TO THE COMMISSIONER RESPONSIBLE FOR TAXATION AND CUSTOMS UNION

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* Taxation policy is largely reserved to member states, but the European Union should nevertheless do more to address the concerns of its citizens and combat tax avoidance, evasion and fraud.

You should also take measures to sustain tax revenues to fund social protection and to plug flows to non-EU tax havens. You should speed up the introduction of a new system to combat VAT fraud, work to tackle profit shifting and address taxation of the digital economy.

In addition, energy taxes are ripe for revision to underpin the low-carbon transition, and you should engage fully in the discussion on tax fairness.

None of this implies harmonisation of tax rates; in fact variation in tax rates in different EU countries can be desirable to enable countries to address their specific circumstances and needs.

Tax policy should increasingly be designed in relation with general EU objectives such as fair competition, energy transition or social justice.

* TAX COORDINATION
* ANTI-TAX AVOIDANCE
* CARBON TAXES

1 STATE OF AFFAIRS

You take over responsibility for an area that citizens in Europe consider a high priority for the European Union. Three-quarters of EU citizens would like the EU to intervene more in the fight against tax fraud, according to a 2016 Eurobarometer survey (Nancy, 2016)[1]. Since taxation is also a source of distortion in the single market, measures you take will complement those of your fellow commissioner for competition. Although EU action in the area is limited given the subsidiarity principle and the unanimity rule for Council decisions, the timing of your appointment is relatively favourable for action.

*WEALTH INEQUALITY

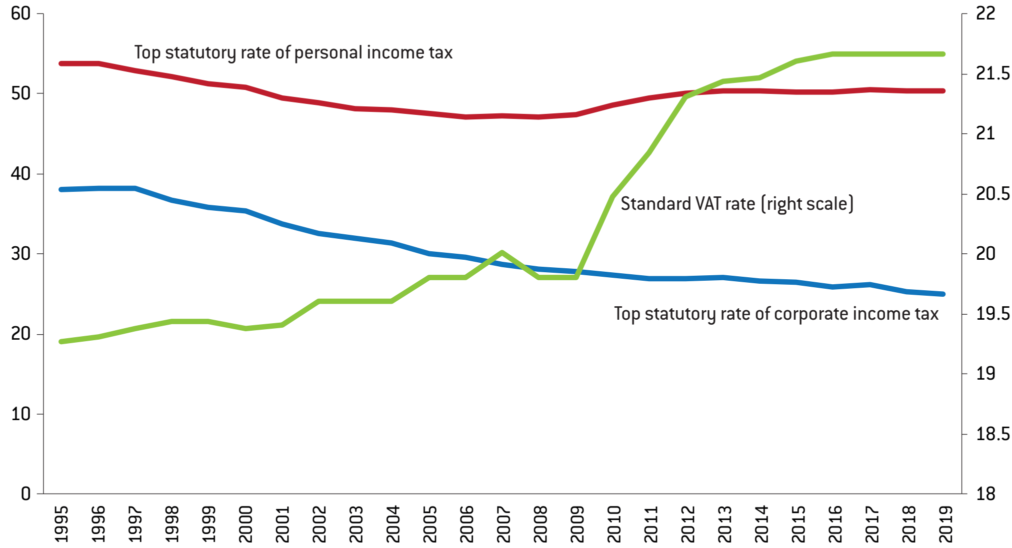
The international landscape is changing fast, under the pressure of public opinion that has become better informed thanks to various leaks of confidential information (eg the 'Panama papers' published in 2016), and in the context of rising wealth inequalities. The Organisation for Economic Cooperation and Development's comprehensive project on Base Erosion and Profit Shifting (BEPS) and the 2017 tax reform in the United States[2] offer the EU new opportunities to make progress on taxation of corporate income. Finally, achieving the EU commitment of reducing greenhouse-gas emissions by 40 percent by 2030 relative to 1990 will likely require tax instruments.

