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REFORZAR A HARMONIZACIÓN FISCAL EN EUROPA*

Notes du Conseil de l'analyse économique, nº 14, Xullo 2014

TAX HARMONIZATION IN EUROPE: Moving Forward

Notes du Conseil de l'analyse économique, no 14, July 2014

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The recent sovereign debt crisis has given an impetus to the debate on tax cooperation in the European union. Tax competition is praised for its positive effect on government efficiency but also accused of distorting public and private choices. This Note argues that, although the taxation of the most mobile bases has become lighter since the mid 1990s, the responsibility of tax competition in Europe is unclear, except for corporate taxation.

Consequently, the authors focus on the taxation of firms and mainly on the corporate income tax (CIT), where many distortions and inefficiencies arise from the combination of rate and base competition. There is room for tax harmonization/ cooperation that would reduce distortions such as high compliance costs, tax planning and funding distortions as they are impediments to a smooth functioning of the single market. In addition, one challenge of tax harmonization/cooperation on corporate taxation in the EU would be to move a collection of "small" countries in the grip of fiscal competition into one "big" player, which would raise the leeway for tax policy.

Consistently, the authors are putting forward three proposals. First, the Note recommends reviving the European project of a Common Consolidated Corporate Tax Base (CCCTB) or some part of it, through the "enhanced cooperation" scheme or an ad hoc initiative or willing countries.

Second, the European banking union would remain incomplete without a harmonization of tax regimes. The authors suggest all specific taxes on systemic banks covered by the Single Supervisory Mechanism (SSM) to be transferred at the central level and merged into a single Financial Activity Tax (FAT). The FAT could fund the Single Resolution Fund (SRF) and accelerate the building up of a credible fiscal backstop. This step would also move banks in the area of taxation to the European level corresponding to the single supervision. The receipts could later form the first building block of a euro area budget.

Once the two first proposals have been implemented, a further step in the direction of a euro area budget could be to transfer at the euro area level the ability to raise the CIT from the banking sect or. A potential problem is that CIT rates widely differ across euro area countries. One solution would be to apply a single CIT rate at the euro area level, and let national government impose national surcharges when necessary to meet their national CIT rate.

INTRODUCTION

The debate on tax competition opposes those who praise its positive effect on government efficiency, and those who accuse it of distorting public choices, inducing inequality but also undermining the functioning of markets.[1] These two polar versions coexist in the European Union. Since decisions on taxation require unanimity,[2] it is not surprising that tax cooperation remains difficult. Still, the argument that tax distortions undermine the single-market has justified some harmonization in the area of indirect taxation (Value Added Tax, excise duties); much less harmonization, however, has happened on the direct taxation of capital and labor.

The sovereign debt crisis that started in 2009 has given an impetus to the debate on tax harmonization, for three reasons:

- Governments have been obliged to rapidly raise taxes while facing international tax competition and domestic discontent concerning the distribution of the burden;
- Emergency assistance to crisis countries has sometimes been considered illegitimate given the low levels of taxation in some countries for companies or wealthy individuals;
- The need for a "fiscal capacity" has emerged as a complement to the monetary union and to the banking union.

It should be noted at this stage that although they are often considered as synonymous, the words "coordination", "cooperation", "convergence" and "harmonization" cover somewhat different concepts (see Box 1). Tax harmonization (e.g. the minimum standard VAT rate, or common rules embodied in different directives on the corporate taxation), is a form of coordination. The Common Consolidated Corporate Tax Base project (CCCTB) envisages a harmonization of CIT bases, but also some cooperation through the consolidation and apportionment of tax bases.3 As for convergence, it is a broader concept that is compatible with both tax coordination and tax competition. In the following, we concentrate on tax harmonization and cooperation.

1. Coordination, cooperation, convergence, harmonization

Consider two countries A and B raising a tax on a specific base so as to maximize some social objective. The reference case is that of tax competition whereby each country sets its tax base and rate independently, considering the tax base and rate of the other one as given. There are different ways to depart from this reference case.

Cooperation refers to joint optimization: countries A and B jointly determine the tax bases and rates so as to maximize some common social objective. In the European union, the common external tariff policy is an example of cooperation.

Coordination refers to commitment: since the choices of country A depend on those of country B and vice versa, there might be multiple equilibria (for instance one with high tax rates and another one with low tax rates). Coordination then consists in a reciprocal commitment to a specific behavior.* The code of conduct on corporate taxation, which commits Member states to eliminate detrimental practices, is an example of coordination. In a looser sense, coordination includes information exchange, for instance on savings income.

Harmonization refers to an equalization of tax bases and/ or tax rates. A variant of harmonization is to impose minimum bases or rates. Harmonization is one form of coordination. The minimum standard VAT rate and the Parent-subsidiary directive are examples of harmonization.

Convergence refers to a narrowing of base differentials or of tax differentials. Convergence may arise from coordination or from competition (e.g. in the case of a "race to the bottom").

* On the difference between cooperation and coordination, see Canzoneri M. and D. Henderson (1991): Monetary Policy in Interdependent Economies Game-Theoretic Approach, MIT Press.

EXISTING TAX HARMONIZATION

Consistent with the willingness to create a well-functioning single market, Europeans have agreed on harmonized rules in the area of indirect taxation. Indeed, the Value-Added Tax (VAT) is part of the *acquis communautaire*, and two directives (1977 and 2006) closely codify the VAT regime in EU Member states, with a minimum standard rate of 15% and a restricted list of reduced rates. Excise duties are also subject to minimum rates, based on Articles 191-192 of the Treaty on the Functioning of the European Union (TFEU). This treaty base allows the Council and the Parliament to take decisions, including on taxes, to protect human health, safeguard the environment and promote a "rational utilization of natural resources".

The second area of tax harmonization concerns capital income. In 1990, the Parent-subsidiary directive tackled the issue of double taxation of repatriated profits by a mother company from its subsidiaries.[4] Member states are requested either to exempt repatriated profits, or to deduct taxes already paid by the affiliates from the mother's tax bill (partial credit system). The objective was to avoid discriminating against foreign subsidiaries (taxed twice) in relation to purely domestic firms (taxed only once). In 2003, the Interest and Royalties directive further reduced the incidence of double taxation by abolishing withholding taxes on cross-border interest and royalty payments within the EU.

