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TAXATION IN THE EUROPEAN UNION
REPORT ON THE DEVELOPMENT OF TAX SYSTEMS

(Presented by the Commission)

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CONTENTS

- I INTRODUCTION
- II THE DEVELOPMENT OF TAX SYSTEMS WITHIN THE UNION
- III ENTERPRISE: COMPLETING THE SINGLE MARKET
- IV EMPLOYMENT
- V THE ENVIRONMENT
- VI THE WAY FORWARD

I. INTRODUCTION

- 1.1 The Commission proposed a new and comprehensive view of taxation policy in its reflection document "Taxation in the European Union" of 20 March 1996. In particular, it highlighted the major challenges facing the Union: the need to create growth and employment; to stabilise fiscal systems; and to fully realise the Single Market. At the informal ECOFIN Council meeting in Verona on 13 April, Finance Ministers welcomed the Commission paper, and agreed on the need to take forward the consideration of these issues in a High Level Group, to be set up and co-ordinated by the Commission.
- 1.2 The ECOFIN Ministers appointed personal representatives to the High Level Group, which met four times, on 24 June, 19 July, 12 September and 7 October 1996. The Council's Secretariat General was also present at the meetings.
- 1.3 The meetings provided a valuable opportunity for representatives to examine and exchange views on some central challenges for taxation policy. In the course of its meetings the Group took oral evidence from the European Trade Union Confederation (ETUC), the Union of Industrial and Employers' Confederations of Europe (UNICE), and Mr Onno Ruding.¹ The European Parliament, through its Committee on Economic and Monetary Affairs and Industrial Policy, was kept informed of the broad topics submitted by the Commission for consideration by the Group.
- 1.4 In June, on President Santer's initiative, the Commission proposed a European Confidence Pact for Employment. This highlighted in particular the need to reverse the tendency of taxation systems to be detrimental to employment, as part of a wide ranging strategy to create more jobs in the Union.
- 1.5 The European Council in Florence emphasised "the essential contribution made by the Internal Market to promote growth and employment"; and requested the Council "to submit to it, before the European Council in Dublin, a report on the development of tax systems within the Union, taking account of the need to create a tax environment that stimulates enterprise and the creation of jobs and promote a more efficient environmental policy".
- 1.6 In this report the Commission:
 - summarises (in sections III - V below) the views expressed by members of the High Level Group on the issues first raised by the Commission's Verona document; and
 - gives (in section VI) its own assessment both of these particular issues and of the way forward for the future.
- 1.7 The Commission wishes to express its appreciation to the ECOFIN Ministers for the support that they have given to its initiative, both through their own

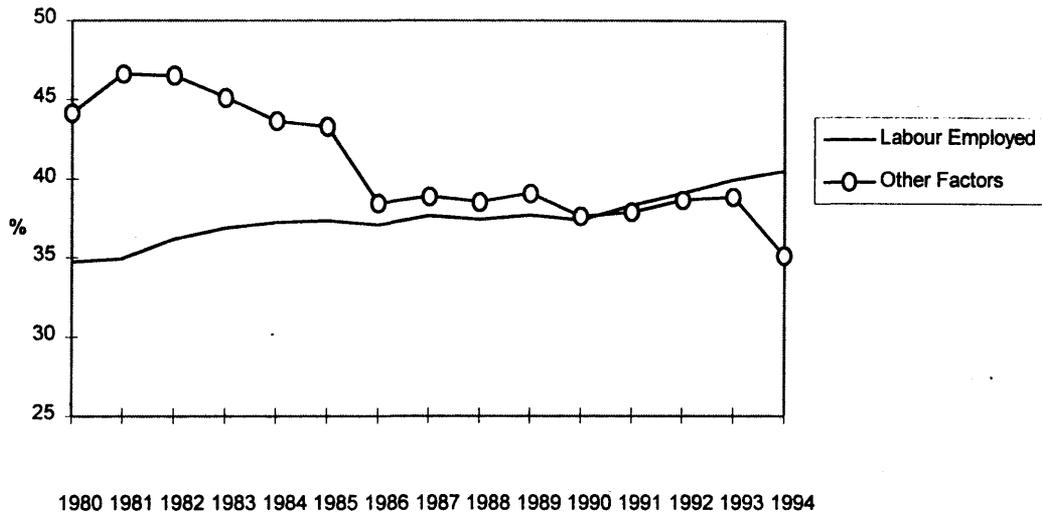
¹ Former Finance Minister of the Netherlands and chairman of the Committee of Independent Experts on Company Taxation in the European Community which reported in March 1992. The Commission's conclusions following that report are contained in its communication of 26 June 1992 (SEC(92)1118).

contributions to the discussions in Verona and through the participation of their personal representatives in the High Level Group.

