László Kovács, European Commissioner for Taxation and Customs

"The future of EU taxation policy"

Speech to Tax Directors' Institute and to PricewaterhouseCoopers

London, 8th December 2005

CHECK AGAINST DELIVERY

Ladies and Gentlemen,

(Introduction)

• I am honoured to have been invited to address this distinguished audience. And I am especially pleased that I will have the opportunity to engage in a discussion with you following my initial remarks.

• I should like to focus my contribution on the main future tax policy coordination goals in the EU.

• I will, in particular, talk about the coordination of EU Member States' tax policies in the light of the Lisbon agenda, about flat taxes, and about the role that the European Court of Justice is playing in the tax field.

(Harmonisation and coordination)

• It might be useful for me first to explain the difference between harmonisation and coordination of tax policies:
- Harmonisation involves replacing national provisions in one area by common EU legislation. This is the case, for example, for VAT where we have the 6th Directive.

- Coordination means keeping national laws but rendering the different national laws compatible with the Treaty and with each other.

- The Commission Communication on tax policy of May 2001 stressed that there is no need for an across-the-board harmonisation of Member States' tax systems.

- Nevertheless, a high degree of harmonisation is certainly essential in the indirect tax field.

- Furthermore, the attainment of common economic objectives can sometimes be undermined if we do not ensure the mutual compatibility of national tax systems and the respect of the Treaty. I believe in this context that the European Union could be more proactive in ensuring the coordination of tax policies.

- I should also stress that, in some areas, the borderline between harmonisation and coordination is not very clear. In some cases there may be a need for some EU-level harmonisation, even if national policies remain the rule. This is the rationale behind, for example, the Commission's initiative on an EU-wide Common Consolidated Corporate Tax Base.

- In other cases, coordination would need only to consist of ensuring that national laws are mutually compatible and compatible with the
Treaty and do not impede the proper functioning of our economies. This co-ordination would be in the interest both of tax administrations and of economic agents.

(Present situation)

- So much for the theory of harmonisation versus co-ordination of EU Member States' tax policies. But what is the actual situation at present?

- There are currently several aspects of the functioning of national tax systems that impede the economic integration of the EU.

- Very often measures that were adopted by the Member States concerned in order to protect their tax bases can constitute obstacles that are incompatible with the EU’s internal market. They can create obstacles to the four freedoms enshrined in the EC Treaty. They can give rise to situations of double taxation or double non taxation. And they can also lead to tax avoidance and tax evasion.

- I should add that they can also give rise to complaints on the part of economic operators that reach the European Court of Justice, to the great concern of Member States.

- The deepening of the internal market, as well as the contribution of taxation to the structural adjustment of our economies, suggests that this situation cannot continue. We need a Community approach aimed at providing a coordinated Community framework for tax policy actions.
It is within this general context that the Commission has recently adopted a Communication that presents the key taxation and customs policy measures that would contribute to fulfilling the Lisbon strategy.

You will no doubt know that this Commission has proposed a new direction for the Lisbon agenda, refocusing our efforts on action to deliver growth and jobs, while maintaining our social model and our overall approach to sustainable development.

The coordination of taxation policies has a significant role to play in the fulfilment of the Lisbon objectives. It can contribute to raising the efficiency of our economies and the competitiveness of our businesses. It can generate more competition in the markets. And it can boost trade and support knowledge and innovation.

I must stress that tax policy coordination can be achieved in different ways and by means of either legislative or non-legislative instruments, depending on the nature of the problems and the solutions proposed.

The Communication presents the key existing and forthcoming Community taxation and customs actions over the next 4 years that will be designed to pursue these goals.

Let me give you some examples of the taxation actions that the Communication highlights.
(Common Consolidated Company Tax Base)

- In the corporate tax area, the Commission considers that if companies were allowed to apply a single EU-wide set of rules for company tax purposes, they would escape most of the current problems, such as double taxation, that they currently face when they do business across national borders in the EU.

- An EU-wide common consolidated company tax base would also lead to a substantial reduction in compliance costs for businesses.

- I would like to stress two points.

- First, this common tax base as proposed by the Commission in 2001 would be optional and would not entail the replacement of national tax bases. The national tax bases would exist alongside the common tax base.

- Second, a common corporate tax base in the EU would not mean a common corporate tax rate.

- Thus the introduction of a common tax base in the EU would only mean allowing EU firms to reduce their compliance costs by being able to compute their aggregate profits in the EU internal market according to a single set of tax rules.
(Transfer Pricing)

- The Lisbon Communication lists as another considerable source of difficulty for EU firms operating across national borders in the EU the management of transfer pricing.

- It was for this reason that the Commission established the EU Joint Transfer Pricing Forum in 2002. It consists of tax experts from Member States' administrations and from the business world. The OECD is also participating actively in the Forum.

