

# **Tax co-ordination and the enlargement of the European Union**

by

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## **Abstract**

In this paper the concept of tax co-ordination within the European Union (EU) is discussed, in view of the coming enlargement of the EU. The tax externalities that possibly arise in a single market are analysed, as well as the ways these externalities can be prevented or internalised. These theoretical reflections are placed alongside the actual system of tax co-ordination within the EU. Focusing on VAT and corporate taxation, the implications of enlargement of the EU for the tax co-ordination issue are discussed.

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## *Contents*

- 1 Introduction*
- 2 Tax externalities in a single market*
- 3 Tax co-ordination in the EU*
- 4 The enlargement of the EU and tax co-ordination*
- 5 Conclusions*

## *References*

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### **1. Introduction**

It is obvious that the transition of former socialist economies to market economies calls for tax reform. According to Gandhi and Mihaljek (1992/1995) the need for tax reform arises for, at least, three reasons.

First, there is the incompatibility of a socialist tax system with a market-oriented economy. For instance, in most socialist economies commodity prices are fixed by government, and taxes cannot be moved forward or backward. Turnover taxes then take the shape of retail-wholesale price differentials, resulting in many different turnover tax rates. In a market economy, where producers and retailers are free to set their prices, complex multi-rate tax systems based on wholesale-retail price differentials are no longer feasible. A uniform sales tax based on the retail price is more functional.

Secondly, changes in the economic structure of a country can only be brought about by different types of economic reform, such as financial sector reform, the creation of factor markets, external sector reform, and price reform. Tax reform can facilitate as well as complement these reforms.

Thirdly, macro-economic stability requires sufficient government revenues. In former days the main government revenue source were profit remittances by state-owned enterprises. Privatisation programs have transferred ownership of these enterprises to the private sector, resulting in a major loss of revenue and in the need to introduce new taxes on corporate income.

Over the last years most former socialist countries have implemented major fiscal reforms, of which

tax reforms are a part<sup>1</sup>. Corporate income taxes have been introduced, value-added taxes (VATs) have replaced complex turnover taxes, and systems of personal income tax have been developed (IMF, 1998, p. 105). For most countries market-directed tax reform suffices, for some countries, that are about to enter the European Union (EU), fine-tuning is required. As a rule new members of the EU are obliged to adopt in full the so called *acquis communautaire* (the standing legislation, rules, instructions and understandings). This ‘classical Community method of enlargement’ does not allow for permanent opt-outs, and does not call the *acquis* as such into question<sup>2</sup>. An important part of the *acquis communautaire* consists of the results of tax harmonisation efforts, mainly in the field of indirect taxes. The countries that established the European Community (EC) have opted for a uniform general sales tax which takes the form of a VAT; countries that later on joined the EC were compelled to adopt the same system. In recent years tax harmonisation efforts in the EU have been directed at other indirect taxes as well, especially at various excises; up to now direct taxation has hardly been the subject of tax harmonisation. The harmonisation of indirect taxation is justified invariably by the requirements of a single market (in casu the unrestricted movement of goods and services), and by the opportunity uniform national indirect taxes offer for ‘piggy-backing’ by supranational government (part of the national VAT-revenues are earmarked as ‘own resources’ of the EU and are transferred to Brussels).

In recent years doubts have been cast on the validity of the concept of far-reaching tax harmonisation. First, the advisability of the ultimate objective of tax harmonisation, the *uniformity* of national tax systems, has been criticised. Such uniformity is not strictly needed for the functioning of the Single European Market (SEM); it can even be harmful if member states impose inequitable and distortionary taxes on one another. Secondly, even if uniformity is desirable, it is argued that it can be brought about more efficiently by tax competition between member states than by tax harmonisation out of

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<sup>1</sup> See Kuligin (1998) for a brief survey of the changes that took place over the last decade in the tax structures in seven countries of Central and Eastern Europe (including the Czech Republic, Hungary and Poland). See Véghelyi (1997) for an overview of trends in tax reforms in the Czech Republic, Hungary and the Slovak Republic. See Casanegra de Jantscher, Silvani en Vehorn (1992/1995), and IMF (1998, p. 106) for the features of national tax administrations and the modifications that have been made in relation to transition.

Brussels. However, tax competition can be harmful as well, as has been argued very recently by the OECD (1998a). There is a case then for *tax diversity*, and for tax co-ordination within the EU, allowing member states maximum flexibility in arranging their tax systems, without interfering with the functioning of the SEM<sup>3</sup>. ‘Improved co-ordination of tax policies’ has become the magic formula in Brussels as well, witness the tax package the EU-Ministers of Finance unanimously agreed upon in December 1997, which aims at limiting the erosion of tax revenues, at contributing to reverse the trend of increasing taxation of labour, and at eliminating distortions in the Single Market.

This paper addresses the relevance of the next enlargement of the EU<sup>4</sup> to the issue of tax co-ordination. The paper will be structured as follows.

First, in *section two*, we will discuss the concept of fiscal externalities, focusing on tax externalities (in a single market). A number of different tax externalities will be discussed, like externalities resulting from tax exporting, from tax (base) sharing, from international tax crediting, from the use of taxes as tariffs, and from tax competition. Next, in *section three*, an overview is given of the way these externalities are tackled in the EU. In *section four* we will discuss the implications the coming enlargement of the EU has for the issue of tax co-ordination, by comparing various features of the tax systems of future EU-members with characteristics of the tax systems of incumbent EU member states. *Section six* finally, contains some conclusions.

## **2. Tax externalities in a single market**

Recently the well-known concept of spill-overs has been expanded to the concept of ‘interjurisdictional fiscal externalities’. Interjurisdictional fiscal externalities occur when a government’s tax and

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<sup>2</sup> See Preston (1995) for a critical analysis of this method.

<sup>3</sup> Amongst others: Cnossen (1990).

<sup>4</sup> Following the European Commission in Agenda 2000: with the Czech Republic, Poland, Hungary, Slovenia, Estonia en Cyprus. In this paper we will set aside Cyprus, because this country is not in a process of transition, and therefore not relevant to the theme of the conference.

expenditure decisions affect the well-being of taxpayers in other jurisdictions either directly by changing their consumer or producer prices or their public good provisions, or indirectly by altering the tax revenues or expenditures of other governments (Dahlby, 1996, p. 398). *Direct externalities* thus affect the utility functions of non-residents; *indirect externalities* affect the budget constraints of other governments. Moreover, fiscal externalities can be *vertical* (when a lower-level government and a higher-level government are involved) or *horizontal* (when governments on the same level are involved). Vertical externalities are always indirect<sup>5</sup>; horizontal externalities are either direct or indirect. Another distinction is that between *tax externalities* and *expenditure externalities*, depending on the kind of decision the externality stems from<sup>6</sup>. Yet another distinction is the familiar one between *positive* and *negative* externalities. Below, in table 1, we give some examples of different sorts of fiscal externalities. A and B stand for two local (or national) governments, C for the central (or supranational) government.

Table 1 Fiscal externalities<sup>7</sup>

<i>Externality</i>	<i>Positive</i>	<i>Negative</i>
Horizontal direct tax externality	A lowers the rates of its local beer excise, of which visitors from B profit as well	B introduces a tourist tax for non-residents
Horizontal indirect tax externality	B abolishes the property tax for small companies; formerly unemployed residents from A get a new job; A can cut back on social services	A lowers the rates of its local beer excise; the turnover in B falls, as do the excise revenues
Vertical indirect tax externality	C introduces an exemption in the motor vehicle tax for all government vehicles	B increases the rate of a ‘piggy backed’ tax (a tax jointly raised by B and C); due to the subsequent increase in tax evasion C gets less tax revenues
Horizontal direct expenditure externality	Anti-pollution policy by A	Subsidising by B of an outdoor heavy metal concert in B, that can be ‘enjoyed’ in A as well

<sup>5</sup> Direct vertical externalities would involve the same set of residents.