In recent years, however, the debate has moved from "double taxation" to "double non-taxation". Indeed, a number of multinational firms have been blamed for paying low taxes thanks to various optimization techniques. In September 2013, the OECD launched an ambitious initiative labeled Base Erosion and Profit Shifting (BEPS), aimed at addressing new challenges of corporate taxation in a globalized economy where the value-added of a firm is not only split up across the globe, but also difficult to measure, a growing part of it resulting from intellectual property. The programme will address fiscal challenges of the digital economy (e.g. the growing role of intangible assets whose value added is difficult to localize). It will also set standards to neutralize the impact of hybrid financing arrangements (i.e. financings that can be labeled debt in one country but equity in another one), to reduce the scope for double non-taxation through within-group loans, etc.[5]

Non-discrimination is a cardinal value of the European Union. Consistently, a code of conduct was adopted in January 2003 to eliminate "detrimental practices" in the area of corporate taxation, such as a different tax treatment for domestic and foreign-owned enterprises. Already launched in 2001, the project of Common Consolidated Corporate Income Tax (CCCTB) goes much further, since it involves both base harmonization and consolidation. Base harmonization would make tax competition more transparent in that only tax rates would matter. It would not necessarily lead to a uniformization of corporate income tax (CIT) rates since taxes are not the only relevant factor for the location of companies. For example, it has been argued that countries with a more central location enjoy location rents that can be taxed, and that the provision of public goods is a relevant factor for company location, sometimes reinforcing the impact of a central location.[6] However, base harmonization could still increase downward pressure on rates, and it would not fully eliminate the problem of profit-shifting: firms could still shift profits to different locations compared to the places where the activity actually is taking place (for instance through transfer pricing). By doing so, they could enjoy public goods in one country while being taxed in another one. Therefore, the Commission also proposed to consolidate the profit of multinationals within the EU and apportion it to the different governments according to a single apportionment formula that

would depend on a combination of turnover, wage bill, number of employees and physical capital. Each member country would then have the ability to tax its apportioned share at its own CIT rate.[7] As of June 2014, no agreement had been found within the Council, even through the less ambitious scheme of "enhanced cooperation".[8]

In the area of savings income, the Savings directive adopted in 2003 foresaw the implementation of full exchange of information across member states on interest income, after a transitory period during which those countries refusing to transfer the information on capital income to the home tax administrations of their banks' customers (Austria, Belgium, Luxembourg) would apply a withholding tax. In March 2014, a revised Savings directive was adopted, which extends the range of information exchange and makes it more difficult to circumvent the rules. Additionally, EU Members committed to align their legislations and practices by the end of 2014 with the OECD Global Standard on automatic exchange of information which was endorsed by the G20 in February 2014.[9]

Finally, in the area of labor taxes, there is no harmonization, but only commonly agreed principles such as the need to progressively "shift the tax burden from labour to energy and environmental taxes".[10]

A NEED FOR MORE TAX HARMONIZATION?

Policy coordination/cooperation is never costless. Tax coordination means that a country may have to depart from its preferred policy, based on national preferences. As for tax cooperation, it involves a transfer of sovereignty. Hence, the case for further harmonization or cooperation needs to be carefully analysed. Here we proceed in three steps:

- Does tax competition distort the functioning of the single market?
- Do we observe a "race to the bottom" of tax rates on the most mobile bases?
- Is there a risk for growth and social cohesion?

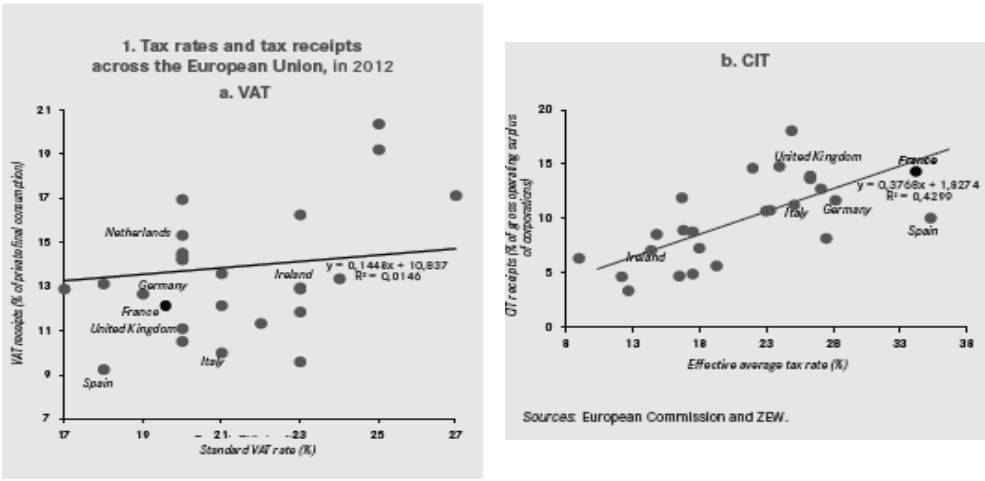
DOES TAX COMPETITION DISTORT THE FUNCTIONING OF THE SINGLE MARKET?

Tax competition is often viewed as a substitute for market competition to induce efficient spending in the public sector. According to Tiebout (1956), citizens "vote with their feet": they move from less to more efficient jurisdictions.[11] In this sense, tax competition is a complement to the single market: higher taxation in one part of the EU corresponds to higher provision of public services, which will not distort relative prices. It only helps to tame the "Leviathan" that sleeps in each government.

However the reality tends to sometimes differ from the textbook. In particular, in a multi-country setting, there are numerous barriers to the mobility of citizens. For example language barriers often prevent that citizens leave inefficient states. As a result, the existing tax competition may not be effective in taming the Leviathan and on the contrary, the higher mobility of capital may mean that inefficient governments shift increasing burdens on the less mobile factor labour.

Additionally, the link between taxation and the provision of public goods may not be clear-cut for the taxpayer. As evidenced in Figure 1 for the VAT and the CIT, the relationship between tax rates and tax receipts is not one to one. Hence it is not clear that households (for the VAT) and companies (for the CIT) do "buy" public services when paying taxes. In fact, due to numerous loopholes, a high tax rate, even when accounting for differences in tax bases, does not necessarily mean high tax receipts to fund public goods.[12]

1. Tax rates and tax receipts across the European Union, in 2012



Sources: European Commission and ZEW

A further problem results from the fact that tax competition is not only done on tax rates, but also on tax bases: governments may be tempted to offer tax exemptions or credits to attract foreign investors or skilled labour. Base heterogeneity across Member states offer possibilities of tax optimization or, in some cases, of double taxation. It also generates compliance costs for companies that are active in different Member states.[13] These costs have been rising with the development of anti-avoidance rules introduced by governments to fight tax loopholes at international level.

