TAX HARMONIZATION IN THE EUROPEAN UNION - DENOTATION AND POSSIBILITIES[2]

Ana Stojkoska, M.A.

European University, Skopje

Abstract

Different tax systems distort trade and factor movements between the member states of a single market. Abolition of trade barriers among the members of the customs union does not necessarily mean that a common, perfectly competitive market has been completed. Impediments to the smooth functioning of the competitive markets for commodities, services and factors of production are still many. Differences between the tax systems of the members of the single market are one of the most important of these impediments and one of the most difficult to alleviate. Tax harmonization is one aspect of the drive to a single market within the EU, removing distortions to trade between its members. Therefore, during market integration it becomes necessary to introduce policies aiming at tax coordination and harmonization. The European Union never had the intention to apply overall tax harmonization. Tax sovereignty is one of the basic components of national sovereignty, and the difficulties in the field of tax harmonization are compounded by deep-rooted differences in economic and social structures, different perceptions on the role of taxation, difference in the acceptability of various taxes, the technical complexity of tax harmonization, and the complications arising from the enlargement of the Community; thus calling for mutual recognition and equivalence as the starting point. However, a high degree of harmonization is desirable in the indirect tax field because indirect taxes may create obstacles to the free movement of goods and services within the single market.

Key words: European Union, Single market, Tax harmonization, Tax systems, Tax policy

I From Common Market to Single Market

The 1957 Treaty of Rome, which set up the European Economic Community, provided for the establishment of common market, through promotion and coordination of economic activities, providing economic stability, economic growth and better standard of living. The establishment of the common market meant realization of four freedoms (free movement of goods, services, capital and labor). The idea was to establish custom union with abolition of tariff barriers in the inter-trade of member-states of the Community; setting of common external tariffs; abolition of quantitative restrictions (quotas) and measures with equivalent effect, all of these in light of providing free movement of goods, services, labor and to some extent of capital. Up to the beginning of the seventies, some level of accelerated integration was achieved. The custom union was accomplished until 1968 (18 months earlier than envisaged), the quotas were abolished, free movement of workers was provided and some level of harmonization of indirect taxes was achieved (with the introduction of value added tax). All of these meant partial realization of the common market. The events in the seventies (oil crises and the collapse of Bretton-Woods monetary system) slowed down the integration process.

2) This paper was received for review on 27 August 2006

This period is known as period of Eurosclerosis. Up to mid eighties, it was obvious that further development is not possible, if there is no way how once more to place in focus elimination of internal frontiers. The respond to these need was the print of the White Paper titled as "Completing the Internal Market", by the European Commission. The White Paper included approximately 300 directives that have to be implemented with deadline 31 December 1992 (that is why this process is known as Europe 1992). The aim was to eliminate all obstacles in completing the internal market.

"Unifying this market (of 320 million) presupposes that member-states will agree on the abolition of barriers of all kinds, harmonization of rules, approximation of legislation and tax structures, strengthening of monetary cooperation and the necessary flanking measures to encourage European firms to work together. It is a goal that is well within our reach provided we draw the lessons from the setbacks and delays of the past. The Commission will be asking the European Council to pledge itself to completion of a fully unified internal market by 1992 and to approve the necessary programme together with a realistic and binding timetable".[3]

The goal to realize the single market was implemented in the Single European Act from 1986, which was addition of the Treaty of Rome. It says:

"The Community shall adopt measures with the aim of progressively establishing the internal market over a period expiring on 31 December 1992… The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of EEC Treaty (Treaty of Rome)".[4]

The aim of White Paper was to give new focus, dynamism and impetus of the goals set with Rome Treaty.

With regard to the complexity of the market of European Community, the single market program included three major chapters, which list the measures necessary to create the single market. One of the major chapters is devoted to taxation.