<sup>6</sup> For the indirect fiscal externalities we could make a further distinction between (tax or expenditure) externalities *on* taxation and (tax or expenditure) externalities *on* expenditure.

<sup>7</sup> It is worth noting that the same decision can cause a direct as well as an indirect externality, or can have a vertical and a horizontal effect.

Horizontal indirect expenditure externality	Building by A of a regional training centre for police officers	Introducing extra bonuses for scarce specialisms in the civil service, by A
Vertical indirect expenditure externality	Subsidising by C of the building of private houses, resulting in higher property tax revenues for A and B	Training of local civil servants by A and B to make optimum use of the subsidies of C

Tax externalities can distort fiscal decisions if the perceived marginal cost of public funds (i.e. the economic cost to taxpayers of raising an additional dollar of tax revenue) deviates from the social marginal cost of public funds (SMCF) which takes into account the effect of a tax change on all taxpayers and on all governments' budget constraints (Dahlby, 1996, p. 398/399). Different taxes<sup>8</sup> offer different possibilities for externalities to arise, as is shown in table 2.

*Table 2 Tax externalities*

<i>Kind of taxes</i>	<i>Keyword</i>	<i>Kind of tax externality</i>
Exclusive taxes	Tax exporting	Horizontal direct externality
	'Taxiffs'	Horizontal direct externality
Shared taxes	Tax base sharing	Vertical externality
Linked taxes	Tax crediting	Horizontal indirect externality
		Vertical externality
Competing taxes	Tax competition	Horizontal indirect externality

Below we will discuss these externalities in more detail, as well as the remedies that are available to prevent or internalise them. With prevention of tax externalities, these externalities do not occur; with internalisation of externalities they do take place, but the distorting effects on fiscal decisions are countered. Horizontal tax externalities can be prevented or internalised horizontally as well as vertically; vertical externalities can only be prevented and internalised vertically.

### Tax exporting

When government A has the exclusive right to tax an economic activity or income source, it can

choose to shift the burden of that tax to residents of jurisdiction B (tax exporting), resulting in an underestimation of the SMCF, and an oversupply of public services in the tax-exporting jurisdiction.

In a way, tax exporting governments exploit monopoly advantages via taxation. Because of the mainly local character of the monopoly advantages at hand, tax exporting is sometimes considered to be hardly relevant internationally (Smith, 1996, p. 287). This view may hold for tax exporting in the case of tourist attractions and the like. However, tax exporting is not only about exploiting, via taxation, monopoly advantages; it has to do with the monopoly to tax. As a principle of international taxation, each country has the basic monopoly to tax all economic activities within its own borders. If a country, in assessing its personal income tax, places a higher tax burden on foreign taxpayers than on domestic taxpayers, tax exporting occurs. If the property tax on houses owned by foreigners is higher than the property tax on houses owned by residents, tax exporting takes place as well.

Tax exports and tax imports arise simultaneously. For welfare considerations, only the difference between the tax exports and imports is relevant (net tax export effects; Fehr, Rosenberg, and Wiegrad, 1993, p. 13). Overall, tax exporting and importing is a zero-sum game, consisting of income transfers from one jurisdiction to another.

As far as tax exporting is concerned, there are two basic remedies:

- prevention of tax exporting by bi- or multilateral agreement. Most tax treaties provide for non-discriminatory taxation by the concluding countries;
- internalisation by transfers offsetting the net tax export effects. These transfers can be horizontal (i.e. intergovernmental) as well as vertical (in which case supranational government gives matching grants to lower-level governments with negative tax export effects, and prunes away positive tax export effects).

### ‘Taxiffs’

When a government has the exclusive right to tax the import, trade and export of goods and services within its borders, trade barriers can be set up when using these (indirect) tax structures to discrimi-

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<sup>8</sup> The distinction used here partly follows Van Rompuy, Abraham and Heremans (1991).

nate between domestic and foreign goods and services. Import duties are an obvious example of 'taxiffs'. Differentiation of VAT-structures and rates, and of excise taxes, can also be used to approximate the mechanism of protection by tariffs.

'Taxiffs' are paid by residents; exported taxes, that were discussed above, are paid by non-residents. The costs of using 'taxiffs' are borne by foreign producers, the benefits accrue to domestic producers, resulting in an underestimation of the SCMF, and an oversupply of public services.

'Taxiffs' can be prevented by tax harmonisation; internalisation of these effects can take the form of compensating grants in case harmonisation rules are not fully met (fines).

### Tax sharing

With shared taxes an activity or income source is taxed by one or more local or national governments (A and/or B) and by central or supranational government C (joint taxation, or tax base sharing). If one government raises its tax rate, by and large the overall amount of taxable activities or goods will fall, resulting in a revenue loss for the other government (that does not change its tax rate). Generally, governments will underestimate the SCMF of raising revenue from shared tax bases, resulting in an oversupply of public services.

A revenue matching grant between the governments involved, equal to the revenue loss of the passive government, would internalise this externality (Dahlby, 1996, p. 406).

### Tax crediting

With linked taxes, the base of a tax levied by one government is statutorily linked with a tax levied by another government. The deductibility of state and local taxes from federal income tax in the USA is an example of linkage. Tax exemptions or tax credits in order to bring relief from double taxation are another. Linked taxes can give rise to vertical and/or horizontal externalities. In most cases, a government that increases a linked tax, will not take into account the resulting loss of revenue for other governments. As with shared taxes, linked taxes give cause for underestimation of the SMCF, and for oversupply of public services, and as with tax sharing, matching grants can be used to internalise

this externality.

### Tax competition

With competing taxes, a common activity or income source is used for taxation by competing governments on the same level (A and B). If these tax bases are mobile between A and B tax competition can occur, resulting in cross border shopping, re-allocation of firms, capital flight, labour migration, etcetera. Tax competition leads to a downward pressure on tax rates, and to an overestimation of the SCMF (additional revenue raised in B as a result of tax increases in A is disregarded). This in turn leads to an inadequate supply of public services. To offset this distortion a revenue matching grant can be used equal to the additional revenue that accrues to the other states when one state raises an additional dollar of tax revenues (Dahlby, 1996, p. 406). Tax competition can be prevented by tax harmonisation.

Tax competition hinges on the movement of tax bases. Taxpayers' decisions to move tax bases to other jurisdictions basically depend on three factors:

1. the nature and magnitude of the fiscal differentials between their own jurisdiction and competing jurisdictions. Fiscal differentials are the differences as far as the welfare of a taxpayer is concerned, between the 'package' of public services and taxes in one jurisdiction, and the 'packages' other jurisdictions have on offer. The more positive these fiscal differentials are, the more likely the movement of tax bases is. Tax rate differentials are at best proxies for tax differentials (due to differences in base definition, assessment, and enforcement of tax laws); tax differentials, in turn, are at best proxies for fiscal differentials. Tax harmonisation reduces tax differentials;
2. the mobility of the tax base in question (or: the costs of movement of tax bases as such). Capital is very mobile, property is not. Mobility has to do with physical characteristics of the tax base, as well as with the extent to which the relevant market is integrated<sup>9</sup>;
3. supplementary costs and benefits as a result of the movement of tax bases (for instance the side-

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<sup>9</sup> See Musgrave (1990), Van Rompuy, Abraham and Heremans (1991), and Smith (1996) for a more detailed discussion of the mobility of various tax bases.

effects of changing residence, in terms of more costly visits to relatives).

Much attention has been given in the literature to tax competition. Below, we will focus on two different relevant aspects:

- the tax competition game;
- tax competition, equity, and Leviathan.

### *The tax competition game*

The decision for a country to engage in tax competition can be considered to be a prisoners' dilemma game, as is shown in table 3.