In order to encourage investment, governments generally offer allowances for interest payments (for corporate taxation) or reduced rates for some capital returns (personal taxation). This generates distortions in investment choices. In the case of the CIT, deductions for interest payments generate three types of distortions: by narrowing the tax base, they necessitate higher rates, which raises the detrimental impact of taxation on economic efficiency;[14] they distort funding choices of companies between debt, retained earnings and equity, possibly leading to excess leverage; they open loopholes for international tax planning.[15] The funding distortion is illustrated in Figure 2 which compares the effective corporate tax rate on capital return depending on how investment is funded, in five large EU countries. In all five countries, the effective tax rate is much lower for debt financing than for either retained earnings or new equity. The lower taxation of investment return when financed by debt encourages leverage.[16] Eliminating this distortion proves difficult in a non-cooperative environment.

> **Statement 1.** There are distortions related to taxation in the single market. These distortions arise from both tax bases and tax rates as well as from the different mobility of factors of production.

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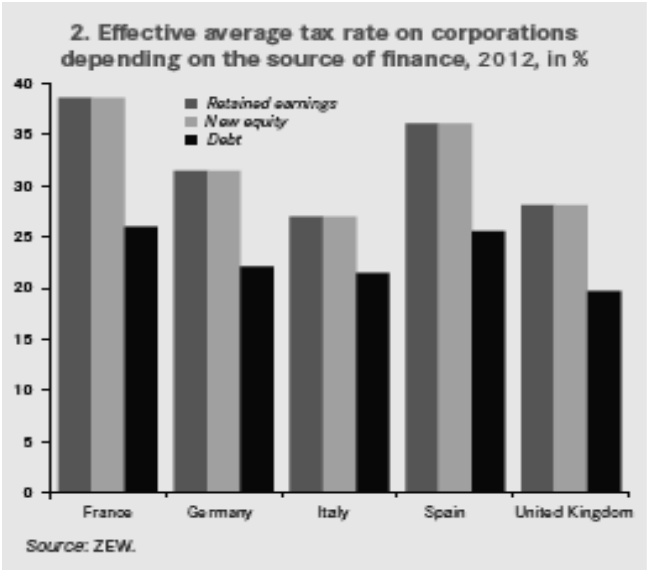
2. Effective average tax rate on corporations depending on the source of finance, 2012, in %



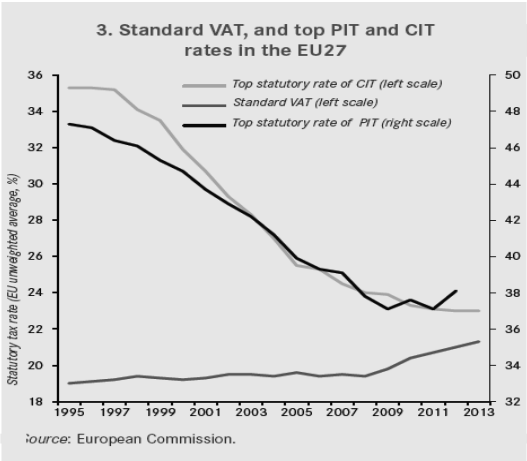
Source: ZEW

DO WE OBSERVE A "RACE TO THE BOTTOM"?

According to the theoretical literature, tax competition induces a "race to the bottom" of tax rates on the most mobile bases (capital income and skilled labour). This may lead either to under-provision of public goods or to a shift of the tax burden from mobile to immobile tax bases (consumption, real estate and unskilled labour).[17]

Top statutory rates of both the personal and the CIT have fallen substantially since the mid-1990s, although in the latter case, there has been simultaneous base broadening. Over the same period, the standard VAT rate has been rising, first smoothly and then, since the 2008 crisis, rather steeply (Figure 3). Several European countries have adopted dual income taxation, which consists in taxing capital income and labor earnings through different schedules: a flat tax on capital while labor income is taxed progressively. Denmark introduced such a dual system in 1987, followed by Italy and Sweden in 1991, Norway in 1992, Belgium, Greece and Finland in 1993, Austria in 1994 and Netherland in 2001. France temporarily applied such tax system until 2013.[18]

3. Standard VAT, and top PIT and CIT rates in the EU27



Source: European Commission

However, this evidence is not a proof of a "race to the bottom" triggered by tax competition. As already mentioned, it is part of the European growth strategy to shift taxation from direct to indirect taxes – a strategy which finds its intellectual roots in the assessment that taxes on production factors distort investment decisions and therefore lower economic growth. The trend observed in Figure 3 could also be the result of the growing political weight of high-income taxpayers in EU countries.

In fact, there is little evidence testified by solid empirical analysis that the downward trend of top marginal rates is a direct outcome of international competition for skilled labor or savings. The evidence is more convincing for the CIT (Box 2). CIT competition arises because cross-border investment does react to taxation, and also due to profit-shifting by multinational companies. We can conclude that, for the CIT, there is something like a "race to the bottom" triggered by tax competition (although the race may not lead to zero taxation, for the reasons mentioned previously). For personal taxation, it is difficult to disentangle the effect of international competition from that of social preferences and the evolution of policy thinking.

> **Statement 2.** The evidence of tax competition is compelling concerning corporate taxation, but less so concerning personal taxation.

IS THERE A RISK FOR GROWTH AND SOCIAL COHESION?

