible remedial measures, taking account of

the respective spheres of competence of the Member States and the Community.”

Taxation is an important factor that companies consider before making location choices, but is only one among many such factors. The geographical accessibility of markets, the existing infrastructure, transport costs, environmental standards, the availability and the quality of the workforce, wage levels, social security systems and the overall attitude of its government all play an important role too. Of course, which of these factors are relatively the more important very much depends on the individual type of investment decision.

At present, cross-border activities of companies give rise to numerous cases of discrimination, double taxation, excessive administrative costs owing to complicated administrative procedures and delays in tax refunds. There are a number of cases, for example, of European multinationals that have had to wait more than five years for the tax authorities of two Member States to agree on transfer prices on cross-border exchanges of services. Then there are the tax issues involved in re-organisations of companies. This type of re-organisation is often accompanied by cross-border mergers and acquisitions, which currently result in a combination of one-off and ongoing tax costs. The tax treatment of European companies must also be addressed following the recent agreement on the European Company Statute. Current EU tax legislation and proposals for legislation will have to be amended to include European companies. The need for a common European tax system as an option for these companies has also been emphasised by industry representatives.

On the basis of this company tax study, the Commission will be in a better position to consider what changes it should propose. One of the important questions that the study will raise is whether the Commission's approach should continue to be to attempt piecemeal solutions to tax obstacles while leaving the 15 different corporate tax systems in the EU (and their associated costs) to continue to co-exist. The alternative would be to pursue more comprehensive, politically ambitious solutions such as providing companies with the option for a single set of rules on the corporate tax base for their EU-wide activities. Under a mutual recognition approach – for example the approach of taxation according to the rules of the residence country (the so-called ‘Home State Taxation’ approach) - these could be the existing national rules; otherwise, new common rules would need to be devised at EU level. Economic operators support this kind of more comprehensive pan-European solution to the elimination of cross-border tax obstacles. This would constitute a very ambitious and far-reaching step touching on fundamental issues of EU tax policy; among other things, it would increase the overall economic importance of corporate tax rates. EU enlargement will also add a new dimension to this development.

Whichever solution is pursued, it is clear that the removal of the tax obstacles will reduce compliance costs and incidences of double taxation, thus generating efficiency gains in the Internal Market and stimulating economically beneficial cross-border operations. This would be a substantial contribution towards improving the competitiveness of EU business.

3.2.3 *Personal income taxation*

As pointed out in section 2.3, personal income taxes fall in their entirety under the sole responsibility of Member States and co-ordination at EU level only becomes necessary to prevent cross-border discrimination or obstacles to the exercise of the four freedoms. In particular, co-ordination of personal income taxes may in some areas be needed to avoid double taxation or unintentional non-taxation in cross-border situations, or to tackle cross-border evasion. The Commission proposal for a Directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community¹⁸ is probably the best example of the latter.

In its Recommendation of 21 December 1993 on the taxation of certain items of income received by individuals in a Member State other than that in which they are resident¹⁹, the Commission proposed a Community system for taxing income of persons having their fiscal residency in one Member State but carrying out their activities in another. In essence this recommendation seeks to avoid the double-taxation of the income of frontier workers. The main feature is that non-resident persons benefit from the same tax-treatment as residents, if they obtain 75 % of their total income in one Member State; in such situations, the Member State of residence would be allowed to reduce the personal tax advantages correspondingly. The recommendation has been largely taken on board by the European Court of Justice (ECJ) in the Schumacker case (C-279/93) and most Member States have since changed their legislation accordingly.

The recommendation only addressed one specific problem in the context of personal income taxation and is far from resolving either the numerous other problems of non-residents in the field of taxation or the inter-relation between taxation and social security. As the growing number of cases before the ECJ reveals, new problems can be expected to arise. If the problem of cross-border issues relating to personal income taxation is not to be completely left to the Court to resolve, greater co-ordination at EU level appears necessary.