*AVOIDANCE AND EVASION

Why should the EU intervene in taxation beyond the historical coordination on value-added tax? There are three fundamental reasons. First, goods, services, capital and labour are more mobile within the EU than between the EU and the rest of the world. This mobility is at the core of the single market strategy. It is beneficial in terms of efficiency, innovation and, ultimately, income *per capita*. However, it also creates opportunities for tax avoidance, evasion and fraud. And it triggers a 'race to the bottom' in terms of taxation of the more mobile tax bases, at the expense of the less mobile (Figure 1). In recent years, the digitalisation of the economy has given a new impulse to this dynamic: the effective average tax rate on investments in digital assets is around 8.85 percent on average for OECD countries, against an average statutory rate of 23.7 percent according to the OECD[3].

Second, the EU differs from the rest of the world in its high

Figure 1: Top statutory tax rates in the EU15, 1995-2019, %



Source: Bruegel based on European Commission. Note: simple average of 15 pre-2004 EU members.

level of social protection, which requires relatively high taxation that cannot be sustained without some form of cooperation. Fortunately, the EU can benefit from a large-country effect: foreign investors will accept slightly lower after-tax returns – in other words higher tax rates – when investing in this large market. This is the third reason for cooperation at EU level: to reap the large-country benefit and to plug flows to non-EU tax havens.

*TAX COORDINATION

These three motivations for tax coordination do not imply harmonisation of tax rates. In fact, there are good reasons for tax rates to differ in different EU countries. For instance, peripheral countries need to compensate for their geographic disadvantage, and different countries might have different social preferences. Tax coordination should rather be viewed as a way to preserve the sovereignty of individual member states.

Existing arguments *against* tax coordination have lost traction in recent years (see eg Becker and Englisch, 2019). A previously powerful argument was that tax competition would put pressure on governments to produce public goods more efficiently, but this idea has lost ground because wealthy households and multinational firms today can enjoy public goods (infrastructure, services) in a jurisdiction without paying their costs. A second argument *against* tax coordination is that it might increase compliance costs for companies and for governments. Today, however, compliance costs are substantial in the EU with little progress in the last decade (KPMG, 2018). Tax coordination might actually offer an opportunity to downsize the existing complex network of anti-abuse rules. A third concern about tax coordination is the risk of double taxation. This risk is real but should be balanced against the risk of double non-taxation. In fact, the *lack* of a coordinated reform of the corporate income tax has already pushed several member states to introduce their own digital taxes, giving rise to a serious risk of double taxation.

2 CHALLENGES

Tax systems in the EU are confronted with three challenges: 1) lost resources; 2) reduced efficiency; and 3) unfairness. These challenges are not specific to the EU. However, as argued above, in the EU they are both more acute and more solvable.

*UNPAID TAXES

1. **Lost resources:** revenue losses due to cross-border tax avoidance, evasion and fraud total at least 1 percent of GDP – a similar amount to the EU budget[4]. Recovering these amounts is key not only for budgetary reasons, but also in order to preserve consent to taxation and to contain induced inequalities among households and among companies.

*PREFERENTIAL TREATMENT

2. **Reduced efficiency:** preferential tax treatment distorts the level playing field for firms. The previous Commission ordered Apple to pay a €12.8 billion to the Irish tax administration as an adjustment for illegal tax rulings that, according to the commissioner for competition, amounted to state aid. However, *ex-post* action on a case-by-case basis entails delays and uncertainty whereas monopolistic positions can build up fast. Additionally, economic theory suggests that rents can be taxed at no cost in terms of efficiency. Thus, fighting aggressive tax planning contributes to a healthy single market. But it needs to be done in a way that does not increase the complexity of the tax system. In fact, simplifying the tax system is a precondition for the corporate sector

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to support the reforms.