Growth

The standard economic theory considers taxation as detrimental to growth. The reason is the efficiency loss related to taxation: a tax introduces a wedge between supply and demand;

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the volume of production is reduced compared to the situation without a tax; the production of public goods funded by the tax is not enough to compensate for the efficiency loss. The extent of the deadweight loss depends on the sensitivity of behaviour to the tax rate. Consumption as a whole is generally considered weakly elastic to taxation, which supports the idea of relying heavily on VAT. In contrast, capital income is highly elastic to capital taxation. For labor income, recent studies have evidenced relatively high elasticities.[19] Based on these results, the evolutions shown in Figure 3 can be considered favorable to growth: lowering capital and labour taxes will raise the incentives to invest, work and innovate. This line of thought has recently been undermined by new research, which shows that lower tax rates do not lead to more productivity and growth but rather to a gradual concentration of rents at the top of the income distribution.[20]

Tax competition may also affect growth through its impact on inequalities. The causal link between inequalities and growth is theoretically ambiguous but a recent IMF paper shows empirically that less inequality is favorable to growth, and that redistribution in general does not reduce long-term growth.[21] Darvas and Wolff (2014) argue that higher inequality and less efficient social models may have led to excessive borrowing in the household sector, increasing vulnerabilities to financial shocks.[22] They also argue that income inequality and unemployment can have major negative long-term growth effects.

2. Tax competition: is it for real?

The empirical literature has followed two alternative strategies to capture international tax competition. First, it has estimated the elasticity of the tax base to international differences in tax rates. Second, it has estimated tax reaction functions whereby the tax rate in one country depends those of neighboring countries.

Elasticity of the tax base to the tax rate

The empirical literature tends to confirm the relatively high elasticity of the tax base to the tax rate for corporate income taxation. Such sensitiveness goes through international capital mobility (the meta-analysis conducted by de Mooij et *al.* 2003 concludes that a 1 pp cut in the home CIT rate raises inward foreign direct investment by around 3.3%), as well as profit shifting.[a] The literature is much less developed for personal taxes. Based on the preferential tax treatment for high-earning foreigners introduced in Denmark in 1991, Kleven et *al.* (2014) find evidence of a very large impact of top PIT rates on international mobility of high-earning tax payers.[b] Conversely, Brülhart and Parchet (2014) do not confirm any significant reaction of the tax base to bequest tax rates across Swiss cantons, which confirms a result obtained by Conway and Rork (2012) on US states.[c]

Tax reaction functions

Similarly, the literature on tax reaction functions is more developed in the case of corporate taxation than for personal taxation. For the CIT, there is solid evidence of a positive interaction between the home CIT rate and the rate of neighboring countries (after accounting for common shocks). For instance, Devereux et *al.* (2008) find that a 1 pp fall in the average foreign statutory CIT rate reduces the home rate by 0.67 pp. Furthermore, they show that such interaction applies only for countries with full capital mobility, which allows them to discard alternative explanations of observed interactions (notably yardstick competition).[d] Still, Egger et *al.* (2007) find similar interactions for the PIT as for the CIT: a cut in neighboring top-PIT rates by 1 pp results in a 0.37 pp cut in the domestic top-PIT rate, while a cut in neighboring CIT rates by 1 pp results in a cut in the home CIT rate by 0.23 pp.[e]

[a] De Mooij R.A. and S. Ederveen (2003): "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research", *International Tax and Public Finance*, 10(6), pp. 673-93. Dharmapala D. (2013): "What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature", *Illinois Public Law and Legal Theory Research Papers Series*, no 14-23.

[b] Kleven H.J., C. Landais, E. Saez and E. Schulz (2014): "Migration and Wage Effects of Taxing Top Earners: Evidence from the Foreign Tax Scheme in Denmark", *The Quarterly Journal of Economics*, 129(1), pp. 333-378.

[c] Brühart M. and R. Parchet (2014): "Alleged Tax Competition: The Mysterious Death of Bequest Taxes in Switzerland", *Journal of Public Economics*, 111, pp. 63-78. Conway K.S. and J.C. Rork (2012): "No Country for Old Men (or Women): Do State Tax Policies Drive Away the Elderly?", *National Tax Journal*, 65(2), pp. 313-356.

[d] Devereux M.P., B. Lockwood and M. Redoano (2008): "Do Countries Compete Over Corporate Tax Rates?", *Journal of Public Economics*, 92, pp. 1210-1235. This literature is surveyed by Devereux M.P. and S. Loretz (2012): "What Do We Know About Corporate Tax Competition?", *Oxford University Centre for Business Taxation Working Paper*, 12/29, and by Zodrow G.R. (2010): "Capital Mobility and Capital Tax Competition", *National Tax Journal*, 63(4), Part 2, pp. 865-902.

[e] Egger P., M. Pfaffermayr and H. Winner (2007): *Competition in Corporate and Personal Income Taxation*, Mimeo, 18th April. This evidence of international competition on the PIT meets that obtained at sub-national level; see Feld L. and E. Reulier (2005): "Strategic Tax Competition in Switzerland: Evidence from a Panel of Swiss Cantons", *CESIfo Working Paper*, no 1516, August.

On the whole, there is no evidence that higher taxes in general are detrimental to growth.[23] Jaimovitch and Rebelo (2012)[24] explain the lack of empirical correlation between taxation and long-term innovation and growth by accounting for entrepreneurs heterogeneity: only the less productive ones stop producing following a tax increase, which has negligible impact on growth. Taxation may hurt growth only when it becomes confiscatory, in which case it stops innovation by the most productive entrepreneurs, or induces them to move to a lower-tax country.

> **Statement 3.** There is no robust evidence that tax competition will enhance growth, neither on the reverse outcome.

SOCIAL COHESION

The second potential risk of declining tax rates is on the capacity for inter-personal redistribution. Since the mid-1980s, most OECD countries have witnessed an increase in inter-personal inequalities amongst households (Figure 4). In the European Union, there seems to be an upward convergence of inequalities towards the highest levels (the UK, Italy and Poland) where they have stabilized. The convergence of the bottom group continued during the crisis, while a number of countries (not all represented in the graph) suffered from higher inequalities due to the rise in unemployment rates.[25] The rise in inter-personal inequalities evidenced in Figure 4 reflects an increase in primary inequalities, i.e. income inequalities before the tax and transfer system. The relative responsibilities of globalization, technical change, and ageing are still discussed among specialists. What is clear, however, is that the tax and transfer system in general did not compensate fully for the increase in primary inequalities. Still, the tax and transfer system has not become less redistributive along these years. Rather, there seems to be also a convergence amongst EU Member states on the extent of redistribution (Figure 5): the system has become less redistributive in Nordic countries but more so in Italy. In France and Germany, the tax-and transfer system seems to have delivered similar amount of redistribution along the period.[26] In 2010, the ratio of after- to pre-tax inequalities ranged from 0.54 in Finland to 0.68 in the Netherlands, to be