*Table 3 Tax competition as a prisoners' dilemma<sup>10</sup>*

Country 1/country 2	Engage in tax competition	Not engage in tax competition
Engage in tax competition	(3,3)	(4,1)
Not engage in tax competition	(1,4)	(2,2)

Obviously, the Nash-equilibrium is (3,3) with both countries engaging in tax competition.

Kanbur and Keen (1993)<sup>11</sup>, focusing on cross-border shopping, offer more insight in the tax competition game. When unrestricted tax competition takes place between a small and a large country (with size being a matter of the number of residents), and each country behaves in the Nash manner (i.e. chooses its own tax rate to maximise its tax revenue while taking as given the tax rate set by the other, bearing in mind the impact on cross-border shopping), in equilibrium the small country undercuts the large country. I.e., the small country's tax rate  $t$  is below the large country's tax rate  $T$  ( $t < T$ ). Compared to the situation in which tax competition is restricted (by closed borders) joint tax revenue is reduced, with the larger country always suffering a revenue loss; if the difference in size is suffi-

<sup>10</sup> In table 3 (x,y) denotes the (ordinal) utility country 1, respectively country 2, derives from the situation in question (with 1=low, 4=high).

<sup>11</sup> See Schwidrowski and Wahl (1991) for similar research (with similar findings), focusing on the effect on governments' discretionary budgets of a clearing house system, of a shift from the destination to the origin principle, of harmonization of tax bases, and of centralization of the power to tax.

ciently great, the smaller country may gain revenue<sup>12</sup>.

Setting a uniform rate somewhere between  $t$  and  $T$  always harms the small country (relative to the Nash-equilibrium). It is beneficial to the large country (again: relative to the situation with unrestricted tax competition) if harmonisation takes place at rate  $T$ ; it is harmful to the large country if harmonisation takes place at  $t$ .

Setting a minimum tax rate (also somewhere between the noncooperative rates) would lead to the small country setting that minimum rate, still undercutting the large country. Compared with the outcome under unrestricted tax competition both countries set higher tax rates; revenue will certainly increase in the large country, as will revenue in the small country.

Clearly, tax competition is inefficient, but what method of co-ordination is optimal? Kanbur and Keen (1993, p. 888/889) offer two criteria of optimality:

- Pareto-efficiency: maximising the revenue of some country conditional on securing some given level of revenue for the other. Relative to the uncooperative situation, setting a minimum tax rate satisfies this criterion;
- joint revenue maximisation.

Another criterion would be an increase of joint revenue, making possible compensating transfers between the revenue-losing country and the revenue-gaining country (the Hicks/Kaldor-variant). Obviously, the problem with any of these criteria is the choice of the status quo: closed borders or unrestricted tax competition.

### *Tax competition, equity, and Leviathan*

Fiscal differentials between two countries are often, wrongfully, depicted as characteristics of countries. They are attributes of individual taxpayers, however. Between two countries there are as many different fiscal differentials as there are taxpayers. As was put forward above, fiscal differentials are

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<sup>12</sup> Cnossen (1990, p. 476) argues that with cross-border shopping the potential revenue loss may be particularly injurious to smaller countries. While large member states can choose their tax rate largely independently of the rate in other member states, because their geographical size minimizes the revenue loss associated with cross-border shopping, small member states are rate takers: as a rule, they cannot impose higher rates than adjacent large states. On the other hand, small member states might make a virtue of necessity by following a low rate/high sales

the differences in individual welfare arising from different ‘ packages’ of public services and taxes. In other words: relevant to the individual taxpayer are the bundle of public services accruing to him in each jurisdiction, and the fiscal residuals involved. These fiscal residuals are the balance of public services rendered, and taxes paid.

Four different situations can be distinguished:

- a. both jurisdictions offer identical public services to the individual taxpayer, who is facing identical fiscal residuals. In this case, no movement will take place;
- b. the jurisdictions offer different public services; the fiscal residuals, however, are identical. Movement of tax bases (especially residence mobility) is efficient: taxpayers move to those jurisdictions that offer public services that are more to their taste;
- c. both jurisdictions offer identical public services, but the fiscal residuals differ, in which case movement of tax bases is induced only by tax differentials;
- d. the jurisdictions offer different public services, and fiscal residuals differ. This possibility obviously is much closer to reality than the last three.

In the situation in which identical services are offered and fiscal residuals diverge (situation c), but also if both services and fiscal residuals differ (situation d), it is important to see what exactly is the cause for tax differentials:

- it may be more costly to produce the public services in one jurisdiction than in another for well-founded reasons (comparative disadvantages);
- it may be more costly as a result of inefficiency due to the behaviour of bureaucrats and politicians;
- tax differentials can be the result of differences in systems of taxation.

The second and third ground need some elaboration.

For all individual taxpayers in a jurisdiction, fiscal residuals are zero if a perfect system of benefit taxation is used. Strict benefit taxation is highly impracticable, however, because of the (non-exclusive) nature of public goods. Moreover, distributional considerations must also be accounted

for (Musgrave, 1990, p. 291). Finally, administrative efficiency may call for departures from strict benefit taxation. Thus, in reality fiscal residuals will generally not be equal to zero. Especially the use of taxation for redistribution results in taxpayers with negative fiscal residuals (often: the rich) and taxpayers with positive fiscal residuals (often: the poor). If the former consider their negative residuals to be an incentive for mobility (of their capital, or of themselves), impoverishment awaits the taxpayers that are left behind.

This problem can also be addressed using the elasticity of tax bases. A basic rule in taxation is that the more elastic a tax base is, the lower the tax rate should be (the Ramsey-rule). According to Sinn tax competition will result in a situation in which those who perform highly elastic activities will be handled with kid gloves, i.e. the mobile part of the labour force, capital-owners, and -generally- consumers. The ‘losers’ are immobile workers and landowners, who “will serve as lenders of last resort to [...] impoverished governments” (Sinn, 1990, p. 501), and the poor, who rely on a large government sector. In sum: tax competition can be at right angles with the distribution branch of the budget, either by free-riding by the mobile and affluent (as with capital-flight), or by shirking the distribution issue altogether (as with residence mobility). One may argue that tax competition brings about jurisdictions with more homogeneous preferences, which is efficiency-enhancing. But what use are homogeneous preferences on redistribution if there is hardly any wealth left to redistribute?

On the other hand, tax competition can have beneficial effects indeed. Tax exporting, the use of ‘taxiffs’, tax crediting, and tax sharing, all lead to a possible overestimation of the SMCF, and an oversupply of public services. Tax competition, on the other hand, leads to an undersupply of public services. This characteristic could give cause to advocate tax competition in order to counter the overexpansion of the public sector resulting from other tax externalities. In addition, tax competition can counter overexpansion of the public sector resulting from the pursuit of their own interests by bureaucrats and politicians. Tax competition could possibly limit Leviathan’s tendency to tax and spend excessively. The premise here is that fiscal preferences of citizens/taxpayers are not correctly transformed in the political process, and tax differentials reflect bureaucratic and political inefficiencies. Voting-with-the-feet then promotes economic efficiency, and tax competition has a wholesome

effect.

Above, the use of revenue matching grants was mentioned as a means of internalisation of various tax externalities, ensuring that the government from whose tax decisions the externalities stem, uses the proper SMCF. However, these matching grants will not, in general, ensure that the SMCF is the same for all governments involved (Dahlby, 1996, p. 407). Point by point, the prevention and/or internalisation of tax externalities has to<sup>13</sup>:

- a. secure an *adequate provision* of public services, by foreclosing free riding and shirking by the affluent and mobile;
- b. provide for a *fair distribution* of tax burden among residents of each jurisdiction (interpersonal distribution), as well as a fair distribution of shared tax bases, and credited taxes, and revenues therefrom, among jurisdictions (intergovernmental distribution<sup>14</sup>);
- c. leave competition unaffected, that is let *taxes* be (*locally*) *neutral* as far as the allocation of resources in the private sector is concerned;
- d. while permitting a *diversity of fiscal structures consistent with taxpayers' preferences*, for the system of taxation that be used, but also for the expenditures made possible by taxation.

