CCCTB, EU/EEA, TAX POLICY

Fair and efficient taxation in the EU. Convergence is needed

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A global silver alert for fair and efficient tax systems is active already for a couple of years.

The heated debate sparked all over the world has engaged national governments, NGOs, international organizations as well as each and every taxpayer – or tax evader. The EU has been driving the discussions and – most importantly – the actions to remedy the deficiencies of the current international tax system. One of its most recent and valuable contributions is the substantiation of fairness and efficiency in taxation through the survey "**Tax Policies in the European Union**" published in November 2016.

The survey was reported by the Directorate General Taxation and Customs Union (DG TAXUD) of the European Commission (EC). It aims at illustrating the EU position regarding *fair and efficient taxation*. To this effect, at a first stage, it defines:

- what is *fair and efficient taxation* for the EU, and
- which features of a tax system are deemed to indicate its existence.

At a second stage, the tax systems of the 28 Member States (MS) are evaluated against these features providing a thorough view of the *current state of play* in the EU. At a third stage, the most recent trends in the reform of national tax systems, the implications of which are not evident yet, are presented along with general directions for potential improvements at national level.

For the EU, a *fair and efficient tax system* is one that achieves to *raise revenue for redistribution and social welfare*, being supportive to *growth, competitiveness and job creation*. There are four keys for its success. It is attractive to investors and hence stimulates economic development. It incentivizes employment, on both the supply and the demand side. It is successfully enforced, i.e. not allowing for incompliance and avoidance. It addresses social inequality through distribution of the tax burden in proportion to resources and proper redistribution of the tax revenue.

Fairness and efficiency is found where the right balance is stricken and this is no little challenge.

The extent to which MS' tax systems encourage sustainable growth is evaluated on the basis of five indicators:

- effective marginal tax rate (EMTR), i.e. the amount of tax on the additional Euro,
- tax treatment of debt and equity,
- research and development (R&D) incentivization,
- environment-friendly taxation and
- efficiency of tax administration.

EMTR takes into account statutory rate, tax base and the investee's assets. Neutral treatment of debt and equity is crucial to reduce fragile projects founded on debt. Well-designed R&D incentives motivate innovation with numerous positive effects, such as job creation and social mobility. While facilitation of environment-friendly investment is the key to long-term viable economies, its social fairness-dimension should not be disregarded. Finally, the stance of the tax administration may well be the clue in practice. Time is money and the hours that a business taxpayer may need to fulfill its tax obligations can be translated to prohibitive costs, especially for SMEs, which form the basis of the EU economy. Simplicity and digitalization on the other hand are words to speak to the heart of business.

The ideal tax system – at least in the Old Continent – has to boost employment within a strong economy. Increased employment rates imply increased amount of taxes to be collected but also decreased public expenditure for social assistance. MS' efficiency in the pursuit of this goal is measured on two factors:

- tax burden on labor in general and
- the so-called *inactivity or low-wage trap*.

The overall burden on labor includes compulsory social security contributions and constitutes the difference between the amount of income received by the employee and that paid by the employer. Extraordinary burden, apart from its obvious discouraging effects on both sides of the employment relationship, is also susceptible to incentivize undeclared work and tax incompliance. Inactivity and low-wage traps are a particularly tricky issue especially in the North of the EU. In case of persons moving from unemployment to employment, the question is whether the difference between the net employment income to be received and the unemployment allowance is such as to *justify* engagement. Correspondingly, the low-wage trap concerns the choice between remaining at low-wedge level and accepting / pursuing an increase. While the trap must be avoided sufficient social welfare and redistribution must also be guaranteed.

Furthermore, a fair and efficient tax system is one *complied with*, leading to collection of the lawful taxes on the income actually produced within the jurisdiction. According to the EC, flaws may be signaled by the extent of

- the non-observed economy (NOE), i.e. of activities that are underground, illegal or informal, e.g. undeclared work and therefore untaxed,
- delays in payment of taxes,
- estimated tax avoidance, i.e. amount of income that could be taxed but is *legally* shifted outside the jurisdiction,
- implementation of anti-abuse rules,
- inconsistencies between financial and substantial economic activity.

Three types of anti-abuse rules are distinguished as *critical*:

(1) interest limitation and thin capitalization rules,

(2) CFC rules and

(3) rules to counter mismatches in tax qualification; alarmingly, the latter (under 3) are implemented only in two MS.

Financial activity that does not correspond to economic structures is considered indicative of tax avoidance. Moreover it is worth observing that the estimate of NOE ranges from less than 5% in some countries of Northern EU to more than 20% in the Balkans.

Finally, no redistribution [means] no fairness. Taxation is one of the basic channels for states to compensate social inequality and EU has always been praised for the weight it attaches to redistribution. The indicators selected in this respect were

- the relationship between inequality at gross and net income level – illustrating taxation's approximating effects and
- progressivity of PIT, allowing for share of burden in proportion to resources.

Nevertheless, important aspects of redistribution may be identified outside the scope of taxation, such as in the tax revenue spent for healthcare and education as well as in the allowances and benefits for the weaker sections of the society. The good news are that the years of the financial crisis saw an increase of redistribution in almost half of the MS' tax systems.

Apart from substantiating *fairness and efficiency in taxation*, the survey contributes to the ongoing worldwide debate by summarizing the recent MS actions in the pursuit of this goal. Enhancement of compliance is a permanent priority. It is principally sought in the enforcement of tax legislation e.g. through (i) extended recording of market transactions, (ii) multiplied audits, (iii) publication of lists of tax debtors, (iv) enhanced cooperation and exchange of information with foreign tax authorities. At legislation level, the said anti-abuse rules have been introduced or strengthened in several MS. The business-friendly dimension of tax systems has been also targeted primarily through digitalization; small steps have been made for the reduction of CIT and debt bias. Tax burden on employment has been effectively removed through reduction of PIT and social security contributions. Such measures helped also boost the redistributive effects of the system. The subsequent loss of revenue was remedied among others through increased taxation of higher income earners, unhealthy products and environment-harmful investments. The above are not enough for the EC though. MS have a long way to go before being able to boast for *fair and efficient tax systems*. EC invites them to promptly give impetus to relevant EU initiatives, such as the CCCTB, as well as to get inspired by other MS' best practices and general directions of the EC.

An implicit – but no less critical – outcome of the survey is the verification of the existing gap among MS tax systems. Different rules, different policies, different deficiencies, different outcomes, different potential are observed in the 28 tax systems that coexist in the *Single Market*. This is a deficiency in itself and an important one. It can be blamed for legal uncertainty within the EU, *per se* appalling to investment. It is also susceptible to facilitate tax avoidance by maximizing the loopholes among the MS' tax systems in light of the fundamental freedoms. Proposals to remedy the situation are not questioned but their coherent implementation at MS level is. More convergence could be seriously considered as urgent.