An issue of more recent concern is regimes for highly qualified so-called expatriate staff. Several Member States with relatively high personal tax rates have introduced low-tax regimes for this group of employees, usually in the form of a flat-rate tax, as a means to attract specific categories of skilled workers and experts. Although, after examination, considered not to constitute State Aid, such schemes not only raise significant equity concerns when seen in comparison to the taxation of other resident taxpayers, but may also lead to a tax-driven "brain-drain" from other Member States. These will in turn feel the pressure to introduce comparable schemes. A number of Member States and the Commission considered in 1997 that such arrangements could come within the range of problems covered by the Code of Conduct for business taxation, and that accordingly this question should be considered with a view to a possible extension of the scope of the Code under the review procedure. While it would

¹⁸ COM (1998) 295

¹⁹ 94/079/CE

be premature to judge on this latter suggestion, the Commission believes that such schemes have a clear EU dimension and have the potential to be harmful. Moreover, they run against the above-mentioned generally accepted policy recommendation to lower the general taxation of low-skilled labour.

3.2.4 Taxation of pensions

On 19 April 2001, the Commission adopted a Communication on the elimination of tax obstacles to the cross-border provision of occupational pensions²⁰, which proposes an overall approach to current problems in this field. At present, Member States often do not allow tax relief for contributions to pension schemes in other countries. This means that employers and employees in one Member State cannot take out pensions with a provider in another Member State. This causes particular problems for the growing number of workers who begin their working life and start contributing to a pension fund in one Member State and thereafter move to work in another. There is also the problem that Member States differ in how they tax pensions. Some give tax relief for pension contributions and then later tax occupational pension receipts. Others do not give tax relief for pension contributions but, instead, do not tax pension receipts. This may lead to either double taxation or double exemption for individuals who work in one Member State and retire in another. To avoid these difficulties, companies operating in more than one Member State are frequently forced to set up pension arrangements in each State where they have employees, at significant additional cost.

The Communication complements the Commission's proposal for a Pension Fund Directive of 11 October 2000, which does not deal with tax issues. The Communication sets out how the Treaty rules on workers and services apply in the area of pensions and demands the swift removal of any discrimination in Member States' tax laws against cross-border pension provision. The Communication also includes proposals designed to protect Member States' tax revenues where pension provision is made across borders. Third, the Communication raises the more deep-seated issue of double taxation and non-taxation arising from the mismatch of tax systems i.e. pensions being taxed when the contributions to those pensions were not tax deductible (or not being taxed where the contributions were deductible). This problem could largely be overcome by convergence of pension arrangements. However, given the present diversity of these arrangements, the Communication explores to what extent such problems could be addressed in the context of existing systems and the existing legal framework.

3.3 Tackling tax fraud – direct and indirect taxes

Both in the area of direct and indirect taxation tax fraud is a phenomenon of growing concern to EU Member States but also globally. On 28 January 2000, the Commission produced a report²¹, which proposes tackling fraud by

²⁰ COM(2001) 214

²¹ COM(2000) 28 - report under Article 14 of Regulation (EEC) No 218/92 and article 12 of Regulation (EEC, Euratom) No 1553/89 to the Council and the European Parliament

improving administrative co-operation. Within the Council, in 1999 an ad hoc working party was charged

- to assess the current situation concerning tax fraud,
- to study possible weaknesses in existing Community rules and control systems, and the efficiency of existing administrative co-operation arrangements for dealing with tax evasion and fraud in the areas of both indirect and direct taxation, and
- to examine the possibility of improved administrative co-operation in these areas, making suggestions for any new arrangements or measures it considers appropriate.

At its meeting of 5 June 2000, the Council took the view that the recommendations of the ad hoc working party were a useful basis for future work by the Commission and the Member States in the fight against tax fraud. The recommendations can be grouped into 3 categories:

- those which fall within the competence of the Commission (these centre on increasing administrative co-operation, mutual assistance and exchange of information between Member States);
- those that fall solely within the competence of the Member States and which require action to be taken (e.g. to optimise control selection methods on the basis of risk analysis); and
- those which require Community action other than legislation (e.g. to study the possibility of amending the VAT Information Exchange System).