Tax uniformity is not the solution here, if only because full harmonisation harms countries whose most-preferred tax policy is far away from the uniform policy. Obviously, as Musgrave (1990, p. 37) points out, the solution is not met by the forces of tax competition either, but requires a complex pattern of co-ordination. In the next section we will turn to the actual system of co-ordination that has been set up within the EU.

### **3. Tax co-ordination in the EU**

Two major economic institutions have been established by the countries co-operating in the EU: the Single European Market (SEM), and the Economic and Monetary Union (EMU). In most textbooks

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<sup>13</sup> Paraphrasing and supplementing Musgrave (1990, p. 290).

<sup>14</sup> Called tax base entitlement rules, reflecting each member state's fair share in the total pie, by Cnossen (1996).

on international economics a common market and a monetary union are treated as highly different stages in the process of economic integration (Balassa). From the point of view of tax externalities the SEM is an internal market with, in principle, free movement of capital, labour, consumers, goods, and services. The EMU, with its fully integrated capital market, adds to the mobility of capital by the reduction of transaction costs. The EMU thus increases the opportunities for tax competition and its possible distortionary effects. Moreover, the loss of monetary instruments for EMU-members as a result of monetary union, may be relevant to the issue of tax externalities. The weight on tax (and expenditure) policies for short-term stabilisation<sup>15</sup> and long-term structural adjustments in individual member states can be expected to increase (Cnossen, 1987, p. 5), giving rise to extensive tax competition, and tempting member states into the use of ‘taxiffs’. This points in the direction of additional harmonisation. However, participating in the EMU already puts considerable restrictions on member states’ preferences, as well as on the choice of instruments of economic policy. This makes uniformity less and less desirable, especially in a field that is so essential to a society as taxation. In sum, the impact of the EMU on the issue of tax externalities within the SEM is not unambiguous. Here we will focus on the SEM, which is a ‘SEM+’ (a single market with increased mobility of capital) for those EU-members that engage in the EMU.

In this section, we will first give a brief overview of the stance towards tax harmonisation and tax co-ordination in the EU, from the start of the EC in 1958 up till now. Next, we will focus on the co-ordination of indirect taxation (including the issue of tax sharing), followed by direct taxation. Subsequently, we will set the actual tax co-ordination efforts alongside the different tax externalities that were discussed in the previous section, and alongside the requirements for tax co-ordination that were formulated there.

#### *The attitude towards tax harmonisation and tax co-ordination*

The SEM, which functions since the start of 1993, was preceded by the European Common Market (ECM), from which it differs in that there are no internal frontiers in the SEM. Essential to both the

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<sup>15</sup> Of course, within the somewhat tight standards as far as the budget deficit is concerned, as laid down in the Pact for Stability and Growth.

ECM and the SEM is that competition (between producers) is the mechanism for allocating resources. The possible distortion of competition constitutes the main motive for tax co-ordination in the EU. The Treaty of Rome assigns to the European Commission the task, in consultation with the member states, of eliminating distortions in competition. In the early stages of the EC, the European Commission interpreted this provision as a mandate to pursue more or less complete equalisation of the various taxes in the member states (Cnossen, 1990, p. 473). A considerable number of reports and proposals was produced, dealing with indirect taxation as well as with direct taxation. The Commission's earlier intentions were effectuated only in the field of commodity taxation, where a value-added-tax (VAT) was established, with a more or less uniform tax base, and aligned VAT-rates. As far as taxes on income and profits were concerned, the Commission's major feats are the harmonisation of capital duty payable by companies, two directives concerning the taxation of groups of companies (the Parent-Subsidiary Directive, and the Merger Directive), and the Convention on the adjustment of profits of associated enterprises<sup>16</sup>. Otherwise, the Commission hardly made any headway.

In 1980, in its 'Report on the scope for convergence of tax systems in the Community', the European Commission took a very cautious stance, and identified (only) two fundamental objectives of EU-tax policy: the elimination of frontier controls, and the alignment of company tax burdens. In 1985 the first issue was dealt with in the White Paper on the completion of the internal market, in which the Commission proposed that border tax adjustments were to be administered on a Community-wide basis by mutual recognition of each member state's tax credits shown on exporters' invoices, balances being settled through a common clearing system. Moreover, special measures were proposed for removing frontier controls in respect of the major excises. The proposed VAT-clearing-house system has not been introduced up till now.

Starting from the late eighties the concept of more or less comprehensive tax harmonisation in the EC, concentrating on the VAT and excise taxes, was gradually swapped for a concept more in line with the idea of subsidiarity. The subsidiarity principle states that intervention at the central level

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<sup>16</sup> Both Directives and the Convention were adopted by the European Council in July 1990.

should only take place in the presence of cross-border externalities or economies of scale, which cannot be properly alleviated by a simple co-ordination between concerned national governments. Accordingly, priority is now being given to co-ordination and mutual approximation of member states' tax systems rather than a to systematic harmonisation imposed at the EU level. The 'improved co-ordination of tax policies' has become the magic formula. This co-ordination is based on the following priorities and guidelines:

- a. limiting fiscal erosion due to excessive tax competition between member states over mobile activities;
- b. improving the functioning of the single market, by introducing a new common VAT system, and by submitting new proposals on the taxation of cross-border interest and royalty payments between associated companies;
- c. promoting employment, by exchanging information between member states on the most effective tax measures in terms of job creation;
- d. respecting the environment, by setting out guidelines on the use of environmental taxes, and new proposals on the taxation of energy products.

"The purpose [...] is to tackle harmful tax competition and eliminate some distortions in the Single Market. Its purpose is not to raise taxes, which would damage the international competitiveness of the Union, nor is it intended to be the start of a process of wholesale tax harmonisation, which would be incompatible with the subsidiarity principle", according to the European Commission<sup>17</sup>.

#### *Tax co-ordination and indirect taxes*

In 1968 internal custom duties were abolished in the EC, and common external tariffs were introduced. Consequently, a VAT was introduced with a largely uniform tax base. A VAT allows for border tax adjustments based on the destination principle. Suppose a Dutch firm buys a British product. With border tax adjustments, the British product is 'detaxed' upon export; a zero-rate is applied and the British exporter can reclaim previously paid VAT in the UK. Upon import in Hol-

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<sup>17</sup> Press release European Commission, 2-12-1997.

land, the going VAT-rate is applied, and VAT is paid to the Dutch government, where VAT is also reclaimed after retail-sale. With border tax adjustments, tax neutrality is provided for, even if VAT-rates vary between member states.

The Single European Act of 1986 aimed at establishing an internal market (starting in 1993) without internal frontiers (the SEM), which meant that border tax adjustments could no longer be used. Commodities that are sold through -taxable- trading channels are not affected by the abolishment of border tax adjustments; the VAT-tax credit mechanism ensures that every product in each member state is always taxed at the rate that is levied at the retail stage in that state, regardless of the exporting member state's VAT (Cnossen, 1990, p. 475). However, two problems arise:

- not all trade occurs between firms. At the start of 1993, as a consequence of the completion of the SEM, the restrictions on the import for personal use of tax-paid goods were lifted, giving rise to direct consumer purchases in member states with low VAT-rates (cross-border shopping);
- if border tax adjustments are forgone, products are not 'detaxed' upon export. Resuming the example of a Dutch firm buying British, VAT that is reclaimed in Holland, has in part been paid to the British government.

The first problem has been addressed in the EU by alignment of the VAT-rates. In the 1987 White Paper on the SEM a more rigorous use of standard and reduced rates was proposed, with reduced rates only applicable for foodstuffs and the like. Moreover, ranges were proposed of 14%-20% for the standard rate, and 4%-9% for the reduced rate. Similar proposals referring to excise taxes were made.

