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EU tax proposals need clarification

Recommendation to the European Commission

by Alex Cobham

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The European tax commissioner, László Kovács,* has reiterated two plans for EU taxation: first, that the EU budget should be funded from taxation in each member state, and second, that concrete steps be taken for harmonisation of the corporate tax base across the EU. Both are sure to cause consternation in some member states.

There are in fact strong reasons to support each; but considerable caution is required. The Commission needs to clarify the grounds for each, in order not only to make the case publicly but because this process will lead to recognition of important flaws that should be corrected before further political capital is committed.

MAIN POINTS
The European Commission tax proposals should broadly be welcomed. Funding the EU bduget via income tax rather than VAT however would strengthen channels of political representation, and ultimately the EU. Arguments for corporate tax harmonisation should be clarified to emphasise the importance of EU-wide over individual member state welfare.

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PROPOSAL 1: FUNDING THE EU

The first proposal, as explained to the Financial Times (Commissioner to press ahead with EU-wide tax, 2 March 2006), is for a tax to fund the EU budget. This "would best be linked to the value added tax raised in the 25 member states".

There are three important reasons why EU funding should be raised as a specific element of member states' tax systems. First, it would provide a stable and predictable basis for long-term EU budget planning. Second, it would fix - in effect - a coherent formula for the distribution of contributions among member states, rather than the current ad hoc basis which inevitably encourages rounds of negotiation where members seek to minimise contributions.

The third, often less emphasised but arguably more important facet of an EU tax levy, concerns the political effect. Following the second point, a consistent formula applied to each member states' contributions could demonstrate 'fairness' to citizens of any given state. Moreover, it would put to one side at least some of the domestic arguments such as that in the UK over whether a particular government has 'sold out' the country by allowing a change to the rebate.

This argument has a further important element however. This relates to the long-established link between taxation and political representation. One of the problems lingering over the EU is the political disconnect, reflected not least in the apathy shown towards successive European elections and of course the proposed EU constitution.

History (and econometrics) show that channels of political representation are systematically strengthened by the levying of tax. As long as EU budgets are funded on ad hoc basis, as the result of successive negotiations by member state governments, citizens perceive taxation at that level only. The establishment of a specific EU tax must surely provide significant support to the process of connecting the costs and benefits of the EU to the political channels available to citizens.

Given these major reasons for EU funding through a tax, it is possible to consider exactly what type of taxation could best fulfil the implicit criteria. In terms of stable revenue provision, the first reason, each main element of tax systems (corporate and/or individual direct taxation, and VAT-type taxes) could be adjusted to include a satisfactory EU element.

The second reason for the general proposal leads to a more specific position. The question of distribution supports a method of tax that is consistent with EU goals - not least of reducing poverty in member states. Although overall tax systems will remain in member states' hands then, it is surely important that tax in the name of the EU is broadly consistent with the aim of progressive redistribution. This clearly supports a tax on income, where strong progressivity is possible, as opposed to the typcially regressive taxation of consumption.

This case is made even more strongly by consideration of the third reason - that of connecting EU citizens politically to the institution. Part of the 'resource curse' of e.g. oil-rich countries is seen in the governments' ability not to charge high direct taxes, since these are the most politically challenging. The impact has typically been to promote tax systems that are unprogressive, and channels of political representation (and hence standards of governance) that are weak at best. The European Commission should bite this particular bullet, recognising that a politically less popular choice will in fact make the best long-term contribution to its own political representativeness - and ultimate success across the full range of its goals.

PROPOSAL 2: CORPORATE TAX BASE HARMONISATION

The proposal for harmonisation of the corporate tax base across the EU has circulated for many years, and hence many of the arguments on each side are well-rehearsed. It is useful again to assess the basis for the measure, as a way to generating criteria to compare particular versions.

The key argument advanced for harmonisation of the base are that it would minimise the compliance and entry costs of businesses wishing to operate in more than one EU market. A secondary argument is that smaller firms, the source of most employment, are especially constrained by these costs. As such, there are likely to be substantial competitiveness benefits from harmonisation.

The main concern raised about such harmonisation - typically by the UK and Ireland - is that it risks undermining the sovereignty of individual member states. The foundation of the argument is that a common tax base would pave the way to common taxation measures, or at least constraints on the flexibility of individual member states. This, it is argued, would eventually limit the possibility for tax competition.

Mr Kovács has instead emphasised the importance of harmonisation to allow effective tax competition between member states. Clearly where the extent of reliefs and exemptions differ markedly between jurisdictions, as is the case within the EU, comparison of tax treatment for businesses will be complex and costly and hence the extent of competition may be impeded.

The benefits of tax competition are in fact not clear in any case. For a union such as the EU, the potential costs of corporate shifting to lower-tax members are large. Where a lower-tax member attracts corporate profit declaration from another member, the net effect for the EU is one of revenue loss only. WHere genuine investment is attracted only becuase of the tax treatment, the implication is that production would otherwise have been more efficient elsewhere. The overall effect is not then one of greater efficiency, but rather less - and the average revenue impact is therefore compounded by a negative productivity effect.

While Ireland may attract corporate profit declaration (more than genuine investment) through its tax policy, this is only of value to the EU if those profits would otherwise have been declared outside its borders. Even in this case, however, it may be seen as irresponsible - and could eventually result in retaliation from losing rivals, leading in the long run to lower revenues all round. The political climate in the US to offshoring of jobs is growing more threatening, and that to profit and hence tax revenue shifting may follow.

While the proposal for harmonisation is welcome then, the emphasis may be clarified. Arguments for sovereignty are valid insofar as member states might reasonably wish to pursue tax strategies which give different emphasis to revenu creation, redistribution and the provision of incentives (be they for growth, environmental or other goals) to individuals and businesses.

Arguments for sovereignty that would seek to protect the power of individual member states to effectively cheat the EU as a whole out of revenue, to further only their own economies, should be given short shrift. Clarification of this point would send a signal that the Commission is willing to stand up against individual country acts that may jeopardise EU-wide welfare - and would find considerable support.

* Full disclosure: Mr Kovács sits on the OCGG Board of Advisors. He has had no involvement in the preparation of this document.

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