*PROGRESSIVITY

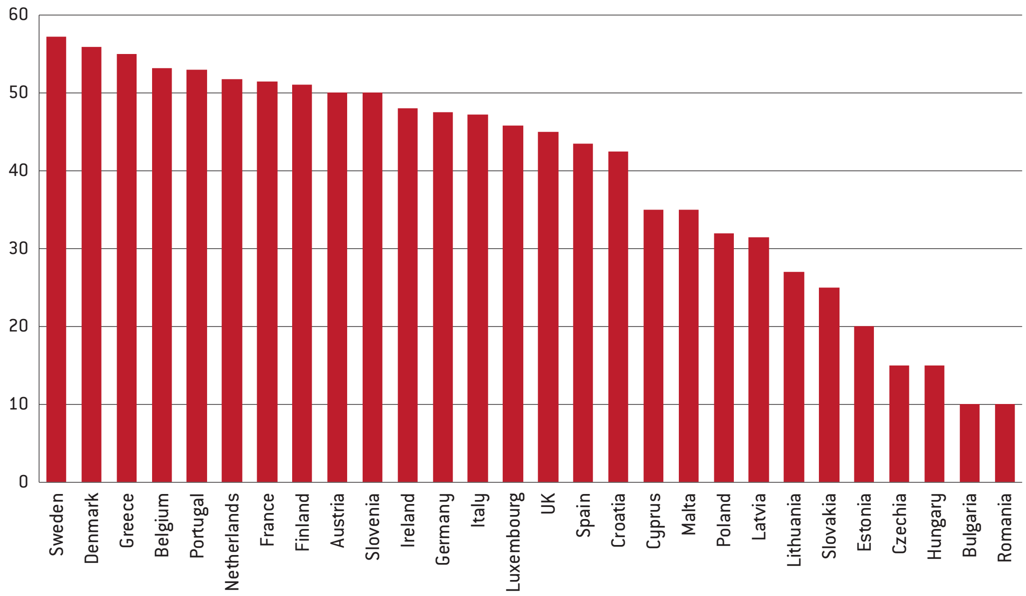
3 **Equity:** the decline in the top personal and corporate income tax rates, together with the hollowing out of wealth and inheritance taxes, have reduced the progressivity of tax systems in the EU. Part of this flattening of tax schedules is related to globalisation (Egger *et al*, 2019). Although Europe on average has performed relatively well compared to the United States in terms of inequality, the top 1 percent of the European population has reaped more benefits from growth than the rest of the population, and wealth inequality has increased (Blanchet *et al*, 2019).

*REDISTRIBUTION

Whether the EU should be involved in subnational redistribution is highly controversial. It is the responsibility of national governments to ensure the level of redistribution that corresponds to their citizens' collective choices, consistent with the subsidiarity principle. However, Article 3 of the Treaty states that the EU *"shall combat social exclusion and discrimination, and shall promote social justice and protection"*. The European Pillar of Social Rights, adopted in November 2017, is an attempt to coordinate national policies in terms of inclusion, equality and protection, without extending the powers of European institutions.

You should take a pragmatic stance in this debate. First, disregarding entirely inequalities within countries could risk a backlash through a rise in anti-globalisation, anti-European public opinion. Previous Commissions understood this risk when introducing the European Globalisation Adjustment Fund in 2006 and the Youth Guarantee in 2013. Second, without international cooperation, taxing high incomes or wealth has proved increasingly difficult in recent years, since these tax bases are highly sensitive to taxation[5].

Figure 2: Top personal income tax rates in 2019 (%)



Source: European Commission, taxation trends database.

Third, your fellow commissioner responsible for the budget might find it increasingly difficult to convince net contributor member states to continue channelling transfers to less advanced regions without minimal contributions from the relatively better-off in receiving countries. In 2019, top personal income tax rates ranged from 57.2 percent in Sweden to 10 percent in Bulgaria and Romania (Figure 2).

3 RECOMMENDATIONS

Your predecessor was especially active in two areas of tax coordination: VAT and corporate income tax. Your priority should be to finalise what has been started, while coordinating on energy and carbon taxes with your colleague responsible for climate action, and starting the discussion on personal taxation.

Your success will depend on your ability to articulate tax policies with more general objectives of the Commission such as fair competition, energy transition and social justice.

Value added tax

VAT fraud is made easier by the exemption of intra-EU cross-border business-to-business supplies: under the 'transitional' system introduced in 1993, intra-EU cross-border supplies of goods are VAT exempt. This exemption breaks the incentive for intermediate suppliers, the effective VAT collectors, to file returns and claim the refund, which ensures a level of self-policing in the system. It exposes the system to so-called missing-trader fraud and consequently to carousel fraud.

*VAT COORDINATION

Although some countries have been successful in fighting VAT fraud (see eg Sarnowski and Selera, 2019, on Poland), VAT gaps remain a major issue in the EU. The development of e-commerce has meant more potential for fraud, while imperfect coordination between tax administrations makes it difficult to identify fraud in real time. From a business point of view, cross-border activity involves high compliance costs since, above a sales threshold, companies must register in each country of final consumption sales. The burden, which has been estimated at 2-8 percent of VAT tax collection (Adam *et al*, 2011), is especially high for SMEs, and penalises digital activities since their business models rely on economies of scale.