To solve the second problem the Commission proposed a clearing mechanism to redistribute VAT-revenues between EU-members, based on the books kept by importing and exporting firms. The EU could only agree on a transitional arrangement however, in which the status quo largely was retained (i.e. the destination principle, without the need for clearing arrangements), by a shift of the border tax adjustment procedure into the books of firms and by a number of special provisions for, for example, cross-border mail order sales, second-hand commodities, and art and antiques. Under this transitional system 'importation' is replaced by 'acquisition' as the taxable event, with a general exemption

in the country of origin, if the acquirer is subject to VAT in another member state.

In 1991 it was decided that each member state should operate one VAT-standard rate and two, but preferably one, reduced rate(s). Existing zero-rates are tolerated; the introduction of new zero-rates is not allowed. Minimum VAT-rates were set: 15% for the standard rate, and 5% for the reduced rate. Further harmonisation of the rates is planned to be proposed in 1999.

In 1996 Commissioner Monti presented proposals for a new VAT, based on the origin principle<sup>18</sup>. If these proposals are adopted, the new VAT will use a clearing-arrangement, based on the National Accounts (and not on the books of firms). The transitional VAT-system, effective as of 1993, will automatically be extended until the new system comes into force.

Tax sharing in the EU between member states is non-existent. There is some vertical tax-sharing however in the field of VAT. Contrary to most federations and most unitary states (Boadway and Keen, 1996), the EU displays a negative fiscal gap: the revenues raised by the higher level of government are not sufficient to cover its expenditures, resulting in the need for upward funding. The only real EU-levies<sup>19</sup> are the customs levies and duties and the levies within the framework of the Common Agricultural Policy (including sugar levies). The remainder is provided for by a share in member states' VAT-revenues, and by a GNP-based-contribution by member states.

In short, the EU has been given no power to tax, in the sense of exclusive taxes<sup>20</sup>. One could argue that the VAT is a tax that is shared in the EU. The share of the EU in a member state's VAT-revenues is 1%<sup>21</sup> of the harmonised VAT-base in that country. By taking the (harmonised) base as a basis, one gets around differences in VAT-rates. Effectively there is a EU-VAT with a rate of 1%. The national VAT-base is relevant however only up to 50% GNP. By using a 50%-GNP-ceiling countries that rely heavily upon the VAT are spared. Instead of the VAT being a shared tax, its

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<sup>18</sup> "A common system of VAT: A programme for the single market", COM (96) 328 final.

<sup>19</sup> We refrain from the use of the term 'own resources', that is commonly used to denote all EU-revenues, including upward funding by member states.

<sup>20</sup> As Smith points out one of the arguments in favour of the complete assignment of particular taxes to the EU would be economies of scale. However, these economies of scale are likely to be of less importance in the EU. The unit cost savings that arise from a transfer from the national level to the EU are likely to be relatively modest, since the national units are already large, and differences in language, legal systems, and corporate structures are likely to reduce sharply the potential for administrative savings from EU-wide tax administration (Smith, 1995, p. 378).

revenues are shared; the EU (unlike its member states) has no autonomous right to unilaterally change its VAT-rate.

### *Direct taxation*

Tax harmonisation efforts in the field of direct taxation display a multitude of reports, initiatives, Commission proposals, proposed Directives, draft Directives, preliminary draft Directives and such, the bulk of which were withdrawn later on. Apart from a Council Regulation on the application of social security schemes to individuals who choose to work in another member state, the harmonisation of direct taxes in the EU has been confined to corporate taxation, more precisely to:

- a. the corporate income tax, and the withholding tax on dividends;
- b. the withholding tax on interest;
- c. the taxation of groups of companies (including taxation of parent-subsidiary dividends).

With *company taxation* a twofold problem of double taxation arises. First, corporate profits are taxed as company profits (corporate income tax) as well as as shareholders dividends (personal income tax). Each member state in the EU has dealt with this problem of double taxation differently. Most countries have some kind of dividend relief system, at the shareholder level (imputation system, tax credit system, or special personal income tax rate). Secondly, profits that are distributed to foreign investors (private investors, or foreign companies) may be taxed in the country where these profits arise, as well as in the country the investor resides. Basically, company profits in the EU are taxed according to the origin or source principle. What happens to repatriated profits, is outside the field of vision of the source state. Even if the source state provides for an identical treatment of domestic and foreign investors, it has no say over the tax treatment of 'exported profits'.

Combined, these two double-taxation problems have proved to be insurmountable for the EU. Initially (in 1975) the European Commission aimed at eliminating double taxation on dividends through a centralised harmonisation of company tax systems. In 1990 these proposals were withdrawn. At present the company tax systems that are used by EU-member states vary considerably, as do the

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<sup>21</sup> The so-called call-up rate.

corporate income tax rates<sup>22</sup>. Imputation is more often than not offered to domestic shareholders only, which, of course, is discriminatory against foreign shareholders. Company taxes in the EU discriminate between (various kinds of) in-state and out-of-state investors and result in an arbitrary division of the company income tax base between the state of investment and the state of the investor (Cnossen, 1996, p. 23). A shift to the residence principle would solve this problem, but would mean that countries forgo the right to tax income arising within their own territory<sup>23</sup>. Therefore, the problem is approached along the lines set out in the 1992 report of the Ruding Committee: aligning company tax systems, and restricting company tax rates (by setting a minimum and a maximum rate).

It must be pointed out that substantial co-ordination in this field has already been achieved through unilateral exemptions and tax credits and bilateral tax treaties (Cnossen, 1987, p. 4). Moreover, the European Commission has been very prompt in bringing to the European Court of Justice cases of discriminatory practices against non-resident corporations. Recently, a similar intergovernmental approach was used in the EU to address the problem of tax competition. On 1 December 1997 the Ecofin Council agreed on a code of conduct for business taxation, which should prevent the introduction of new fiscal measures that could influence the place of investment, like tax measures which provide for a significantly lower effective level of taxation (including zero taxation) than those which generally apply in the member states in question, like granting special advantages only to non-residents, like providing rules for calculating the profits of multinationals which deviate from OECD-rules, and like the less strict application of tax regulations by the tax authorities. The Code of Conduct provides for a review process to determine which potentially harmful measures are actually harmful. These measures are required to be rolled back (in principle by 31 December 2002). For new measures there is a standstill clause: member states will refrain from introducing new harmful measures.

The problem of *withholding taxation on interests and royalties* has to do with tax evasion as well as with tax competition. As far as the taxation of interests and royalties is concerned, the residence principle applies: interest income is not taxed in the country where it is earned but in and by the in-

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<sup>22</sup> For an overview of systems and rates, see Cnossen (1996).

<sup>23</sup> See Cnossen (1996, p. 25-27) for a discussion.

investor's country of residence. Each member state however levies a withholding tax on savings income paid to residents of other member states. If that withholding tax is zero-rated and the source country provides adequate information to the tax administration of the country of residence on exported interests, the system makes investors indifferent between domestic and foreign assets. Unfortunately, not every member state uses zero-withholding taxes, and there is hardly any exchange of information between member states. One could argue that without adequate information (and with the subsequent incentive for tax evasion), any rate for the withholding tax is better than the zero-rate. This line of reasoning is followed by the Ecofin Council, which has opted for a 'co-existence' -model: each member state should either operate a withholding tax (with a minimum effective rate), or provide information on savings income to other member states. The European Commission has been requested to bring forward a proposal for a Directive along this lines<sup>24</sup>.