- The purpose of this Forum is to find pragmatic solutions to the high compliance costs and the double taxation that often arise in the case of cross-border inter-group transactions. These problems occur because of disagreements between companies and tax administrations, as well as between national tax administrations, on the pricing of the transactions. Bringing together all parties concerned in this way to discuss the issues at stake has already led to better common approaches.

- On the basis of the work of the Forum, the Commission has proposed two "Codes of Conduct", one concerning the effective implementation of the EU Arbitration Convention and the other proposing a common approach to transfer pricing documentation.

- These Codes are so-called "soft law" instruments. They are not legally binding but all Member States have signed up to the first Code and we hope that they will agree to the second Code very soon.
The Forum will continue its work in 2006. It will, in particular, focus on alternative procedures for dispute avoidance and resolution, including Advance Pricing Agreements and prior consultation. It will also look at interest and penalties relating to transfer pricing adjustments.

(Cross-border loss relief)

Another example of an area where co-ordination of tax policies appears necessary is that of tax relief for cross-border losses. The lack of cross-border relief tends to impact on business decisions by inciting companies either to invest domestically or to make cross-border investments only in larger Member States. This is because in those situations there is a greater likelihood that the companies would have a tax base against which losses could be set off.

The Commission intends, following technical discussions with Member States, to present a Communication on this topic next year.

(VAT)

The Lisbon Communication draws attention to the fact that cross-border economic activities in the EU are also confronted with VAT measures that act as barriers to trade and investment.

The Commission has named as a particular priority in this regard the simplification of compliance obligations relating to intra-Community activities.
• You may be aware that the Commission presented a proposal to the Council and Parliament in October 2004 for a "one-stop shop" system. This would allow a trader to fulfil all his VAT obligations for his EU-wide activities in the Member State in which he is established. Unhindered access to the Internal Market is essential to creating the elements for growth. The one-stop-scheme would be just one step towards facilitating such access.

• Another Commission proposal relating to VAT that is on the Council's table concerns changing the place of taxation of services supplied from business-to-business and from business-to-consumers. The proposals would ensure that services are taxed at the place of consumption in the case of most supplies of services to business and in the case of certain supplies of services to private consumers. Having business customers account for VAT on services they receive from another country will, together with the one-stop shop, ensure that VAT rules are simpler to apply and more fair.

• I hope that Member States will adopt both of these proposals at an early date.

(Tax fraud)

• I must finally point to the reference in the Lisbon Communication to the need to coupling the punishment of fraudsters with enhancing the environment for honest and legitimate operators.
• Fraudsters can undermine the competitiveness of legitimate traders as well as eroding the revenues of Member States. I believe that the Commission has a valuable role to play in improving co-operation between Member States and providing fora in which tax authorities can enhance their knowledge and operational capacities.

• The Commission is currently preparing a new anti-fraud tax policy at European level. Instruments that could be considered include cooperation between national administrations; reducing obstacles to the effective exchange of information such as incomplete access to bank information; promoting negotiations with third countries to introduce provisions for exchanging information; further developing the use of intra-Community administrative cooperation tools; and improving basic tax legislation.

• The Commission intends to present a Communication on this subject in 2006.

(Enlargement of the European Union - Flat tax)

• Let me now briefly touch on tax policy developments since the enlargement of the European Union, and specifically the issue of flat taxes.

• Since the enlargement of the EU, we see an increasing diversity of tax regimes as compared to the situation that existed in the "EU-15". An example is the zero rate of taxation on undistributed corporate profits as applied in Estonia.
• In general, we have seen reductions in corporate tax rates, accompanied by a broadening of tax bases. But we see no evidence at present of a "race to the bottom" or a "beggar thy neighbour"-situation involving Member States trying to attract tax bases at the expense of the other EU Member States.

• Another example of the diversity of tax regimes is the increasing political interest in "flat tax" systems.

• In fact I must stress that "flat taxes" cover quite different systems and they really have only one thing in common, which is the fact that they involve a single tax rate.

• This single tax rate is in the case of some countries applied only to some portion of taxable income, such as personal or corporate income, while in other countries it is applicable to the total taxable income, including both direct and indirect taxation. Furthermore, the tax levels and systems in those EU Member States that have, or are contemplating, flat taxes are quite different.

• For this reason we must be careful about concluding that all tax regimes that involve a "flat rate" can be analysed in the same way.

• In electoral times, political parties may propose tax reform with a view to attracting voters. Flat taxes are currently being discussed by a number of EU countries. The main common purpose of these ideas for reform is to simplify tax systems. But the global economic and distributive impact would very much depend on the specific characteristics of any such tax.
• In principle, replacing a comprehensive progressive income tax system with a flat tax system could improve the efficiency and the simplicity of the tax system. But these gains are uncertain and they would depend critically on the details of the reform. A number of these gains could be made simply by modifying existing income tax systems.

