EUROPA briefing

European taxes: Do we need them?

In the European Union, each member state is responsible for its tax system. Different national regimes help with tax competition, but can also lead to tax evasion or unfair rules in the Single Market. That is why better coordination or even standardisation of taxes is debated. What tax regulations are there already in the Single Market? What would be the advantages and disadvantages of a European tax? And what reforms are being discussed in Europe?

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Why are taxes a European issue?

The member states in the EU determine their tax regime. That is why the individual types of taxes and tax rates differ. The corporate tax rate in Ireland is only 13 percent, for example, while in France, it is almost three times higher at 34 percent and in Germany it is 30 percent and thus clearly above the EU average of 23 percent.

This tax competition inside the EU has advantages and disadvantages. Advocates of different tax rates argue that it is especially important for smaller member states. Countries such as Ireland, with a smaller labour market, would be less attractive than other locations without such an advantage. Critics fear by contrast that excessive tax competition could lead to a downward spiral with lower and lower tax rates, also known as a race to the bottom, where ultimately companies profit and the availability of public goods such as education may be jeopardised.

The EU must simultaneously establish fair competitive conditions in the Single Market. National tax systems may not distort competition, for example by providing unfair fiscal benefits for domestic companies. This is often referred to as a ➔ **level playing field.** At the same time, the European Commission must also take care that member states are globally competitive.

National taxes are also used for financing the EU budget. This occurs indirectly through member state contributions. The European Treaties do not currently allow the EU to levy taxes directly. However, this rule could be amended with a view to reforming the complex EU financing system and closing the ➔ **Brexit gap**.

Even if taxes are solely a matter for member states, that could change in future. At least two issues, the Single Market and financing the EU budget, speak in favour of coordinating national tax policies through European regulations.

➔

Level playing field
For the European Single Market to function properly, all must be subject to the same rules. It is hard to find the right balance. Too much harmonisation will hurt competition; too little will lead to unfair competitive advantages. Therefore, the goal of creating the same conditions for all may result in either more or less regulation.

Brexit gap
The departure of the United Kingdom from the EU will open up a gap in the EU budget, which is estimated to be more than ten billion euro a year. The budget must then either be reduced or financed differently.

"Member States cannot give tax benefits to selected companies – this is illegal under EU state aid rules."

Margrethe Vestager, EU Commissioner for Competition
on the Apple ruling by the European Commission
on 30 August 2016

"The EU Commission has understood that citizens find companies' tax tricks to be very unfair. The patchwork arrangement of national tax codes to date is not compatible with the Single Market in Europe."

Sven Giegold, Greens/EFA group in European Parliament
in reaction to a corporate tax reform introduced by the European Commission on 25 October 2016

What is the state of the EU tax debate?

The fight against tax evasion and/or avoidance has been discussed time and again. The LuxLeaks scandal in 2014 showed that more than 300 companies used letter box firms in Luxembourg to shift profits to low tax countries and reduce their tax bills. Other EU countries have also been criticised for such practices.

A ground-breaking decision was made in the case of Apple. In 2016 the European Commission, as the highest competition authority, decided that the tax agreement between Apple and Ireland is illegal because it distorts competition in the Single Market. Apple had a tax rate of less than one percent for many years. The Commission decided that Ireland must demand repayment of illegal tax breaks to the tune of 13 billion euro.

Some areas of tax policy are already coordinated, as for example with the EU Value-Added Tax Directive. It is designed to prevent competition distortions among member states by establishing a minimum rate of VAT. Furthermore, the EU has wanted (for some time) to standardise corporate tax rates in the Single Market. In autumn 2016, the Commission presented a draft proposal for a coordination of corporate taxes designed to prevent illegal tax breaks and simplify Single Market rules.

New ideas for taxation are on the table. In early 2017, an expert group headed by the former Italian Prime Minister Mario Monti put forward proposals for financing the EU budget. It recommended that EU member states agree on taxes that contribute either to the functioning of the Single Market or the achievement of EU policy goals. Examples given were taxes on corporate profits, fuels, CO_2 or electricity. The member states would impose these taxes, with a portion of the revenue passed on to the EU.

EU Value-Added Tax Directive
According to this 2006 directive, VAT in EU member states must be at least 15 percent. Furthermore, countries may introduce two reduced rates of at least five percent. Some goods and services may be exempted from the tax and others must be, such as medical treatments.