As far as *the taxation of groups of companies* (including taxation of parent-subsidiary dividends) is concerned, two directives are in force and have been implemented as of 1992: the Parent-Subsidiary Directive and the Merger Directive. The Parent-Subsidiary Directive aims at reducing the differences between taxation rules for nationally organised groups of companies and taxation rules for EU-wide groups. It compels the member state of the parent company to either refrain from taxing the profits of a subsidiary that is resident in another member state, or, if taxing such profits, to authorise the parent company to deduct from its own tax amount due the corporation tax paid by the subsidiary in the other member state. Furthermore, exemption from (or zero-rating) withholding tax of profit distributions (dividends) by the subsidiary to the parent company is provided for. The Merger Directive provides for the deferral of taxation on capital gains on defined cross-border mergers or reorganisation within the Community<sup>25</sup>.

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<sup>24</sup> Press release European Commission, 2-12-1997. See Gérard and Hadhri (1994) for a discussion of possible coordinative measures in this field.

<sup>25</sup> For the sake of completeness, the Convention on the adjustment of profits of associated enterprises must be mentioned. This convention, adopted by the European Council in 1990, addresses the problem of double taxation, which arises when one member state upwardly adjusts the taxable income of an enterprise (because of transactions that are not valued 'at arm's length'), but another member state does not allow a corresponding decrease of the taxable income of the associated enterprise.

### *The EU-method of tackling tax externalities*

A complex and diverse pattern of tax co-ordination has developed in the EU, in which four major coordinating instruments can be made out:

- the use of directives and resolutions for harmonisation (often: equalisation) of taxes;
- the ‘ use’ of the Court of Justice to fight discriminatory taxation;
- the use of bilateral agreements, like tax treaties;
- the use of multi-lateral agreements within or without the EU-framework (like codes of conduct, and OECD-models).

The former two instruments are used especially in the field of indirect taxation; the latter two are dominant in the field of direct taxation.

Focusing on the tax externalities that were discussed in section two, one could argue that preventing and opposing the discriminatory use of (mainly indirect) taxation, labelled ‘*taxiffs*’ above, has been predominant, in line with the preoccupation within the EC with possible distortions of the SEM, witness the abolition of internal import duties, and the equalisation of the general and specific sales taxes.

*Tax exporting* is an important problem in the field of direct taxation. Tax exporting has to do with the monopoly to tax. That monopoly has been elegantly apportioned (by border tax adjustments and similar administrative measures) over source and destination states as far as commodity taxes are concerned, but it is a recurrent problem in direct taxation. Within the EU, there is no equal treatment of resident and non-resident taxpayers. The edge of the problem is, fragmentarily, taken off by bilateral agreements, and by rulings of the European Court of Justice. For corporative taxpayers that reside in more than one member state (parent-subsidiary companies, companies with permanent establishments, etcetera) solutions have been found at the supranational level, by explicit EU-directives. *Tax competition* has become a major issue in the EU recently. A number of instruments are used here: minimum rates for commodity taxes, alignment of company tax systems and rates, and the code of conduct on harmful tax competition. Two notes on the way the EU tries to tackle tax competition can be made:

- the imposition of minimum and maximum rates within the field of corporate taxation, as suggested by the Ruding Committee and adopted by the European Commission, is overdone. Tax competition leads to a loss of revenue to the high-tax government, which should be incentive enough not to set rates above other member states'. Minimum rates suffice;
- the code of conduct on harmful tax competition does not address tax competition in full. It is aimed at fighting unwarranted favours to not-yet-resident taxpayers<sup>26</sup>. Setting a net personal wealth tax rate (for all residents) below that of the neighbouring state, is a (non-business taxation example of a) measure that is not affected by the code of conduct.

The problem of double taxation, and its tackling by tax treaties, gives rise to possible externalities that were discussed in section two under the heading *tax crediting*. The interesting thing here is that preventing externalities like tax exporting can cause other tax externalities like tax crediting. The possible solution of tax exporting problems in indirect taxation by a clearing-house can also be considered to be a tax crediting problem. One could argue that tax crediting externalities are the other side of the picture of tax co-ordination as such. As far as tackling tax crediting externalities are concerned, the subsidiarity principle should be dominant: intervention by the EU is only acceptable if economies of scale make centralisation the more efficient solution. When the European Commission, in 1987, proposed its first version of the clearing-house, member states, with good reason, had their doubts as to the efficiency of that design.

As with tax crediting *tax sharing* in the EU can be regarded as being the result of the solution of other fiscal externalities, and creating tax externalities of its own. Expenditures in the EU can (or should be) carried back to the alleviation of spill-overs and/or to economies of scale. To cover these expenditures, inter alia, the mechanism of VAT-revenue-sharing has been brought into being. The possible externalities arising from tax base sharing are prevented by mechanisms like the call-up-rate, and the GNP-ceiling. Moreover, the institutional texture of the EU, which is basically intergovernmental, makes sure that decisions on the EU-VAT-rate are always co-ordinated.

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<sup>26</sup> One could argue that this kind of tax competition is similar to 'taxiffs' and tax exporting. While 'taxiffs' and tax exporting harm foreign taxpayers, tax competition favours them.

Section two was ended with listing four issues with which tax co-ordination has to deal:

1. an adequate provision of public goods (by foreclosing free riding and shirking);
2. providing a fair interpersonal distribution of tax burden as well as a fair intergovernmental distribution of tax bases;
3. locational tax neutrality;
4. permitting fiscal diversity.

It is clear that the third goal of tax co-ordination (tax neutrality) has been predominant in the EU, especially with regard to commodity taxes, by means of EU-directives. The second goal has been dealt with by member states themselves as far as direct taxation is concerned, by conducting tax treaties. With indirect taxes the base-distribution-issue has been managed smoothly by the VAT-credit-mechanism. In the years to come, it will become clear whether or not the EU has a role to play in that mechanism, by means of a clearing-house. The first goal has only recently become an issue, in relation to the issue of tax competition. As far as fiscal diversity is concerned (the fourth goal): such diversity is history in commodity taxation; however (and as a consequence?) the systems of direct taxation display a considerable variety.

#### **4. The enlargement of the EU and tax co-ordination**

Competition is not only the keyword as far as the SEM is concerned, it is central to the EU-strategy of enlargement as well. Without playing down the importance of enlargement with regard to stable international relations in Europe, the possible economic profits of enlargement of the EU with Central and East European Countries (CEECs), which are generally considered to be large<sup>27</sup>, are put first (and foremost) by the EU. However, ‘safety first’ is the motto the EU uses in its enlargement strategy. The European Council in Copenhagen (June 1993) agreed on a number of economic and political criteria that newcomers would need to satisfy in order to accede to the EU. In Essen (December 1994) the European Council adopted its pre-accession-strategy, which has to do with a

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<sup>27</sup> See Baldwin, Francois and Peters (1997) for a detailed analysis.

range of initiatives to familiarise the EU and the associated countries with one another. In Agenda 2000 the European Commission selected a small group of countries, with which it will engage in negotiations on accession treaties: the Czech Republic, Poland, Hungary, Slovenia, Estonia en Cyprus. Until recently accession of these countries was expected to take place in 2002, but at present accession could well happen on a later date.

The economic criteria of the Copenhagen Summit are:

- a. the existence of a functioning market economy;
- b. the capacity to cope with competitive pressure and market forces within the EU;
- c. the ability to take on the obligations of membership, including adherence to the aims of economic and monetary union.

The last criterion is the economic version of the criterion of full and unrestricted acceptance of the *acquis communautaire*. In this section we will discuss whether the *acquis*, which has always been inviolable in EU-enlargement processes, should be modified as far as taxation is concerned, in view of the coming enlargement of the EU. Put differently: what changes in tax co-ordination within the EU are recommendable as a result of the enlargement?

In table 4 the share of different taxes as a percentage of GDP is listed for the five countries at hand, as well as for the incumbent EU-members.