• A central issue for a "flat rate" would be the distributive effect that would result from its implementation. In general, the application of a flat system would reduce the progressivity of the system. The redistribution effects would have to be considered carefully.

• The Commission is required to check the compatibility of national law with Community law. Member States must respect the rules on non-discrimination and fiscal state aids and the rules established under the Code of Conduct against harmful tax competition in the business tax area.

• But I must also stress that, under the principle of subsidiarity, Member States are free to implement the tax system they wish according to their economic and social objectives, as long as this tax system respects Community law.

(The influence of the European Court, the need for co-ordination and the example of "exit taxation")

• I mentioned that I would also say a few words about the European Court of Justice. Its recent decisions in the tax area have received considerable publicity.
• First, I have to stress that the Court is there to interpret the Treaty. One of the main tasks of the Commission under the EC Treaty is to ensure that Member States respect their Treaty obligations, including, where necessary, by launching infringements proceedings against the Member States. The Court must pronounce on cases referred to it either by the Commission or by national Courts.

• The Court is obliged to take certain positions in order to remain coherent with the Treaty, and in particular the four freedoms, and with its other judgments. The Treaty freedoms are aimed at ensuring a better functioning of the common market by facilitating its role as a single economic area. The function of the Court, like that of any tribunal, is an ex-post control of national legislation.

• The Court has, in doing its job, been successful in removing many tax obstacles to the single market.

• But several Member States feel that the Court does not have sufficient regard in its decisions to specific national policies and particularly to the financial consequences of its judgements.

• I must add that Member States are free to submit observations to the Court, individually or jointly, in order to explain their views on the national implications of any decisions. But Member States have not been very active up to now in doing so.
• The Commission is sensitive to the concerns of Member States and it has indicated its readiness to evaluate their views, particularly as regards the budgetary consequences of Court decisions. In fact, on the specific question of the retroactive effect of these decisions, the Court may soon in some pending cases provide further clarification on the limits imposed by the Treaty.

• I for my part am all too conscious of the problems that the Court's decisions are presenting for Member States. I am certainly not happy with certain implications of this development.

• In particular, I am not happy with the fact that EU tax policy is increasingly being made as a result of Court decisions rather than as a result of coordinated policy actions of Member States. I am convinced that the recent developments in this area could lead to a situation where it will become almost impossible for Member States to protect their tax bases at national level.

• In fact, in certain cases, coordinated solutions at European level could enable Member States to maintain better control over the design of their tax systems and their tax bases. And they would do this while at the same time complying with their Treaty obligations.

• Over the past few years the Commission has been drawing the Member States' attention to the increasing influence of the Court's decisions in the direct tax field. It has advocated more intensive tax policy coordination as the best means of adapting to that development and of resolving the problems that these Court decisions can cause.
• The Commission in its Communication of October 2001 concerning corporate taxation proposed that it would develop guidance on important rulings by the European Court of Justice. It suggested that it could also coordinate the implementation of those rulings by Member States.

• By way of example, the Court's decision in 2004 favour of the taxpayer in the *De Lasteyrie* case illustrates that "exit taxation" is an area where coordination might prove useful for Member States. But although Member States admit that there may be EC Treaty problems with their exit taxation rules, most appear to be reluctant to examine the scope for a coordinated approach at EU level. They prefer instead to rely on national or bilateral solutions.

• I have asked my services to prepare a Communication for the first half of 2006, detailing what we mean by "coordination" in this exit taxation area.

• This Communication will examine the existing mismatches between Member States' tax systems, which can result in double taxation and double non-taxation when an individual transfers his place of residence from one Member State to another. The Communication will propose co-ordinated solutions that would render national exit tax rules compatible with Community law and with each other.
(Conclusions)

Ladies and gentleman, it is now time for me to conclude:

- In my address, I have spoken to you about recent EU tax developments and plans for the future.

- I have in particular highlighted some of the main areas where closer EU tax coordination appears necessary.

- This may require a limited loss of formal tax sovereignty for co-operating countries. But I think that this is preferable to the substantive loss of tax sovereignty resulting from policy changes imposed on governments either because of economic developments or of Court rulings.

- The discussions that will follow today will certainly underline differences in views concerning the need for coordination of tax policies at EU level.

- But ultimately it is my firm conviction that a debate on taxation in Europe can only be productive if we have regard to the bigger picture. We must consider taxation in the context reaching our common EU objectives. We must, I repeat, ensure that taxation policies contribute to sustainable growth and job creation in Europe.

I thank you for your attention.