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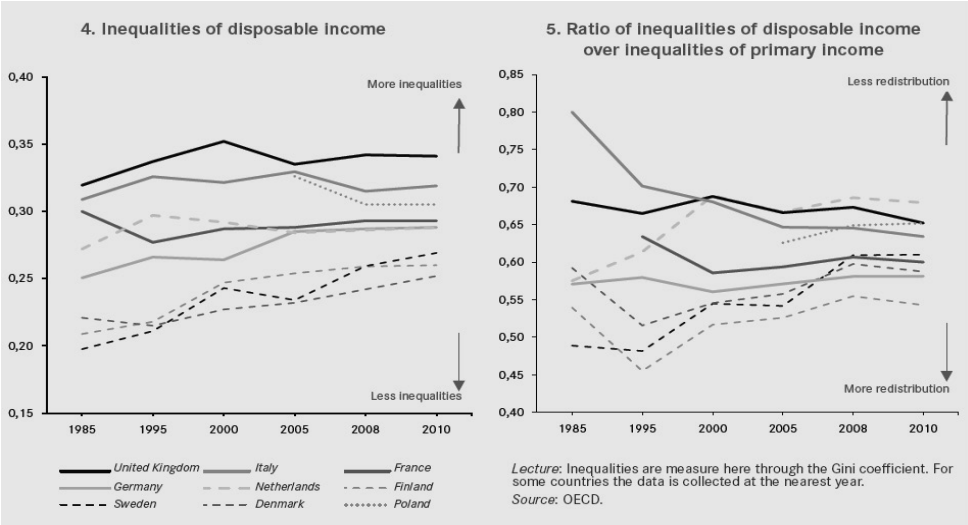
compared to 0.69 in Japan, 0.71 in Australia, 0.72 in Canada and 0.76 in the United States: EU countries have seemed to converge to a degree of redistribution that is higher than in other advanced regions.[27]

> **Statement 4.** Despite substantial reduction in top personal income tax rates and measures taken by many European countries to reduce the tax burden on capital income and wealth, the tax and transfer systems have not become less redistributive on average.

It can be argued however that the system should have become more redistributive to counter-act the rise in primary income inequalities. This is especially the case for the top-1% of the population whose share in pre-tax income has risen very fast in some OECD countries.[28] However, it is not possible to say that governments have lost part of their ability to redistribute.

4. Inequalities of disposable income

5. Ratio of inequalities of disposable income over inequalities of primary income



THREE PROPOSALS

Based on the previous analysis, we would argue that there is a need for further tax harmonization in Europe essentially because tax competition introduces distortions in the single market. Independently from this argument, the crisis of the euro area has launched a debate on a "fiscal capacity" or euro area budget as a necessary complement to the single currency.[29] This immediately raises the question of the resources to such budget, hence of tax cooperation. Finally, models of tax competition make a clear distinction between "small" countries (which take global variables as given), and "big" ones (which do have an impact on the global economy). One challenge of tax coordination/cooperation in the EU would be

to move a collection of "small" countries into one "big" player, which would raise the leeway for tax policy.

A powerful counter-argument is the needs for each country to express its own social preferences (taste for public versus private goods, willingness to redistribute income) in its tax system. Although social preferences do differ across the EU, the convergence of redistributive patterns illustrated in Figure 5 suggests that the social preference argument may have become less relevant at least for Western Europe.[30]

In the following, we concentrate on corporate taxation and more specifically on the taxation of banks. The reason is the clear distortions reviewed above for the corporate sector, and the building up of the European banking union. Following the taxonomy presented in the first section of the paper, our recommendations amount to extending tax harmonization on the CIT and starting an initiative of tax cooperation.

THE CORPORATE INCOME TAX

The CCCTB project concentrates on a harmonization of tax bases and on its consolidation across Member states. Although some harmonization of tax rates (for instance through a minimum rate) would make sense, we believe that there are already large efficiency gains to be reaped from base harmonization and consolidation. For instance, base consolidation would eliminate several channels of tax optimization but also improve the ability of multinational firms to carry their losses. Base harmonization would allow Member states to reduce the distortion introduced by the deductibility of interest payments. Additionally, both harmonization and consolidation would reduce compliance costs.[31] Therefore, we recommend adopting the CCCTB project or at least some part of it (e.g. base harmonization), possibly through enhanced cooperation (nine countries) or through an *ad hoc* initiative of willing countries. Although less secured than enhanced cooperation (that is as binding as a Directive), an *ad hoc* initiative could be a useful step in the path to further harmonization, along the same process as the Schengen agreements.[32]

We are aware that no agreement on the CCCTB project has been found so far among Member states. However, as already mentioned, the crisis has recently triggered far-reaching international initiatives in the area of automatic exchange of information on capital income and of CIT base erosion. Governments have now understood that tax coordination would help to recover some tax sovereignty. Additionally, the prolonged stagnation in the euro area asks for any source of economic inefficiency to be addressed. The CCCTB project or a variant of it should be re-examined in these two mindsets.

> **Recommendation 1.** Revive the CCCTB project, in the context of increased awareness of EU governments about tax optimization and economic inefficiencies, and within the framework of "enhanced cooperation" or through *ad hoc* initiative by a group of willing countries.

TAX COOPERATION AS A COMPLEMENT TO THE BANKING UNION

In June 2012, the Heads of State and Government of the European Union agreed to create a banking union as a complement to the monetary union. The objective was to break the vicious circle between banks and government finances at the national level. The new

framework that is being implemented in 2014 relies on a single regulatory framework for all the banks of the EU28, a Single Supervisory Mechanism (SSM) for all banks of the euro area plus those of non-euro countries that will participate in the scheme (all but the United Kingdom and Sweden, hence EU26), and a Single Resolution Mechanism (SRM) relying on bail-in principles and on a Single Resolution Fund (SRF) to allow bank resolution to be managed in a similar way across the banking union and to minimize the impact of bank resolution for tax payers and for fiscal sustainability at the national level.