Coordination of corporate taxes
The Common Consolidated Corporate Tax Base (CCCTB) is a proposal by the European Commission and sets out that companies must comply with just one national tax regime and not 28 different ones for determining its tax base.

"It should no longer be about more money for the EU budget, but rather about using the funds better."

Jens Spahn, State Secretary in the German Federal Ministry of Finance
in Die Welt in reaction to the Monti Report on 12 January 2017

"One possibility is to use the subject of climate protection and to increase the taxation of CO_2 pollution rights in the EU, for example. This revenue is based on European laws, but has so far gone to member states."

Günther Oettinger, EU Budget Commissioner
in an interview with DER SPIEGEL on 21 June 2017

EUROPEAN TAXES

A look ahead

SCENARIO 1

Tax competition among EU countries

In this scenario, all taxes continue to be set and collected by the member states with a minimum of coordination at EU level. This allows for maximum tax competition in the Single Market. Structurally weak countries can attract companies with lower tax rates, for example. Furthermore, different national preferences and historic fiscal compromises remain in place: Member states which finance their pension and health insurance systems through taxes instead of individual contributions can continue to do so.

The EU budget will be reformed without collecting common taxes. This may happen, for example, by getting the member states to agree upon funding it exclusively through customs duty revenues and contributions based on gross national income (GNI).

This scenario, barring a few minor exceptions, comes closest to the status quo and would be suitable for an EU that confines its activities to areas in which the advantages of common rules are most obvious and uncontroversial. The different tax systems would also bring costs, however: on the one hand owing to the complexity of different rules that must be obeyed; on the other due to possible tax avoidance, as witnessed in the LuxLeaks scandal.

SCENARIO 2

Combination of national and European taxes

In this scenario, the EU countries agree on further steps towards integration and finance the common budget largely through European taxes. For example, corporate profits may be subject to an EU tax. The member states may impose extra taxes on companies located in their country, but not below the common standard. That would prevent a race to the bottom among EU countries and eliminate tax havens. Furthermore, a European tax on CO_2 emissions offers the possibility of achieving EU objectives in climate protection and simultaneously ensuring that no member state faces competitive disadvantages.

In a largely tax-financed EU, the European Commission and the European Parliament have more policy leeway, but are also under greater pressure to justify their income and expenditure priorities to European citizens. Whether this will ever happen is questionable: So far most EU countries are very sceptical about the idea of transferring competencies for fiscal policy to the European level and thus giving up one of the last important privileges of the nation state.

SCENARIO 3

Far-reaching tax coordination in the Single Market

In this scenario, a floor is set for some or all taxes in the EU, but the responsibility for the tax system remains with the member states. Three challenges must be addressed here:

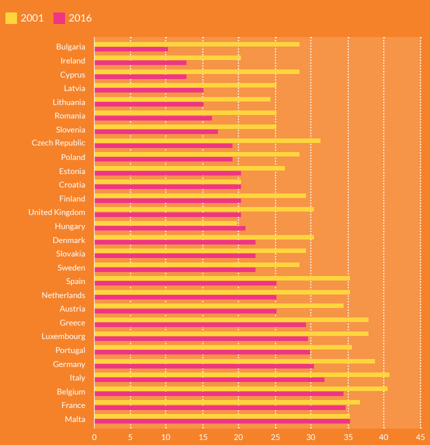
First, EU countries are structurally different: Some finance a majority of their social security systems through tax revenues, while others handle this through different contributions. Coordination would therefore have to leave room for dissimilar systems. Second, the common tax rates would have to be adjusted over a period of time. If national parliaments and the European Parliament were to decide jointly on tax policy, it would be necessary to clarify responsibilities. Third, European tax reform is a great deal more complicated than national tax reform. And the latter is already politically difficult to implement on account of the many conflicts of interest, for example between governments and companies or taxpayers and recipients of social benefits.

However, individual countries such as Germany and France could conceivably move ahead and standardise certain tax rates. Such an approach would be particularly sensible for taxing the digital sector or for environmental taxes. Other EU countries could join in later. This would lead to bottom-up tax harmonisation in some areas.