*SINGLE VAT AREA

In April 2016, the Commission adopted an Action Plan on VAT (European Commission, 2016) to modernise the system and create a single EU VAT area. The idea is to treat cross-border sales the same as domestic sales, consistent with the single market approach, while keeping the destination principle. Businesses will file for VAT only in the country where they are established, and a 'one-stop shop' will allow them to charge VAT on their cross-border sales according to the rates of each country of destination. The country of origin will then transfer the corresponding revenue to each country of destination. As a first step, a mini one-stop shop was introduced for e-services in 2015. The second step will concern e-commerce and distance selling in 2021. Eventually, the one-stop shop will be generalised, while keeping the option of having the VAT paid by 'certified' customer firms at the destination.

It was initially intended for the EU VAT system to switch at some point from destination-based to origin-based. Consistent with this objective, VAT rates were tightly coordinated. Moving instead to a definitive destination-based tax allows for more diversity in the rates. In practice, member states will have more leeway to decide on reduced rates provided the weighted average of all VAT rates exceeds 12 percent.

Based on the first experiences of one-stop shops, your task as commissioner will be to convince member

states that the new scheme can deliver on both fraud and compliance costs, provided information systems are quickly harmonized and upgraded, and anti-fraud strategies are better coordinated between tax administrations. You may want to organize national tax authorities as a network coordinated by the Commission in a similar way as for competition authorities. Tax collection meets the various conditions for being delegated to independent authorities. In particular, it has a clear, verifiable mandate with no political trade-off involved. Furthermore, it has to deal with the pressure of specific interest groups, which is less difficult for an independent authority.

To build mutual trust, accelerate IT projects and strengthen resistance against external pressure, you could explore the idea of merging these administrations with customs services and granting them autonomy at national level, in the spirit of the European network of national competition authorities. These agencies would be accountable to their national parliaments, and could be inspected by national auditors and (possibly) by the European Court of Auditors.

Corporate income tax (CIT)

While VAT is destination-based, CIT is source-based: it is levied where the value is created. If all companies were held by domestic shareholders, raising the tax at the level of the firm (source) would be equivalent to raising it at the level of the shareholder (residence). With foreign shareholders, however, CIT can be viewed as a way of having foreign-owned firms contribute to the funding of domestic public goods, some of which (including infrastructure and education) directly affect their productivity[6]. In order to avoid double taxation (at the source, and then at the residence), complex networks of bilateral tax treaties have been developed. These provisions have created loopholes that have become more and more difficult to combat in the era of the intangible economy.

> *The digitalisation of the economy has multiplied the opportunities for tax optimisation*

*COMMON CORPORATE TAX BASE

To tackle these problems, the Commission has proposed a comprehensive reform – the Common Consolidated Corporate Tax Base (CCCTB), which dates back in 2001, with the first draft directive proposed in 2011. The idea is to harmonise the various definitions of the corporate tax base applied by member states, to consolidate the bases at the EU level and to apportion the consolidated base to the various countries where the firm is active based on a formula that depends on physical capital, employment and sales in each country. Member states would then be free to tax their apportioned profits at whatever rate they wish. In 2016, the Commission proposed a new version that splits the project into two steps: first, base harmonisation; second, consolidation and apportionment formula. However, no agreement has been reached in the Council. One reason for disagreement is the redistribution of tax revenues across member states. Another, more fundamental, reason is that CCCTB will not prevent a company from escaping taxation in one country if the company does not have a *"taxation nexus"* (a permanent establishment that carries out some key activities for the local market).