The 128 banks considered "systemic" (accounting for 80% of total assets of the banking sector) will be directly supervised by the SSM, whereas smaller banks will be supervised indirectly by the SSM, through national supervisory agencies. The SRF will progressively be fed by contributions of the banks themselves. The contributions will be based on their liabilities, excluding own funds and covered deposits. They will be calibrated so as to allow the fund to reach EUR 55 bn (or 1% of covered deposits) in eight years.[33]

Although they will be subject to the same regulatory and supervisory environment across the banking union, banks will still be applied different tax treatment (Box 3). We consider a single European tax on the banking sector as the logical counterpart to the banking union, for three reasons. First, there is a need to remove tax distortions across the banking union, since such distortions contradict the single regulatory and supervisory treatment of the banks. Second, existing tax distortions between banks and non-banks need to be eliminated and a common tax could help achieve this objective along with the right regulatory treatment of banks and non-banks. These distortions arise due to VAT exemption of the financial sector and also due to the implicit subsidy enjoyed by the systemic banks.[34] Finally, there is a need for a permanent tax resource to make the resolution scheme fully credible.

3. Financial taxes in the European Union

The taxation of banks differs considerably across the EU. In France, firms of the financial sector pay a wage tax (EUR 2.5 bn in 2010)[a] which compensates for their exemption from VAT. They also pay a systemic risk tax (introduced in 2011, which raised EUR 1 bn in 2012) and a stamp duty (introduced in 2012, which raised EUR 245 mn the same year).[b] A wage tax also applies in Denmark, but not in other EU countries. Some countries apply a stamp duty and/or a tax on bonuses, and some have bank levies on the 'non-insured' liability side of the balance sheet (mostly debts and uninsured deposits). The only attempt to harmonize the taxation of the financial sector at the European level so far (through the "enhanced cooperation" procedure) is the Financial Transaction Tax (FTT) in preparation, whose purpose is to tax gross financial transactions at a low rate to discourage short-term transactions, along the polluter-payer principle.

a Conseil des Prélèvements Obligatoires (2013): *Les prélèvements obligatoires des entreprises du secteur financier*, January.

b *Cf.* Ministry of Economy and Finance (2014): *Rapport économique et financier* 2014, tome 1.

4. The Financial Activities Tax (FAT)

Taxing financial activities may be assigned three distinct objectives:

– raise revenues, in particular to cover too-big-to-fail costs, i.e. costs resulting from the necessary intervention of the government when a bank failure may put the entire banking sector at risk;

– correct excessively risky behaviors of market participants, consistent with the polluter-payer principle;
– ensure a level playing field between different economic activities.

The first two objectives are contradictory: successful corrective taxation will unlikely raise large receipts. The second objective is already tackled through financial regulation; hence the question is whether financial regulation is enough or whether a tax would be useful on the top of the regulation. Finally, the third motivation for taxing financial activities arises due to the difficulty in applying the same tax legislation as for other activities. In particular, financial services are generally exempted from the VAT.

The FAT was initially proposed by the International Monetary Fund in 2010 as a way to correct a distortion across economic activities related to the exemption of financial activities from the VAT. The FAT would apply to the sum of profits and remuneration of financial institutions, as a proxy of their value-added. The wage tax applied to financial institutions in Denmark and France is close to the concept of a FAT. Different variants of the FAT can be designed. For instance, restricting the tax base to only high levels of remuneration and applying a basic allowance on profit would exempt the "normal" return of capital from taxation.

Consistently with these three objectives, we suggest all specific taxes as well as fees on the banks covered by the SSM to be transferred at the banking union level and merged into a single Financial Activity Tax (FAT), which would simplify bank taxation and would not necessarily increase the tax burden. The FAT is a levy on the sum of remunerations and profit – a proxy for banks value added (Box 4). It has initially been suggested by the IMF (2010).[35] Several versions of the FAT can be designed. Based on the calculations provided by the European Commission (2011c)[36] a 5% FAT applied to the EU26 (i.e. the banking union) could raise EUR 10.6 to 23.4 bn annually, depending on the scheme adopted.

The FAT could allow the SRF to receive a yearly budget that would accumulate until a specific size is reached. After the fund has been filled, it could constitute the first building block of a euro area budget, while countries covered by the banking union but not in the euro area (e.g. Denmark) would see their contributions returned to their national budgets. Excluding non-euro countries, a 5% FAT could contribute EUR 10.3 to 20.9 bn per year. One could use this budget, for example, to fund trans-frontier investment projects in the euro area, when they cannot be financed by the private sector. National spending should be reduced accordingly in order to avoid that a national budget deficit emerges as a result of the reduced national tax revenues.

Transferring FAT receipts to the SRF would accelerate the building of a credible fiscal backstop to the banking union, which would be consistent with the willingness of euro area members to use a common budget to fund public goods that are specific to the euro area (here financial stability).

Recommendation 2. Transfer all national specific tax levies on the banks within the European banking union as well as fees used for the Single Resolution Fund at the euro area level and merge them into a single Financial Activity Tax (FAT). Assign the receipts first to the bank Single Resolution Fund. Then, use the receipts (except those from non-euro area member states) as the first building block of a euro area budget.

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The perimeter of this proposal needs to fit that of the banking union, after an agreement is reached on base harmonization. We believe if would be less difficult to obtain an agreement on bank taxation than on the corporate income tax since Member states have already transferred the supervisory power to the European level, and they have already agreed to use an intergovernmental setting to collect a common fee for a bank resolution fund.

5. A banking CIT for the Euro area

In 2010, French financial institutions (including insurance companies) paid a total CIT bill of EUR 6.5 bn, hence 20% of total CIT receipts, or 0.34% of GDP.[a] The implicit CIT rate (tax payments divided by some measure of gross or net profit) was broadly in line with non-financial corporations.[b] It is difficult to collect similar information for other EU countries. On average over 2006-2008, the IMF (2010)[c] estimates at 18% the share of financial institutions in CIT receipts in France, 26% in Italy, 21% in the UK. Hence the shares are of similar orders of magnitude across countries. The European Commission itself estimates the CIT revenue on the European financial sector to be EUR 34 to 46 bn in 2009.[d] Assuming that the euro area accounts for 68% of this amount,[e] we get an indicative budget of EUR 23 to 31 bn yearly, assuming unchanged tax rates. However CIT rates differ across countries. One solution would be to apply a single CIT rate at the euro area level, and let national government impose national surcharges when necessary to meet their national CIT rate (to avoid any discrimination between banks and other companies). Assuming, national governments as a whole retain one fourth of the CIT on banks,[f] we get an annual budget for the euro area of around EUR 17 to 23 bn, or 0.17 to 0.23 of euro area's GDP.