FACT #1

The corporate tax rate has fallen substantially in the EU

Corporate tax rates in percent



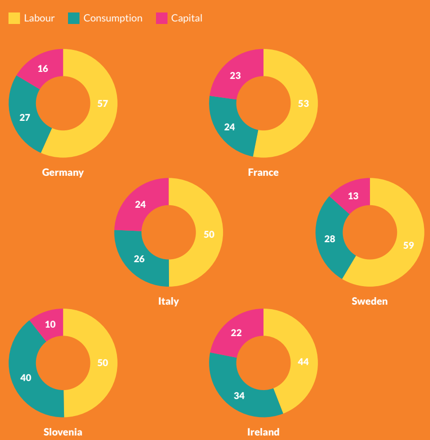
In almost all EU countries, the corporate tax rate has fallen in recent years. While the EU average was still above 30 percent in 2001, it declined to 22.5 percent in 2016. The differences between the member states have become somewhat larger in the meantime. On average, the corporate tax rate in 2001 varied by just under six percentage points; in 2016 it was seven percentage points.

Source: European Commission 2016.

FACT #2

The tax burden is distributed very differently in the EU member states

Share of total tax revenue in percent, 2014



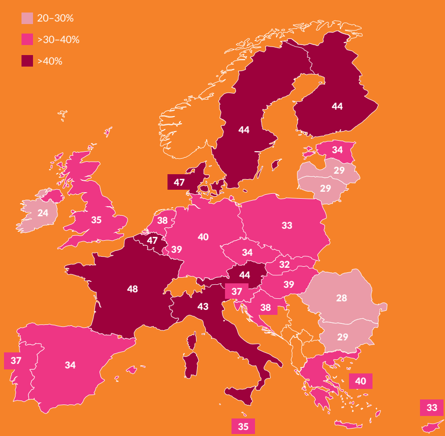
The greatest differences in the EU are in taxing labour, which makes up half of the tax revenue on average. Consumption taxes are particularly important in smaller and new member states and make up just under 30 percent in the EU on average. Capital contributes about one-fifth of the tax revenue on average in the EU.

Source: European Commission 2016.

FACT #3

The public sector has an important financing role in some EU countries

Taxes and social security contributions as a percentage of GDP in 2015



The importance of the public sector varies from member state to member state: In Ireland, taxes and social security contributions to the state make up only a quarter of gross domestic product (GDP); in France they make up almost half. There, and in the Scandinavian countries or Belgium, the public sector spends a lot on social security systems, health and education. Since the introduction of the euro, there has been no significant alignment of revenue and expenditures between the member countries.

Source: Eurostat 2017.

"Setting common tax rules in the EU is just as difficult as the introduction of the euro. But we will not get around a tax coordination, for example with lower limits, forever in the Single Market. Until then, a bottom-up harmonisation in selected areas appears to be the best strategy."

Dr. Anna auf dem Brinke
The author is a Research Fellow at the Jacques Delors Institut – Berlin.

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EUROPA briefing

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Project team

Prof. Dr. Henrik Enderlein
Director,
Jacques Delors Institut – Berlin,
Vice President and Professor
of Political Economy,
Hertie School of Governance

Joachim Fritz-Vannahme
Director,
“Europe’s Future” programme,
Bertelsmann Stiftung

Dr. Anna auf dem Brinke, Author
Research Fellow,
Jacques Delors Institut – Berlin

Sabine Feige
Project Assistant,
“Europe’s Future” programme,
Bertelsmann Stiftung

Dr. Katharina Gnath
Senior Project Manager,
“Europe’s Future” programme,
Bertelsmann Stiftung

Jörg Haas, Author
Research Fellow,
Jacques Delors Institut – Berlin

Heidi Marleen Kuhlmann
Project Manager European Politics
and Communication,
Jacques Delors Institut – Berlin

Max Emanuel Mannweiler
Project Manager European Politics
and Communication,
Jacques Delors Institut – Berlin

Katharina Späth
Project Manager,
“Europe’s Future” programme,
Bertelsmann Stiftung

Philipp Ständer
Research Fellow,
Jacques Delors Institut – Berlin

Imprint

Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
33311 Gütersloh, Germany
Tel. +49 5241 81-81183
www.bertelsmann-stiftung.de

Jacques Delors Institut – Berlin
Pariser Platz 6
10117 Berlin, Germany
Tel. +49 30 467 260-905
www.delorsinstitut.de

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Joachim Fritz-Vannahme

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