For its part, the Commission will follow up the recommendations concerning VAT by:

- strengthening existing Community legal instruments on administrative co-operation. The Commission will present to the Council and the European Parliament, in the first half of 2001, a proposal for a Regulation and an amending Directive to increase administrative cooperation between Member States in order to combat VAT fraud. It will also present , during the course of 2001, a proposal for a Regulation of the Council and the European Parliament which will allow the Member States to receive assistance from the Commission in the most complex cases of fraud;
- examining closely the action taken by Member States; and
- taking all necessary initiatives to implement the recommendations that require Community action other than legislation, either in the Standing Committee on Administrative Cooperation or in the Commission-chaired VAT Anti Fraud Subcommittee.

In the field of excise duties, in order to prevent fraud and to simplify procedures for operators the Commission intends to present a proposal for the introduction

of a computerised Excise Movement and Control System ("EMCS") between Member States.

In the field of direct taxation, in order to reduce fraud the Commission will present appropriate initiatives following up the report of the ad hoc working party after further discussions with Member States.

3.4 Achieving the tax policy objectives in the enlargement process

The enlargement process should not be ignored when considering the objectives of EU tax policy. The candidate countries' ability to take on the obligations of the *acquis communautaire* leaves certain issues open for negotiation. For the vast majority these issues relate to some of the fundamental cornerstones of the tax *acquis*. Where such issues are considered to jeopardise the proper functioning of the Internal Market or may even lead to significant distortions, the Commission will recommend, in line with existing negotiation principles, that the Council does not grant transitional periods. Increasingly, however, EU tax policy development is taking account of the prospect of enlargement. Thus, for instance, it was agreed at the European Council in Santa Maria Da Feira in June 2000, in respect of the proposal for a Directive on savings taxation, that no derogation from the exchange of information requirement should be granted to the candidate countries in the enlargement negotiations. Candidate countries are also expected to respect the principles of the Code of Conduct for business taxation; all of the current candidates have in principle undertaken to do this.

4. MECHANISMS TO ACHIEVE THE OBJECTIVES

4.1 The decision process

The Commission has traditionally relied mainly on making proposals for Directives, and in some cases Regulations, as a way of achieving progress in the tax field. Directives and Regulations have as advantages that they are adopted only after full discussion in the Council, the European Parliament and the Economic and Social Committee, and that they offer legal certainty because they may be enforced by the ECJ.

However, the pace at which proposals for Directives in the tax field are agreed has been disappointingly slow. There are currently 16 Commission proposals for Directives in the taxation domain on the Council's table. Some of these have been on the table since the early nineties. It is hoped that, in the VAT area at least, a greater willingness will be shown by Member States to adopt new and outstanding proposals, as a result of their agreeing to the current strategy. Nonetheless, in the context of rapid economic and technical change, where the need to adapt and modernise legislation quickly is apparent, the Commission intends to make more use of the implementing powers conferred on it by the Council as provided for in the Treaty.

The disappointing progress in the field of taxation has given rise to discussions about the way in which the EU institutions handle tax issues. Ideas have surfaced and are being discussed about the possible creation of a new body to

co-ordinate tax issues in the framework of the Council. While these discussions are in themselves a welcome demonstration of the increased political profile of tax issues at EU level, it is the insufficient political will combined with the unanimity requirement rather than the existence of one body or another that are the main obstacles to progress. Any proposal of this nature should therefore respect the institutional structure and methods of the Community. The Commission will contribute to further discussions of this issue.

As noted above, it remains the Commission's view that a move to qualified majority voting at least for certain tax issues is indispensable. Since the legal basis will, for the present, remain unanimity it will, after enlargement, be much more difficult to have any new Community legislation agreed. So where legislation is not absolutely essential (notably in the direct tax field), other methods will have to be found to achieve progress in removing tax obstacles and distortions to the Internal Market, which taxpayers have a right to expect.