[a] *Cf.* Conseil des Prélèvements Obligatoires (2013): *Les prélèvements obligatoires des entreprises du secteur financier*, January, Table 7 p. 83; Ministry of Economy and Finance (2012): *Rapport économique et financier*, tome 1, p. 73.

[b] According to the Conseil des Prélèvements Obligatoires (*op.cit.*), financial institutions are more profitable than non-financial ones, which explains why they pay high wages; conversely, financial institutions have lower labor intensity, which explains why they pay relatively less in terms of social contributions.

[c] IMF (2010): *A Fair and Substantial Contribution by the Financial Sector, Final Report for the G-20*, Table A.5.1, June.

[d] European Commission (2011d): *Commission Staff Working Paper Impact Assessment Accompanying the Document Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC*, COM(2011), 594 final.

[e] According to the Liikanen Report (*op.cit.*), banks from the euro area totalized around 68% of EU27 bank assets in 2011. Here we assume taxable profit to be proportional to aggregate bank asset at the country level.

[f] In 2013, the median of euro area top CIT rates was 25%, with only four countries below 20% (Ireland, Latvia, Slovenia and Cyprus). The highest nominal rate was that of France (36.1%). *Cf.* European Commission (2013): *Taxation Trends in the European Union*.

TOWARDS A EUROZONE BUDGET

Beyond the banking union, the case for a fiscal union in the euro area has been raised as a useful complement to monetary union.[37] The main motivation for a fiscal union is to help Member states to compensate for the lack of an independent monetary policy at the national level when facing a specific shock. According to the theory of optimum currency areas, countries in a monetary union need to rely on alternative adjustment devices, namely price and wage flexibility, capital and labour mobility, or a federal budget.[38] The latter can have direct stabilizing impact in case of asymmetric shocks (e.g. sustaining disposable income in crisis countries), or an indirect one (by facilitating labor mobility and stabilizing capital movements during a crisis). Then, the crucial question is that of the resources of the budget. We suggest that the CIT raised from the banking sector could constitute the first building

block of a Eurozone budget. A rough calculation suggests annual receipts of the order of EUR 20 bn (Box 5).

> **Recommendation 3.** In the euro area, after harmonizing corporate income tax bases and specific tax levies on the banking sector (see recommendations 1 and 2), introduce a minimum corporate income tax on banks. The proceeds would be transferred to the euro area budget.

CONCLUSION

Taxation in the EU is already high by international standards, so any discussion on tax cooperation should not be used to increase the tax burden even further. Our proposals aim at correcting existing distortions created by tax competition within the EU, mainly for the corporate sector and more specifically for the banking sector. The creation of a banking union makes this a natural step.

Given the high social costs of the crisis in the euro area, a discussion on how the winners of European integration (mainly the skilled workers and capital owners) could contribute further to supporting the more vulnerable (e.g. through funding a European unemployment and/or labour mobility scheme) is needed. It requires a high degree of national tax enforcement as well as further international cooperation to fight global tax evasion, including through tax havens. This discussion will also have to look at the structure of expenditure and its adjustment, which has in many countries increased the generational divide and come at the expense of investments in education and research.˜

Notas

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1. The different views are synthetised in Wilson, J.D. and D.E. Wildasin (2004): "Capital Tax Competition: Bane or Boon", *Journal of Public Econo*mics, 88, pp. 1065-1091.
2. Art. 223.2 of the Treaty on the Functioning of the European Union, TFEU.
3. See ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm. In 1992, the Ruding report proposed to harmonize CIT rates through imposing a minimum rate, but this proposal was rejected by the Council. See Report of the Committee of Independent Experts on Corporate Income Taxation chaired by Onno Ruding, March 1992, aei.pitt.edu/8702/1/8702.pdf.
4. Without any coordination, the same profit would be taxed twice: first at the affiliate's level, and then at the mother's level.
5. See www.oecd.org/tax/beps.htm
6. See Andersson, F. and R. Forslid (2003): "Tax Competition and Economic Geography", *Journal of Public Economic Theory*, 5(2), pp. 279-304; Bénassy-Quéré A., N. Gobalraja and A. Trannoy (2007), "Tax and Public Input Competition", *Economic Policy*, 22(50), pp. 385-430.
7. See European Commission (2011a): *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base* (CCCTB), COM(2011) 121/4.
8. Enhanced cooperation allows a subset of at least nine Member states to proceed to further integration provided they do not infringe the treaties and stay open to new participants. See Treaty of the European Union, Article 20.
9. See the Communiqué of the Meeting of the G20 Finance Ministers and Central Bank Governors Sydney, Australia, February 23, 2014; and conclusions of the March 20-21 2014 European Council in Brussels.
10. See "Europe 2020, A European Strategy for Smart, Sustainable and Inclusive Growth", *Communication of the Commission*, COM(2010) 2020, 3 March 2010, p. 28. The Europe 2020 strategy was adopted in June 2010.
11. Tiebout, C.M (1956): "A Pure Theory of Local Expenditures," *Journal of Political Economy*, 64(5), pp.416-24. An efficient jurisdiction is a local or a national government that offers the highest quantity or quality of public services for a given level of taxation, or the lowest level of taxation for a given provision of public services.
12. In the case of direct taxes (like the CIT), tax receipts are reduced by tax credits, tax optimization and evasion; in the case of indirect taxes (like the VAT), they are reduced by multiple rates and fraud. In all cases, openness adds to the blurred relation between effective rates and receipts (e.g. carrousel fraud for VAT, international tax planning for the CIT).
13. According to the European Commission (2011b): *Impact Assessment Accompanying the Document Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC*, September, compliance costs are around 2 percent of the corporate income tax bill for large companies in the EU.