The measures envisaged in this chapter relate solely to indirect taxation, since this is an area, which gives rise to checks at frontiers between member-states. One of the principal reasons for frontier checks is the need to levy or monitor value added tax and excise duties. The abolition of tax frontiers, which plague both firms and individuals, is key element on the moves to complete single market.

Direct taxation does not necessitate frontier checks. Nevertheless, national provisions exist which raise invisible frontiers that hamper cooperation between firms from different member-states. For instance, there is double taxation, which impedes mergers between firms established in different member-states. Elimination of such double taxation is therefore an integral part of the program for completing the single market.

Up to 1993, some progress in realization of single market was achieved. However, there is no complete realization of the ultimate goal. The idea for establishment of complete single market was not accomplished. There are still many barriers that impede the free movement of factors. There are still policies where nations have discretion in making decisions. One of the fields where limited success is achieved is the field of taxation.

Taxation is an important and, at the same time, difficult aspect of the program for completing the single market. It is important because without proper rules governing the tax treatment of cross-frontier transactions, tax barriers would remain in place, and difficult because any decision relating to taxation has immedi-

3) Commission of the European Communities: Completing the Internal Market, White Paper from the Commission to the European Council, Brussels, 1985, p.6

4) Nugent, N.: The Government and Politics of the European Union, Duke University Press, Durham, 2003, p.298

ate repercussion for national budgets. The unanimity required in the Council of European Union compounds the difficulties. [5]

II Tax System in Economic Integration

The economies of member-states of an economic integration are highly integrated because of the free movement of goods, services, capital and labour across national borders. National goverments have discretion right to rule the tax policy, i.e. over a wide range of tax types, subject to any tax harmonization that may be in effect. The implications of ruling individual tax policies, is that these actions may have spillover effects that can affect the well-being of other member-states.

To see the importance of the tax policy in an economic integration it is useful to distinguish between income taxes and consumption taxes.

In an economic integration, redistributive policies are responsibility of individual member-states, there is no central authority. This implies, given the mobility of skilled persons and firms that the extent of redistribution is subject to inter-nation competition that is called "race to the bottom". However, the fiscal spillover effects not only affect the redistributive goal. There are also likely to be consequences for the efficiency of the economic union, as well for the integrity of national tax systems. The mobility of skilled persons gives possibility of a misallocation of resources among nations (but here we should mention that the tax factor is not the only which has effect on the persons mobility - cultural and language differencies also have an effect on this mobility).

There will be difficulties also in taxation of the income of firms, working in more than one country. Nations will have an incentive to use not only their rate structures but also elements of their base to attract capital. Here the harmonization is viewed as a possibility, which will mitigate the problems. The harmonization is a necessary process in the light of introduction of the single currency and realization of the economic integration, taking into consideration that one of the factors that have influence on investment decisions, the exchange rate adjusting, in these terms is eliminated. The harmonization would be essential, if tax factor is the only factor that influences investment decisions. However, in practice prevails tax competition that per se will lead to tax harmonization.

The functioning of different tax systems, from the aspect of the consumption taxes, has its implications in the free movement of goods and services. That is why the convergence of these taxes is crucial in an economic integration, where there is no risk of exchange rate adjusting, where the comparison of prices of one product is much easier and where the transaction costs are eliminated.

In the theory there are two approaches dealing with the consideration of the importance of the tax system in an economic integration, i.e. whether the tax policy should be governed at the national or supranational level .

If we have in mind the externalities that can be caused with the functioning of the different tax systems (spillover effects) it would be better to govern the tax policy at unions' level. The other argument is that some policies are more efficient when carried out on a large scale. The acceptance of this approach would mean to give up sovereignty and delegate a task to a supranational institution.