*Table 4 Main taxes in the general government revenue structure (% GDP, 1996; EU-15: 1992)*

	Czech Republic	Estonia	Hungary	Poland	Slovenia	EU-15
Total tax revenue (including social security contributions)	39%	36%	36%	40%	45%	41%
• personal income tax	5%	4%	6%	9%	7%	11%
• corporate profit tax	4%	2%	2%	3%	1%	3%
• social security contributions	16%	11%	14%	11%	17%	12%
• VAT/sales tax + excise taxes	12%	13%	15%	15%	20%	13%
• various other taxes	2%	6%	0%	2%	0%	2%

Based on:

- IMF World Economic Outlook, May 1998, p. 105;
- Revenue statistics of OECD Member Countries 1965-1993

Two points stand out. First, the personal income tax is relatively ‘underused’ in the five countries compared to the EU-15. Secondly, Slovenia relies relatively heavily on general and specific sales taxes. It is worth mentioning that as from 1999 a new VAT-system will be introduced in Slovenia.

Apart from these two points, the tax structures of the countries at hand are largely similar to the tax structures of the incumbent EU-members. From the point of view of tax co-ordination this means that the extent to which the tax co-ordination system has to allow for growing diversity in systems of taxation of an enlarged EU is limited. The striking similarity between the two groups of countries can be explained by the considerable tax reform efforts in the former socialist countries that were mentioned in the introductory section. Moreover, it is likely that in reforming tax systems these countries have anticipated substantially on the possibility of accession. It is not clear, however, whether this anticipation took place wholeheartedly (i.e. in line with existing fiscal preferences) or not.

On the basis of our discussions in section two and three, we can pinpoint a number of features of the tax structures of future members that may be relevant to the tax co-ordination issue, and that will be discussed below. First, we discuss indirect taxation:

- the extent to which discriminatory provisions (tax exporting devices) are part of the indirect tax systems of future members, and the use of indirect taxes as ‘taxiffs’ ;
- tax (rate) differentials between the VAT structures of future members and the going EU-VAT-structure;
- the issue of cross-border shopping;

Secondly, we deal with some issues of direct taxation:

- corporate tax systems and the discriminatory use of direct taxation;
- the use of tax crediting.

### *Indirect taxation*

In table 5 the relevance of sales taxes and excises for the government budget is outlined for the five countries. Estonia and Slovenia clearly stand out.

*Table 5 Sales taxes and excises as % of government budget, in the Czech Republic, Estonia, Hungary, Poland, Slovenia*

	Czech Republic	Estonia	Hungary	Poland	Slovenia
General sales tax revenues as % total central government budget (1995)	22%	42%	21%	25%	N/A
Excises as % total central government budget (1995)	13%	11%	10%	15%	N/A
Sales taxes and import duties as % total central government budget (1995)	N/A.	N/A	N/A	N/A	70%

Source: Bulletin EU (various supplements 1997)

Using the *European Tax Handbook 1998* we have analysed the use of indirect taxation as a means of exporting the tax burden, in the case of exclusive taxes, as well as the use of taxes as ‘taxiffs’ in commodity taxation. Going by the information offered in the handbook, such discriminatory practices do not exist (in indirect taxation) in the Czech Republic, nor in Hungary, nor in Poland. In Estonia a minor infringement of non-discrimination can be found in the VAT, where subscriptions to domestic periodicals are zero-rated (subscriptions to foreign periodicals are not). In Slovenia the 5% tax on international transport stands out. This tax is levied from foreign citizens that perform business transport activities and acquire income in the territory of Slovenia.

Below (table 6) the main characteristics are depicted of the VATs<sup>28</sup> in the countries at hand, excluding Slovenia. In Slovenia presently a single-stage sales tax is used, which is levied at the point of retail sale. As from 1999, Slovenia will switch to a VAT. Unfortunately, we are not familiar with the main features of the new Slovenian VAT.

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<sup>28</sup> Because of lack of information we will not discuss excise taxation here.

Table 6 Main characteristics of the VATs in the Czech Republic, Estonia, Hungary, and Poland

Feature	Czech Republic	Estonia	Hungary	Poland
Year of introduction	1993	1991	1988	1993
Standard rate, reduced rate(s), zero-rate	22%, 5%	18%, 0%	25%, 12%, 0%	22%, 7%; 17%, 0%
Major items reduced rate(s) <sup>29</sup>	Most food products, water Pharmaceutical products, aids for the disabled Thermal energy, electricity, coal, gas Newspapers, periodicals, books New buildings, construction activities Recreation, cultural and sports activities Transportation Telecommunications Funerals	--	Most food products Pharmaceutical products, aids for the disabled Electricity, household fuel Newspapers, periodicals, books Washing, dry-cleaning Social housing Hotels, motels, boarding houses Transportation Funerals	Electricity, fuel (17%) Food products (7%) Medicines, medical supplies (7%) Children' s goods (7%) Building materials, basic appliances (7%) Passenger transportation (7%) Telecommunications (7%)
Major items zero rate (other than exports)	--	Subscriptions to periodicals published and printed in Estonia Tickets of theatres, state concert halls	Medicines	Basic medicines Newspapers, periodicals, books Housing units Feed, fertiliser, pesticides Farm machinery and equipment Domestic air services
Exemptions (without credit; other than standard ex-	Medicines	Medical services, medicines Funerals	Legal/financial services	Semi-processed foodstuffs, water Horticultural products

<sup>29</sup> In the new Slovenian VAT the following commodities will fall under the lower rate: foodstuff for human and animal consumption, pharmaceutical products, medical equipment, newspapers, periodicals, books, and children' s clothing (Cnossen, 1998, p. 243).

emptions)				Cultural services Agricultural services Legal/financial services R&D activities
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Based on: European Tax Handbook 1998, Bulletin EU (various supplements 1997), Cnossen (1998)

The VATs in the countries in question are relatively new. Via the mechanism of anticipation, discussed above, this probably explains why the VATs are largely congruent with the EU-standard-VAT. However, following Cnossen (1998), some structural shortcomings can be mentioned:

- the exemption of various essential products is not congruent with EU-standards;
- various other essential products are taxed on reduced rates, in a rather haphazard way;
- the basis of the VATs can be broadened by including more public sector bodies (especially transportation services) and cultural services.

As far as the level of the VAT-rates is concerned, the rates are consistent with the minimum rates set by the EU.

How about cross-border shopping in an enlarged EU?

Table 7 offers information that may be relevant to the issue.

*Table 7 Size, population, and information on first trading partners for five future EU-members*

	Area in 1.000 ha (1995)	Population x 1000 (1995)	VAT-rates	Bordering on ... (enlarged EU)	First trading partner (import from)	First trading partner (export to)
Czech Republic	7.887	10.321	22, 5	Poland Austria Germany	Germany	Germany
Estonia	4.523	1.476	18, 0	-	Finland	Finland
Hungary	9.303	10.212	25, 12, 0	Slovenia Austria	Germany	Germany

Poland	31.269	38.609	22, 17, 7, 0	Germany Czech Republic	Germany	Germany
Slovenia	2.025	1.990	N/A	Italy Austria Hungary	Germany	Germany
Germany (1997)	35.697	82.021	16, 7			
Austria (1997)	8.386	8.068	20, 10			
Italy (1997)	30.132	57.461	20, 10, 4			

Source: Bulletin EU (various supplements 1997), Eurostat On-line statistical indicators, European Tax Handbook 1998

From table 7 it becomes clear that the future members are in danger of losing considerable VAT-revenue to -especially- Germany, if they maintain the VAT-rates they apply at present, which stands in contrast to our theoretical reflections, which focused on undercutting by small countries. With Luxembourg (15%) and Spain (16%) Germany has the lowest standard-VAT-rate in the EU, and in that respect it is unfortunate for most future members to be bordering on Germany.

#### *Direct taxation*

In section 3 it became clear that ‘patchwork’ may be the best way to describe corporate taxation in the EU. Will enlargement of the EU change that overall picture? Probably not. Table 8 lists information on corporate and personal income taxation.