14. When the tax is small, and in the absence of rents, economic inefficiency related to taxation is approximately proportional to the square of the tax rate. See Bénassy-Quéré A., B. Coeuré, P. Jacquet and J. Pisani-Ferry (2010): *Economic Policy: Theory and Practice*, Oxford University Press, Chapter 7.
15. For instance, a multinational can borrow in Ireland to invest in France. Interest payments paid by the French affiliate to the Irish one will be (partially) deductible from the French tax bill while being taxed in Ireland at a low rate. Profit shifting is limited by anti-avoidance provisions which themselves are perceived as burdensome by large companies. Empirical evidence of profit-shifting is provided e.g. by Huizinga H. and L. Laeven (2008): "International Profit Shifting Within Multinationals: A Multi-Country Perspective", *Journal of Public Economics,* 92, pp. 1164-1182.
16. Many studies have found evidence of such effect. According to the meta-analysis by Feld and *al.* (2011), a 1 percentage point increase in the CIT rate raises the debt-to-equity ratio by 0.3 percentage point. See Feld L., J.Herckermeyer and M. Overesch (2011): "Capital Structure Choice and Company Taxation: A Meta-Study", *CESIfo Working Paper*, no. 3400, March.
17. See Zodrow G. and P. Mieszkowski (1986): "Pigou, Tiebout, Property Taxation, and the Under-Provision of Local Public Goods", *Journal of Urban Economics,* 19(3), pp. 356-370. Lehmann and *al.* (2014) show that a race to the bottom of tax rates on top income may also arise when two governments compete for mobile high skilled labor while trying to optimize their labor-income tax schedule to the benefit of the worst-off (Rawlsian social objective). See Lehmann E., L. Simula and A. Trannoy (2014): «Tax Me If You Can! Optimal Nonlinear Income Tax between Competing Governments",» *AMSE Working Paper Series*, 2014-15.
18. Eggert W. and B. Genser (2005): "Dual Income Taxation in EU Member Countries*"*, *CESifo DICE Report*, 1/2005. Inheritance and wealth taxes have also been reduced and in many case scrapped. As of 2014, the only EU countries to run wealth taxes are Luxembourg and France. The inheritance tax was abolished in Italy in 2001 (with a reset at the symbolic rate of 4% – 8% for non-relatives – since 2006), Sweden in 2005 and Austria in 2008. See Scheve K. and D. Stasavage (2012): "Democracy, War, and Wealth: Lessons from Two Centuries of Inheritance Taxation", *American Political Science Review,* 106(1), pp. 81-102.
19. See Chetty R. (2012): "Bounds on Elasticities with Optimization Frictions: A Synthesis of Micro and Macro Evidence on Labor Supply", *Econometrica,* 60(3), pp. 969-1018; Chetty R., A. Guren, D. Manoli and A. Weber (2013): "Does Indivisible Labor Explain the Di¤erence between Micro and Macro Elasticities? A Meta-Analysis of Extensive Margin Elasticities", *NBER Working Paper*, no 16729.
20. Piketty T., E. Saez and S. Stancheva (2013): "Optimal Taxation of Top Labor Incomes: A Tale of Three Elasticities", *American Economic Journal: Economic Policy*, 6(1), pp. 230-271.
21. Ostry J., A. Berg and C.G. Tsangarides (2014): "Redistribution, Inequality and Growth", *IMF Staff Discussion Note*, SDN/14/02, February.
22. Darvas and Wolff (2014): "Europe's Social Problem and its Impact on Economic Growth", *Bruegel Policy Brief*, 2014/03, April.
23. See Easterly W. and S. Rebelo (1993): "Fiscal Policy and Economic Growth, An Empirical Investigation", *Journal of Monetary Economic,* 32(3), pp. 417-458; Mendoza E., A. Razin and L. Tesar (1994): "Effective Tax Rates in Macroeconomics: Cross-Country Estimates of Tax Rates on Factor Incomes and Consumption", *Journal of Monetary Economics*, 34(3), pp. 297-323; Piketty Th., E. Saez and S.e Stantcheva (2014): "Optimal Taxation of Top Labor Incomes: A Tale of Three Elasticities," *American Economic Journal: Economic Policy*, 6(1), pp. 230-271.
24. Jaimovich N. and S. Rebelo (2013): "Non-Linear Effects of Taxation on Growth", *CQER Working Paper*, 2013-02, Federal Reserve Bank of Atlanta.
25. The rise in inequalities in Europe should of course be put in a broader perspective. In the United States, the Gini coefficient rose from 0.34 in 1985 to 0.38 in 2010, hence to 11% more than the figure in the UK.
26. Restricting ourselves to individuals aged 18 to 68 (to avoid the composition effect related to ageing) does not alter the picture.
27. Due to data limitations, it is not possible to derive similar analysis for other EU countries, especially Eastern European ones.
28. See Alvaredo F., A.B. Atkinson, Th. Piketty and E. Saez (2013): "The Top 1 Percent in International and Historical Perspective", *Journal of Economic Perspectives*, 27(3), pp. 3-20.
29. See Van Rompuy H. (2012): *Towards a Genuine Economic and Monetary Union*, Report of the President, 5 December. Pisani-Ferry J. E. Vihriälä and G. Wolff (2013): "Options for a Euro-Area Fiscal Capacity", *Bruegel Policy Contribution*, 2013/1.
30. Eastern European countries seem to have followed a different path, which undermines the appeal of a tax harmonization scheme at the EU28 scale.
31. The reduction in compliance costs is estimated up to 8% under the CCCTB, see European Commission (2011b), *op. cit*.
32. In 1985 five of the then ten Member states (Belgium, France, Luxemburg, The Netherlands, and West Germany), signed an agreement on the gradual abolition of common border controls – an agreement that was later turned into a protocol attached to the treaty of Amsterdam. This example shows that solid European law can be preceded by an *ad hoc* agreement between willing Member states.
33. See the Intergovernmental agreement on the SRF, 21 May 2014, www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/142710.pdf
34. According to the IMF (2014), the implicit subsidy could be of the order of 60-90 basis points for 2013, or EUR 60 to 210 bn for the euro area. See IMF (2014): *Financial Stability Report, Chapter 4*.
35. IMF (2010): *Financial Sector Taxation: The IMF's Report to the G20 and Background Material,* Washington DC 2010, www.imf.org/external/np/seminars/ eng/2010/paris/pdf/090110.pdf. To look at the pros and cons of the FAT, see Fuest C. (2011): *The Financial Activities Tax (FAT) as a Way Forward?*, Presentation at Brussels Tax Forum, Taxation of the Financial Sector, March 28-29.
36. European Commission (2011c): *Impact Assessment Accompanying the Document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC*, vol. 12, Annex 11.
37. See Van Rompuy (2012) and Pisani-Ferry and *al.* (2013), *op. cit.*
38. Mundell R. (1961): «A Theory of Optimum Currency Areas», *American Economic Review*, 51(4), pp. 657-665.