The other approach is to retain the national competences in this field. The arguments here are the existence of heterogeneity of preferences and information asymmetries. Heterogeneity of preferences and information asymmetries imply that it would be inefficient to share competence at a supranational level.[6]

5) European Commission: Taxation in the Single market, Office for Official Publications of the European Communities, Luxembourg, 1990
6) Baldwin, Richard and Wyplosz, Charles: The Economics of European Integration, Mc Graw-Hill education, UK, 2004, p. 389

III Definition of the Harmonization

1. Abstract of the Harmonization

The analysis of tax systems of the member-states of the Union gives opportunity to conclude that there are no states:

1. Between which there are no differences in the structure of tax incomes,

2. In which there is equal number of tax incentives and reliefs and

3. In which there is equal number and level of tax rates.

The convergence of tax systems because of legislative acts at a Community level is defined as harmonization. Here we differentiate complete harmonization, which means same tax bases, rates, systems etc. and partial harmonization or approximation, which for example includes setting of minimum or maximum tax rates, elimination of double taxation etc.

The process of tax harmonization is a process of elimination of fiscal barriers and differences between tax systems of the separate member-states of the Union. Tax harmonization is the process by which the tax systems are aligned with each other so that tax considerations do not influence the movement of factors of production. Tax harmonization is required when there are fiscal externalities between member-states whereby one state's decision affects other states. Tax harmonization attempts to internalize these effects by making different tax systems more compatible with each other and with the objectives to establish economic union.

2. Objectives of the Harmonization

Considering all the tax types, the Treaty of Rome generally identifies the need to harmonize the indirect taxes. It specifies that "the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation" is a principal objective of the Community. The Treaty of Rome does not explicitly calls for harmonization of direct taxes, but provides base to approximate the laws, regulations or administrative provisions of member-states, which directly affect the functioning of the common market.

The general aim of tax harmonization is fiscal neutrality, defined as equal treatment for domestic production and imports from member-states. The Commission clarifies that tax harmonization is not an attempt to design an ideal fiscal system for the Community but a blueprint for abolition of fiscal barriers.

Tax harmonization in the European Union has aimed two objectives:[7]

1. Competition on equal terms among the EU partners, implying abolition of tax frontiers and

2. Acceleration of the process of integration and unification of the market.

7) Hitiris, Theo: European Union Economics, Pearson Education Limited, England, 2003, p. 111

In practice, tax harmonization has proved more difficult than envisaged. The sovereignty of member-states in making the tax decisions, which is one of the fundamental components of national sovereignty, means limited results that are achieved at a slow pace.

Taxation in European Union is based on the principles of:[8]

1. National competence, whereby policy is exclusively a matter for member-states if the Community does not have competence under the treaty;

2. Subsidiarity, whereby action should only be taken at Community level where the objectives cannot be sufficiently achieved by member-states and can be better achieved by Community;

3. Unanimity, whereby EU-wide taxation matters can only be adopted by a unanimous vote of member-states.

IV The Importance of Tax Harmonization for Realization of the Single European Market

Tax harmonization is one of the aspects that are essential for realization of the single market. Different tax systems are impediments of the free movement of factors of production. They can distort the economic behavior of consumers, workers and investors, in a way that affects the functioning of the single market. Different tax systems on personal income tax and social contributions are one of the factors that influence the decisions for residency and location of work. Tax competition may lead to inefficient allocation of resources. The movement of the mobile factors (capital and investments) from one to another state may lead to decrease of tax incomes, through decrease of tax rates. The decrease of corporate tax rates confirms the shift of the tax burden from mobile to immobile factors, i.e. an increase of the tax burden of the labor. High taxes on labor tend to increase unemployment if trade unions manage to shift the tax burden forward onto employers via higher gross wages. The employers may try to pass the cost increase on to consumers. But in a globalized economy, the scope for price increases is limited. Therefore, they reduce the demand for labor instead. Unemployment increases. High tax rates on labor are also considered as a major factor behind the shadow economy, particularly for labor-intensive industries. In order to solve these problems, the European Commission suggested in 1994, and the European Council agreed the same year at its summit in Essen, that the tax burden on labor should be reduced by at least one or two percentage points of GDP. This requires coordinated action to eliminate tax competition, which so far has not been forthcoming.[9]

The single market program, which is not yet completed, includes in itself provisions related to harmonization of indirect taxation of goods and services, especially harmonization of the value added tax.