4.2 The Commission's role as guardian of the Treaty

A different means of removing tax obstacles to the smooth functioning of the Internal Market is to make more, or more carefully focussed, use of infringement proceedings. It is clear from the above examples of tax obstacles and many others which have not been cited that there are a number of areas (the taxation of companies and collective investment vehicles, for example) where Member States' tax rules may contravene either the Treaty or existing Community legislation. While the Commission regularly submits its observations to the ECJ in tax cases brought by individual taxpayers, it has itself brought only a limited number of infringement proceedings against Member States in the area of direct taxation. However, the rapid development of EC case law in the direct tax field over the last few years through cases brought by individual litigants has highlighted the need for more Commission action.

The different levels to which case law has developed in the indirect and direct tax fields can be largely explained by the different degrees of Community competence in these areas. However, it is also true that Court actions involve high costs for both taxpayers and administrations. Moreover, in many instances the general application of a specific case in an individual Member State is not entirely clear. The current legal approach also tends to be asymmetrical in its effects in that, even where a ruling forces a number of Member States to introduce new tax rules they often do so in vastly differing ways. The Commission has a role here in proposing a common response to such rulings, including where necessary through Community legislation. The Commission also plays an important role in ensuring that ECJ rulings are respected and properly implemented by Member States.

Beyond this, however, it is clear that the Commission cannot, as guardian of the Treaties, be lenient on infringements in the tax field. The Commission Communication of 26 July 2000, "Matching the Commission's activities with its human resources"²², advocated a strengthening of the Commission's efforts in its

²² SEC (2000) 2000

role as guardian of the Treaties. It specifically identified work in the tax and customs fields as a key element of that activity. In this context, it may also be recalled that Article 96 of the Treaty provides a legal basis for the Commission to take action to deal with distortions of the conditions of competition in the Internal Market, including proposing directives, which may be adopted by qualified majority.

Since both direct and indirect tax measures may fall under the State aid provisions of the EC Treaty, the Commission pays close attention to them and will continue to take steps to ensure the Treaty is respected. As regards direct taxes, in its 1998 Communication on the application of State aid rules to measures relating to direct business taxation²³ the Commission has explained in detail the criteria it uses in this area.

In short, the Commission now intends to adopt a more pro-active strategy generally in the field of tax infringements and be more ready to initiate action where it believes that Community law is being broken. It will also ensure the correct application of judgements of the ECJ. There is a particular imperative in the direct tax field: the current approach of leaving the development of case law in the area of direct taxation to chance by simply reacting to cases taken by taxpayers to the ECJ is not a proper basis for progress towards agreed Community objectives.

4.3 Broadening the range of policy instruments

The use of non-legislative approaches or "soft legislation" may be an additional means of making progress in the tax field. For example, peer pressure, which is the basis of the Code of Conduct for business taxation, could be applied in other areas. Other instruments - notably Commission recommendations, which have been used in the past - but also guidelines and interpretative notices could also be considered. Such non-legislative approaches should, to the largest extent possible, involve the European Parliament through the existing mechanisms for the consultation of Parliament.

The use of non-legislative or soft law approaches could be particularly effective in cases where they have a firm legal foundation, based on the Treaty and the case law of the Court of Justice. In such cases, instruments such as Communications, recommendations, guidelines and interpretative notices can provide guidance to Member States on the application of the Treaty principles and promote the rapid removal of obstacles to the Internal Market. The use of such instruments can also address, at least to a certain extent, the above-mentioned problem of the asymmetry of a legal approach. This is because, first, these instruments can point to potential legal problems and indicate possible ways forward for dealing with them in order to avoid legal conflicts or even litigation. Second, these instruments can contribute to the development of new tax rules when the Court has found the old ones unlawful. The Pension Communication is just such an example. A further example of an area where this approach could be applied would be that of the bilateral tax treaties which

²³ OJ C384 of 10.12.1998, p.3

Member States conclude with each other and with third countries. In a way, the Recommendation on the taxation of non-residents of 1993 represents a forerunner to the use of soft-law.

The downside of using soft law approaches is, however, that they can be very resource-intensive and also they are not directly enforceable in legal terms.