*Table 8 Basic company tax (CT) rate, top personal income tax (PIT) rate, double taxation relief systems (SL: at the shareholder level; CL: at the company level), net wealth tax (NWT) rate (1998)*

	Basic CT-rate <sup>30</sup>	Top PIT-rate	Double taxation relief system	Top NWT-rate
Czech Republic	35%	40%	Dividend-deduction system (CL) and special PIT-rate dividends 25% (SL)	None
Estonia	26%	26%	Full dividend exemption (SL)	None

<sup>30</sup> CT- and PIT-rates include surcharges and local income taxes. Percentages have been rounded to the nearest integer.

Hungary	19%	42%	Special PIT-rates dividends 20%-35% (SL)	None
Poland	36%	40%	Special PIT-rate dividends 20% (SL)	None
Slovenia	25%	50%	PIT-credit (SL)	None
Austria	34%	50%	Special PIT-rate dividends 25% (SL)	Abolished 1994
Belgium	40%	58%	Special PIT-rate dividends 15%-25% (SL)	None
Denmark	34%	58%	Special PIT-rate dividends 25% -40% (SL)	Abolished 1997
Finland	28%	55%	PIT-credit (SL)	0.9%
France	37%	59%	PIT-credit (SL)	1.5%
Germany	43%	59%	PIT-credit (SL) <sup>31</sup>	Abolished 1997
Greece	35%	45%	Full dividend exemption (SL)	None
Ireland	36%	48%	PIT-credit (SL)	None
Italy	41%	46%	PIT-credit (SL)	None
Luxembourg	37%	49%	PIT-credit (SL)	0.5%
Netherlands	35%	60%	Small general dividend exemption + special PIT-rate dividends 25% for substantial interest shareholders (SL)	0.7%
Portugal	44%	40%	PIT-credit (SL)	None
Spain	35%	56%	PIT-credit (SL)	2.5%
Sweden	28%	56%	Special PIT-rate dividends 30% (SL)	1.5%
United Kingdom	31%	40%	PIT-credit (SL)	None

Source: European Tax Handbook 1998

As far as the basic company tax rates of the five countries at hand are concerned, generally these rates are below EU-level, as are the top personal income tax rates. As with the VAT, it is important to point out that these tax systems are relatively new. Tax systems gradually become more complicated, by all kinds of exemptions and deductions, thus eroding the tax base, and giving rise to relatively high tax rates, in order to secure adequate tax revenues. Incumbent EU-members are engaged in reversing this process, by broadening the base and lowering tax rates. It is likely that in future some conversion of the main direct tax rates will take place.

With regard to the main question (will enlargement perpetuate the present diversity in corporate

<sup>31</sup> In part: split-rate system (at the company level)

taxation?) the answer is yes. As with the EU-15 there is no uniform system of double dividend relief in the five acceding countries. As with the EU-15 that brings us to the issue of bilateral solutions via tax treaties. Table 9 shows the presence of tax treaties between the acceding countries and the incumbent EU-members. It becomes clear that especially Estonia, and to a lesser extent Slovenia, have not fully exhausted their possibilities of bilateral tax co-ordination.

*Table 9 Treaties on dividends and/or interest and/or royalties*

	Czech Republic	Estonia	Hungary	Poland	Slovenia
Austria	x		x	x	
Belgium	x		x	x	x
Denmark	x	x	x	x	x
Finland	x	x	x	x	x
France	x		x	x	x
Germany	x		x	x	x
Greece	x		x	x	
Ireland	x		x	x	
Italy	x		x	x	x
Luxembourg	x		x	x	
Netherlands	x		x	x	x
Portugal	x				
Spain	x		x	x	
Sweden	x	x	x	x	x
United Kingdom	x	x	x	x	x
Total #	15	4	14	14	9

Source: European Tax Handbook 1998

Let us have a look at the withholding tax on interest. Table 10 lists the standard withholding tax rates, as well as the rates provided for in tax treaties with EU-members. We have omitted Slovenia, because the treatment of interest paid to non-resident individuals in that country is currently unclear.

*Table 10 Withholding tax on interest paid to recipient individual resident abroad*

	Czech Republic	Estonia <sup>32</sup>	Hungary	Poland
Standard rate (without tax treaty)	25%	0%	18%	20%
If agreed upon bilaterally, rate for most EU-members	0%	0%	0%	0%
Number of treaties with incumbent EU-members (out of 15)	15	4	14	14
Number of treaties with other future members (out of 4)	3	2	2	3

Just as most incumbent EU-members have agreed upon mutually, a 0% withholding tax is applied by all four countries. It is unclear to what extent the acceding countries provide information to resident states on outgoing interest.

With company taxation, as well as with the taxation of border-crossing interest, the accession of the five countries at hand, does not diminish the tax co-ordination problem in the EU. On the contrary: diversity is added. What implications can that diversity have for the issue of tax competition? As far as tax competition in corporate taxation is concerned (leading to possible shifts in the location of forms, and in their pattern of investment) the data presented in this section do not enable us to draw univocal conclusions. As is shown by Cnossen (1996) the treatment of the returns on equity and on debt differs between countries, as well as the treatment of corporate and non-corporate investors, and of resident and non-resident investors. All in all, it is not possible to pinpoint ‘ tax havens’ in the present EU, nor is that possible for the enlarged EU<sup>33</sup>.

Residence mobility on the other hand, may be a little bit more straightforward. In table 8 we have listed the top personal income tax rate, and the (top) net wealth tax rate (if such a tax is levied). Bearing in mind that tax rate differentials are only proxies for tax differentials, let alone for fiscal differentials, it is clear that the current trend to abolish net wealth taxes in the EU, has led the acceding

<sup>32</sup> In Estonia the withholding tax on interest is 0% for interest paid by banks and other credit institutions, which was 10% up til 1-7-1998. For interest paid by other debtors the 10% rate still applies.

<sup>33</sup> A major element as far as capital mobility is concerned is of course the fact that the acceding countries do enter the EU, but not the EMU. Compared to EMU-members, capital mobility to and from the acceding countries will be relatively restricted.

countries to refraining from introducing such taxes. This act, combined with the relatively low personal income tax rates, encourages residence mobility to the acceding countries.

## 5. Conclusions

The more integrated the EU is, the harder it is to meet the requirements of taking on the *acquis*, compared with previous accessions. Often, the transition of socialist economies to market-oriented economies is put forward as an element that further complicates meeting the requirements of the *acquis*. In this paper it was shown that by the virtue of being in the position of designing their tax systems afresh, combined with anticipation on acceding the EU, the acceding countries will not meet to much problems as far as the taxation part of the *acquis* is concerned. Put differently: in the field of taxation much of the efforts of meeting the *acquis* has been combined with transition efforts.

With regard to the VAT, the future members, have opted for ‘EU’ -VATs, as a result of which the indirect tax co-ordination issue in the EU will not really be aggravated. There are a few strings attached however. A VAT, especially if used as a upward funding mechanism as in the EU, and if accommodated with a clearing-house-system, should be administered exemplarily. Cnossen (1998, p. 253) throws doubt on the effectiveness of VAT-administration in CEECs. Moreover, the VAT-rates set by the future members are not excessively high compared to the EU-15, but they diverge from the relatively low VAT-rate Germany has set (16%), possible leading to considerable VAT-revenue loss for the acceding countries due to cross-border-shopping.

With company taxation, as well as with the taxation of border-crossing interest, the accession of the five countries at hand does not diminish the tax co-ordination problem in the EU; on the contrary: it will make the tax co-ordination issue more complicated than it already is. Although it is obvious that the current company tax systems in the EU are distortionary, it is not possible to make out a clear pattern of distortion (even for that the systems are too complicated). With increasing diversity, ongoing pleas for (further) harmonisation in the field of corporate taxation can be endorsed.

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