The found of harmonization of indirect taxes, as it is mentioned before, is in the Treaty of Rome. It says: The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market[10]. The aim is to harmonize and not to standardize the national systems of indirect taxation. It is important not just to make more compatible tax systems with each other but also to ensure that they are in accordance with the objectives of the Treaty of Rome.

8) Ibid.
9) Genchel, Philipp: Globalization, Tax Competition, and the Fiscal Viability of the Welfare State, MPIfG Working Paper 01/1, May 2001
10) Consolidated version of the Treaty establishing The European Community, Article 94, www.europa.eu.int

The first step toward harmonization of indirect taxes was the introduction of value added tax in the late sixties. Since than there are a lot of directives and proposals concerning not just the value added tax, but also, excise duties. However, only a partial harmonization is achieved. The appliance of the unanimity principle in the Council of ministers for decisions in the field of tax policy is identified as core reason for the limited results. These results affect not just the slow realization of the single market, but also have a negative effect on the problem of unemployment and encourage the erosion of tax base. Under the circumstances, the Commission in a communication dated 20 March 1996, identified the three main challenges that would be the key elements of the European Union's tax policy in the years ahead:[11]

1. The stabilization of Member States' tax receipts;
2. The smooth functioning of the single market;
3. The promotion of employment.

The intend is to find appropriate solutions to these problems that are consistent with the principle of subsidiarity.

The progress achieved in the field of harmonization is slow, a lot of differences stay, but the variations in the VAT systems from the mid eighties tend to reduce. One of the first and long-term aims of the general tax policy of the Community was to eliminate differences in tax rates and on the whole indirect tax systems, which distort the competition in the single market and the functioning of the market.

The results that are achieved in the field of direct taxation are also limited, and in addition, the number of initiatives and proposals is limited. As we mentioned, there is no provision in the Treaty of Rome that explicitly calls for harmonization of direct taxes. The unanimity decision making in the Council of the European Union in the field of tax policy, gives opportunity the resistance of member-states to impede the harmonization of direct taxes.

The single market program did not directly point out the need to reduce the differences between corporate tax systems, but gave some indirect directions in this field, through promotion of cross-border investments.

The harmonization of direct taxes is generally based on two aims: elimination of tax evasion and elimination of double taxation. In order to prevent the distortion of the competition, especially in the field of investment decisions it is important to achieve some level of harmonization of direct taxation.

Single market realization, as well as the introduction of the single currency leads to new initiatives in the field of taxation, at Community level.

The matter of taxes continues to be one of the most important fields, that are impediment in realization of the ultimate aim, i.e. smooth functioning of the single market. Beside the need to achieve some level of tax harmonization, national goverments of member-states of the Union resist making higher steps in direction of its realization.

In 2000, at the Lisbon Summit, was set new strategic goal for economic development of the Union that should be accomplished by the end of the decade. European leaders pledged to make EU by most competitive and dynamic knowledge based economy in the world, capable of sustaining economic growth with more and better jobs and greater social cohesion.

The European Commission has adopted a comprehensive plan of EU-wide taxation and customs measures that would help the EU to achieve its Lisbon objectives. The measures proposed are not intended to change the structure of Member States' tax systems or to impinge on their national fiscal sovereignty. Instead, they are simply aimed at reducing the negative effects, which co-existing national tax systems can have on market integration.