4.4 Enhanced co-operation

The possibilities introduced by the Amsterdam Treaty and developed by the Nice Treaty for closer co-operation between sub-groups of like-minded Member States could also be envisaged in certain cases. In particular, this could be used in tax policy areas where, even in the long term, decisions in the Council are taken by unanimity. These must be self-contained policy areas so that Member States cannot pick and choose between policies as best suits them. The decision at Nice will enable the Commission to propose to the Council that as small a group as eight Member States may co-operate more closely, after approval within the Council by qualified majority. However, in line with the principles agreed at Nice, this approach must not, among other things, undermine the Internal Market, constitute a barrier to or a discrimination of trade, distort the conditions of competition, or affect the competences, rights and obligations of the non-participating Member States.

In the field of direct taxation, co-operation between Member States has been organised mainly through bilateral tax treaties. The enhanced co-operation could be targeted so as to produce such benefits for the participating countries that non-participants would be motivated to become involved.

As regards indirect taxation, the possibility of enhanced co-operation could provide a way forward in the area of environmental and energy taxation. A majority of Member States have indicated their strong desire to make progress in this area.

5. CONCLUSION

The Community must, in addition to continuing the important fight against harmful tax competition, ensure that tax policy underpins the Lisbon goals, supports the continued success and development of the Internal Market, contributes to a durable reduction in the overall tax burden, reinforces other agreed EU policies and supports the modernisation of the European Social Model. In recent years, there has been an increased trend towards closer cooperation on tax policy. The priority now is to ensure the smooth functioning of the Internal Market and EMU. In particular, the EU must focus on the practical problems for individuals and businesses operating within the Internal Market, and the level of co-ordination between Member States necessary to deal with these problems. This work must be accompanied by steps to assist Member States in combating fraud and tax evasion. Double taxation due simply to the cross-border nature of economic activity cannot be accepted, but its elimination should not create opportunities for tax avoidance and evasion. Neither should

any greater co-ordination of Member States' tax systems give rise to unintentional non-taxation.

A number of specific tax policy objectives have been identified in this Communication, which the Commission will pursue. Most notably:

- The Commission has established a clear VAT legislative strategy for the next five years. The Commission will push for this strategy to be implemented rapidly in the Council.
- In view of the urgent need for more approximation of Member States' laws in the area of environmental and energy taxation in the EU, all possible ways forward for making progress will be thoroughly examined by the Commission.
- Both for health protection reasons and to restrict fraud and smuggling in the internal market, the Commission has proposed measures which enhance convergence between the excise duty levels in the Member States on tobacco, and is consulting in relation to excise duty on alcohol.
- In the corporate tax area, the question that is increasingly being asked is how extensive co-ordination should be. The debate is whether, with increasing cross-border activity, tax obstacles can continue to be tackled by piecemeal approaches that leave national company tax systems intact. While the Commission acknowledges that the setting of corporate tax rates falls within the exclusive competence of Member States, a more ambitious approach might be a more comprehensive solution such as a common set of rules for company taxation. The study on company taxation will assist the Commission in arriving at a view on this fundamental issue.
- It is very necessary to eliminate tax obstacles to the cross-border provision of occupational pensions, an issue addressed in the recent Commission Communication on pensions taxation. To achieve this objective, the Commission will actively monitor Member States rules in this area and take action where necessary.
- It remains the Commission's view that a move to qualified majority voting at least for certain tax issues is indispensable, and in particular when there are serious distortions of the Internal Market, but the legal basis will, for the present, remain unanimity. So, while Community legislation on taxation will continue to play an important role, the Commission believes that, in pursuing tax policy objectives, all available mechanisms should be pursued, in particular:

a more pro-active, well-focused and even-handed use of infringement proceedings in the tax field is now required;

careful consideration should be given to an increased use of non-legislative solutions and to the mechanism of enhanced co-operation.

The problems and obstacles highlighted in this Communication cannot be allowed to continue if the European Union is to meet the challenge of globalisation and the objectives set by the Treaty and by recent European Councils. The Commission, fully respecting the subsidiarity principle but having regard also to the requirements of the Internal Market and to its own role as guardian of the Treaties, will therefore energetically pursue the avenues of tax policy co-ordination identified in this Communication.