*ANTI-TAX AVOIDANCE

The discussion has been taken up by the OECD with its 2013 international 15-point action plan against BEPS[7]. The 2016 EU Anti-Tax Avoidance Directive (ATAD) (Box 1) is consistent with this international effort. However, ATAD will not prevent a company from creating value in a member state while not being taxed there (Collier *et al*, 2018). The main channels for transferring profit to low-tax jurisdictions include transfer mispricing, the strategic location of intellectual property and of headquarters, international debt shifting, tax-treaty shopping and tax deferral (Beer *et al*, 2018). The

*DIGITALISATION

digitalisation of the economy has multiplied the opportunities for tax optimisation. For instance, data and algorithms are generally not exchanged on a market, hence the arms-length principle can

Box 1: The Anti-Tax Avoidance Directive (ATAD, (EU) 2016/1164)

1. Limited deductibility of interest payments (up to 30 percent of earnings before interest, tax, depreciation and amortisation);
2. Exit tax in case of transfer of an asset to a low-tax jurisdiction;
3. General anti-abuse rule: no preferential tax treatment will apply to an arrangement or a series of arrangements whose main purpose or one of the main purposes is to obtain a tax advantage;
4. Controlled foreign company (CFC) rule re-attributing the profit of a controlled foreign subsidiary in a low-tax country to the parent company;
5. To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the member state where such a payment has its source.

Transposition was required by 31 December 2018.

The Directive is complemented by: 1) country-by-country reporting; 2) recommendation on tax treaties; 3) external strategy (ie common lists of third countries); 4) study of aggressive tax planning within the EU.

hardly apply. Digital activities also generate a problem in that user participation (eg through search on the internet) creates value (and possibly location-specific rents) at the market without being taxed.

Accordingly, the European Commission in March 2018 proposed to introduce the concept of *"significant digital presence"* that would be sufficient to create a taxable nexus (European Commission, 2018c)[8]. Alternative schemes being discussed at the OECD relate taxable nexus and profit allocation to *"market intangibles"* or to *"active user contribution"* (OECD, 2019)[9]. The common idea behind these various solutions is that part of the value is created at the market, rather than in the source country. As the commissioner responsible for taxation and customs union, you should use the momentum provided by BEPS to push forward the EU digital presence proposal, which is relatively simple and will prevent disorderly national initiatives to tax the digital economy. Since large importing countries could benefit from this reform at the expense of smaller exporting countries, it might be advisable to implement the reform in a progressive way, eg by changing smoothly the profit split method. In any case, since the EU is relatively divided on this issue, the best strategy will be to work in line with the OECD, which aims to deliver in 2020[10].

*PROFIT SHIFTING

Other forms of profit shifting (such as the payment of royalties for the use of a brand) could be addressed through a revision of the Interest and Royalties Directive (2003/49/EC) that would allow the market country to levy a withholding tax on the royalties paid on intellectual property when the payments are made to a country with a low tax rate (with appropriate tax credit in the residence country, see Fuest *et al*, 2013; Collier *et al*, 2018). The Commission project along these lines has been blocked by the Council since 2012. However, the US tax reform of 2017 might be a game changer. Through this reform, the US has switched from a worldwide to a territorial system (where repatriated profits are exempted). But at the same time it has introduced a minimum tax rate on profits made by controlled foreign companies (CFCs) and on outbound payments to related parties[11]. A similar reform in the EU would complete and strengthen existing CFC rules, while simplifying the complex and uncertain system of anti-abuse rules (Becker and Englisch, 2019). Set at a low level (eg at 12 percent, the US level being 13.1 percent), such a minimum tax rate would not constrain those member states with low rates and would protect them from non-EU tax havens[12]. It would also provide a backstop for bilateral tax treaties, which remain a national prerogative. Here again, the OECD initiative offers a good opportunity to overcome internal divisions in Europe.

Greening the tax system

A major challenge for the new Commission will be to coordinate national efforts in pursuit of EU emissions-reduction goals. The EU emissions trading system (ETS), introduced in 2005, only covers 45 percent of the EU's greenhouse gas emissions. The 2030 climate and energy framework (European Commission, 2014) requires non-ETS sectors to reduce their emissions by 30 percent by 2030 compared to 2005, with national targets ranging from

*CARBON TAXES

zero to minus 40 percent. National Energy and Climate Plans are monitored at EU level to assess their consistency with the emissions targets[13]. So far, few EU countries have introduced a carbon

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tax, although carbon emissions are taxed indirectly through levies on energy. Effective taxes on carbon emissions vary widely across EU countries, energy sources and sectors (see OECD, 2018). These differences distort the internal market and raise the cost of reducing carbon emissions. You should aim to revise the 2003 Directive on energy taxation (2003/96/EC) in order to: 1) make minimum rates consistent with the carbon content of the different energy sources; 2) eliminate the numerous exemptions and preferential treatments; and 3) index the minimum rates on the ETS carbon price.