11) Activities of the European Union: Indirect Taxation, www.europa.eu.int

Table 1: Lisbon Strategy: Key Taxation and Custom Policy Measures

Making Europe a more attractive place to invest and work	Knowledge and innovation for growth
1. Extending and deepening the internal market - A Common Consolidated Corporate Tax Base for EU businesses (2008); - Simplifying the tax environment and creating a level playing field; - VAT compliance obligation: one stop shop (2004);home state taxation (2005); - VAT rules international services and financial services (2005), (2006); VAT public bodies, (2006); - Targeted measures to remove cross-border tax barriers faced by EU businesses: cross-border loss relief, (2006); transfer pricing, (2005); capital duty, (2006); - A new strategy for car taxation (2005); - Reducing distortions created through tax fraud and tax evasion (2006)	1. Increasing and improving investment in R&D - A Communication providing guidance on R&D tax incentives (2006)
2. Ensuring open and competitive markets inside and outside Europe - A strategy against counterfeiting (2005); - Improving customs legislation with a view to promoting e-Customs (2005) 3. Improving European and national legislation - Modernising VAT rules (2005)	2. Facilitating the sustainable use of resources - Energy, transport and Environment-related taxes: taxation of commercial diesel, (2005); energy taxation, (2006); car taxation, (2005)

Source: Taxation and Customs: Commission sets out actions to boost European competitiveness, www.europa.eu.int

Concluding Remarks

The 1957 Treaty of Rome, which set up the European Economic Community, provided for the establishment of common market. The establishment of the common market meant realization of four freedoms (free movement of goods, services, capital and labor). The need to realize the four freedoms was supported as well with the print of the White Paper titled as "Completing the Internal Market", by the European Commission. The White Paper included approximately 300 directives that have to be implemented with deadline 31 December 1992 (that is why this process is known as Europe 1992). The aim was to eliminate all obstacles in completing the internal market.

With regard to the complexity of the market of European Community, the single market program included three major categories of barriers that had to be eliminated to complete the single market. One of those categories of barriers were fiscal barriers.

Fiscal barriers distort the terms of competition and the free movement of factors of production. Different tax burdens may influence and change the costs related to the product in a way that can reduce the competitive advantage of the product. In interest of the single market development, it was important to take over some measures to eliminate these barriers, principally to make changes in the system of indirect taxation (to harmonize tax rates).

The functioning of different tax systems, from the aspect of the consumption taxes, has its implications in the free movement of goods and services. That is why the convergence of these taxes is crucial in an economic integration, where there is no risk of exchange rate adjusting, where the comparison of prices of one product is much easier and where the transaction costs are eliminated.

The aim is to harmonize and not to standardize the national systems of indirect taxation. It is important not just to make more compatible tax systems with each other but also to ensure that they are in accordance with the objectives of the Treaty of Rome.

The single market program did not directly point out the need to harmonize the direct taxes. However, liberalization of capital flow seeks out harmonization in this field. National provisions concerning direct taxation create barriers in the cooperation between firms from different member-states of the Union.

Different tax systems impede the free movement of factors of production between member-states of the common markets. That is why tax harmonization is needed. European Union never had the intention to apply overall tax harmonization. Tax policy is symbol of national sovereignty and part of economic policy. Taxation in European Union is based on the principles of subsidiarity, national competence and unanimity. Tax policy in the Union is a matter of responsibility of member-states. However, some level of tax harmonization is needed, in particular in field of indirect taxation, as indirect taxes slow down realization of free movement of goods and services in the single market area.

Single market realization, as well as the introduction of the single currency leads to new initiatives in the field of taxation, at Community level.

Nevertheless, beside all these aspects, in practice, tax harmonization has proved more difficult than envisaged. The matter of taxation continues to be one of the most important fields that are obstacles in realization of the ultimate aim, smooth functioning of the single market. The sovereignty of member-states in making the tax decisions, which is one of the fundamental components of national sovereignty, means limited results that are achieved at a slow pace.

Beside all of the efforts in the field of tax harmonization, the achieved level is just partial. As main impede in realization of higher level of tax harmonization (beside the sovereignty of member-states in making the tax decisions), we exactly identify the appliance of the unanimity principle in the process of making decision in the tax field, in the Council of ministers. Those results are not just an impede in the realization of the single market, but have a negative influence on the unemployment problem and also encourage the tax base erosion.