Personal taxation

In the last few decades, EU coordination on personal taxation has been limited to the difficult introduction of automatic exchange of information between national tax administrations, first through the Directive of 2003 on taxation of savings income in the form of interest payments (2003/48/EC) and then with its various amendments ending with the full implementation of the new OECD standard on automatic exchange of information for interest income, dividends and other types of capital income (Directive 2014/107/EU which entered into force on 1 January 2016).

*WEALTH TAXES

In the United States, a debate has recently developed on taxation of personal wealth[14]. A similar debate will unlikely emerge at EU level since it is a matter for national tax policy. You could nevertheless try to emulate the initiative that led to the proclamation of the European Pillar of Social Rights in November 2017, and work on tax fairness tests to be used as an element of the new conditionality approach to EU transfers[15]. Such a test could be viewed positively by those who criticise EU policies as excessively focused on the free market; it could also attenuate the divide between eastern EU members who are attached to continuing structural funds and western members that consider such funding increasingly unfair without wealthy eastern citizens contributing more to the funding of infrastructure and public services in their own countries.

NOTES

1 Although fraud should be distinguished from avoidance and evasion, it is unclear whether this distinction actually matters for citizens.

2 Tax Cuts and Jobs Act of 2017.

3 Unweighted averages, source: http://ftp.zew.de/pub/zew-docs/gutachten/Digital_Tax_Index_2018.pdf.

4 This approximate figure encapsulates: €50 billion per year lost to cross-border VAT fraud (European Commission, 2016; the total VAT gap being about €150 billion according to CASE/IAS (2018) for the European Commission), €20-70 billion lost due to profit shifting (Dover *et al*, 2015; Cobham and Jansky, 2017; Álvarez-Martinez *et al*, 2018; and Bruegel calculations based on Tørsløv *et al*, 2018), and around €56 billion lost because of evasion of personal income taxes on capital income (Zucman, 2014). 1 percent of GDP is a lower bound; some authors estimate the revenue loss up to 5.6 percent of GDP (see Murphy, 2019). Crivelli *et al* (2016) estimated revenue losses because of profit shifting alone to be around 1 percent of GDP.

5 Saez and Zucman (2019) report wide differences in the elasticity of net wealth to taxation depending on enforcement and on the existence of exemptions.

6 The CIT also acts as a backstop for personal income tax.

7 Source: www.oecd.org/ctp/beps-actions.htm.

8 A firm that supplies digital services would have a significant digital presence if it meets one or more of the following criteria in a member state: 1) turnover above €7 million annually; 2) at least 100,000 users over the fiscal year; 3) over 3,000 commercial contracts generated between the firm and active users over the fiscal year. The member state could then tax the related 'residual' income. This proposal is fully compatible with the CCCTB: the related income would eventually be introduced in the apportionment formula.

9 The BEPS strategy was endorsed by the G20 in Osaka (29 June 2019) and by the G7 Finance in Chantilly (17-18 July 2019). In particular, the fact that the tax nexus needs to be adapted to the digital economy is now accepted internationally, and so is the idea of a minimum taxation rate.

10 See https://www.oecd.org/tax/beps/international-community-agrees-on-a-road-map-for-resolving-the-tax-challenges-arising-from-digitalisation-of-the-economy.htm.

11 The provisions are complementary since a minimum tax on repatriated profits from CFCs could incentivise company inversions in which the headquarters becomes the affiliate and vice-versa.

12 A more fundamental reform would be to switch to a destination-based cash-flow tax, which would involve raising the corporate income tax at the destination instead of the origin. Since such reform requires worldwide coordination (see IMF, 2019), we consider it as not achievable within the mandate of the new European Commission.

13 See the memo in this volume to the commissioner responsible for climate action and energy.

14 Notably, US senator and potential presidential candidate Elizabeth Warren has em-

braced the Saez-Zucman idea of a wealth tax of 2 percent on a family's wealth above $50 million, with an additional surcharge of 1 percent on wealth over $1 billion (Saez and Zucman, 2019).

15 For instance, that the ratio of the disposable income of the top 10 percent to the bottom 10 percent (or bottom 50 percent) should be below a certain threshold.

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