The tax field remains as one of the most important fields, which are obstacle in achieving the ultimate goal. Next to the need of achieving some level of tax harmonization, national goverments of the member-states of the Union refuse to give in to making higher steps in its realization.

This resistance of the national governments would means not just slow realization of the single market, but also, what is more important, it makes difficult the process of full economic integration in the Union i.e. achieving on the next stage of the integration process - complete economic union (which in the same time is the final stage of economic integration). After complete economic integration, the integrated units have no or negligible control of economic policy, including full monetary union and complete or near-complete fiscal policy harmonization.

Regarding these aspects of the European economic integration process and the limits of overall realization of an economic union one of the arguments surrounding economic integration is consideration: regionalism versus nationalism, which would set the question: what concept prevails? Is it the concept of intergovernmentalism or the concept of supranationalism that prevails? Could the European Union reach the phase of full economic union or the achieved level is the apex?

These processes of the European economic integration are not just interested in its' self but also from the aspect of Macedonian aspirations to become part of these processes. That's why the field of taxation (as one of the chapters of acquis communitaire) is one of the considerations that are highly discussed today.

References

1. Baldwin, Richard and Wyplosz, Charles: The Economics of European Integration, Mc Graw-Hill education, UK, 2004

2.Cini, Michelle: European Union Politics, Oxford University Press, New York, 2003

3. Commission of the European Communities: Commission communication to the Council and to the European Parliament - Completion of the internal market and approximation of indirect taxes, Brussels, 1989

4. Commission of the European Communities: Completing the Internal Market, White Paper from the Commission to the European Council, Brussels, 1985

5. Consolidated version of the Treaty establishing The European Community, Article 94, www.europa.eu.int

6. Cowles, G., Maria and Dinan, Desmond: Developments in the European Union 2, Palgrave Macmillan., New York, 2004

7. Daianu, Daniel: Economic Development - The Role of Institutional and Policy Diversity, Workshop paper, Academy of Economic Studies and the Romanian Center for Economic Policies, Bucharest, November, 2003

8. Desai, R., Sonal: Taxation without Harmonization in the European Union, University of California, Department of Political Science, San Diego, 2003

9. Dinan, Desmond: Ever Closer Union: An introduction to European Integration, Lynne Rienner Publishers Inc., London, 1999

10. Eijffinger, C., W., Sylvester and Haan, De Jakob: European Monetary and Fiscal policy, Oxford University Press, New York, 2000

11. Genchel, Philipp: Globalization, Tax Competition, and the Fiscal Viability of the Welfare State, MPIfG Working Paper 01/1

12. Hansen, J., Drud: European integration - An Economic Perspective, Oxford University Press, New York, 2001

13. Hitiris, Theo: European Union Economics, Pearson Education Limited, England, 2003

14. Hoeller, Peter and Louppe, Marie-Odile: Fiscal relations within the European Union, OECD Economic Studies No. 163, Paris, 1996

15. Hoeller, Peter and Louppe, Marie-Odile: The ECCs Internal market-Implementation and Economic effects, OECD Economic Studies No. 23, 1994

16. Joumard, Isabelle: Tax systems in the European Union countries, Economics department working papers, No. 301, OECD, 2001

17. McDonald, Frank and Dearden, Stephen: European Economic Integration, Longman, England, 1999

18. Nugent, N.: The Government and Politics of the European Union, Duke University Press, Durham, 2003

19. Overturf, F., Stephen: The Economic Principles of European Integration, Praeger Publishers, New York, 1986

20. Thompson, Grahame (editor): Governing the European Economy, The Open University, 2001

21. Todorov, Todor i Vasilevski, Van|el: Evropa 92, MG, Prilep, 1991