II. THE DEVELOPMENT OF TAX SYSTEMS WITHIN THE UNION

- 2.1 The development of taxes and social charges in the 15 Member States of the European Union may be seen by considering both the evolution of the level of taxation (measured for example as a percentage of GDP) and trends in the structure of taxation (as they appear for example in the effective rates applied to different economic bases).
- 2.2 Between 1980 and 1994, total taxes and social charges as a percentage of GDP for the EU average increased by about 2 points. There were however large variations between Member States. Looking at the traditional breakdown between direct and indirect taxes and social security contributions, most of the total increase in taxation in this period was accounted for by social security contributions (rise of 1.5 points for the EU average, with most of the rise in the 1990s). The evolution over this period is more relevant than the data for a given country in any one year.
- 2.3 One method for analysing the long term trends in the structure of taxation is to calculate implicit tax rates (tax revenues divided by the tax base) according to economic functions (factors of production and consumption). Between 1980 and 1994, the European average of the implicit tax rate on employed labour increased steadily from 34.7 % to 40.5%. The same rate for other factors of production (capital, self-employed labour, energy, natural resources) decreased from 44.1% to 35.2% (see graph below). The rate for consumption was broadly stable, rising slightly from 13.1% to 13.8%. Again there were large variations between individual Member States. Those Member States which had the largest rises in the implicit tax rate on employed labour over this period were mainly those where the level of total taxation also increased most.
- 2.4 There are many possible explanations for these changes in the structure of taxation, including the evolution of tax rates and bases, the ageing of the population, and the fact that employment income is a relatively stable and easy base to tax. Another factor might be the progressive erosion of certain fiscal bases that could be caused by excessive or harmful tax competition. The OECD Ministerial and the G7 Lyon summits have this year underlined fears that especially favourable tax regimes, particularly for internationally mobile activities, can cause economic misallocations and undermine other countries' revenues. Although there is no measure of the overall impact of fiscal erosion, there is some evidence that effective taxation of investment income has been endangered by movement of investments between Member States or outside the Union purely for tax purposes.

Implicit Tax Rates 1980 - 1994



III. ENTERPRISE: COMPLETING THE SINGLE MARKET

Background

- 3.1 Enterprise is an essential force for the creation of growth, prosperity and employment within the Union. Creating an environment which enables enterprise to flourish is vitally important to maintain and enhance the Union's competitiveness world-wide. The Single Market is central to this. As regulatory restrictions are disappearing, those tax hindrances or distortions that do remain are becoming increasingly visible, and taxation is widely seen as one of the most important areas in which the Single Market has not been fully achieved. This is the case even in areas such as VAT where, in spite of a considerable amount of Community legislation, the system is still far from being adapted to the needs of a Single Market and where its complexity and the diversity of its application cause real problems.
- 3.2 Tax systems must allow cross-border economic activity to develop within the Union. However, at the same time, there is a need to ensure that the increased opportunities for cross-border trade and investment do not lead to an unacceptable loss of tax revenues through tax arbitrage, avoidance or fraud. Just as it is necessary to prevent the double taxation of cross-border income flows, transactions within the Union should not be able to escape tax altogether.

Promoting growth and enterprise

- 3.3 There was broad agreement within the High Level Group that the best conditions for enterprise lay in taxation systems that were as simple, fair and effective as possible. Over recent years the trend has been towards broadly-based systems at generally

low rates of tax. These were generally thought best suited to promoting continuing economic growth, and preferable to a series of particular tax exemptions or deductions targeted at individual business sectors or niches.

- 3.4 Nevertheless, some Member States have taken particular initiatives to stimulate business start-ups and small and medium sized enterprises. Both of these areas are primary creators of new wealth and jobs, and both can suffer from disproportionately high compliance costs.

The Single Market

- 3.5 There was general recognition both that taxation rules were an important element in fully realising the Single Market; and that the development of the Single Market had posed certain challenges for tax systems themselves, notably in the protection of tax bases and the prevention of cross-border fraud and evasion. There was, however, a variety of views on the need and the urgency for specific actions at the Community level. While all representatives pointed to the political sensitivity of taxation decisions and the need to respect the subsidiarity principle, some went on to stress that these should not be excuses for inaction or stagnation in taxation.
- 3.6 A number of representatives expected taxation distortions to be even more visible under Stage III of EMU, when there would be fewer variables and transaction costs and currency risks would be less of a barrier to trade. Others, however, thought that the major impact of EMU would be to underline the importance of retaining national flexibility in taxation policy.
- 3.7 The Group in general thought it important to have a clear medium to long term view of the role of taxation within the Single Market, but within that framework to take a pragmatic and practical approach to individual issues. It also noted that, even in the absence of new legislation in taxation, an increasing number of cases are coming before the Courts, either nationally or before the European Court of Justice. In this sense, the understanding of the law is constantly developing. A number of representatives expressed serious concern that, unless Court judgements were supplemented by other instruments, the development of Community tax systems risked being piecemeal.
- 3.8 Many personal representatives gave as their immediate priority for Community action the removal of tax disincentives to cross-border income flows. Indeed, a significant number singled out interest and royalty payments between companies and asked the Commission to make a new draft directive on which discussions could be relaunched. Many pointed as well to a need for a simpler and more effective VAT system in order to remove the complexities, market segmentation, and opportunities for fraud in the current transitional arrangements. Some called for work to commence urgently to implement the Commission's programme for a new common system of VAT.
- 3.9 A number of representatives thought that the 1992 report of the Ruding Committee had provided a useful analysis of steps that should be taken in the company taxation field. Among the priorities that were mentioned for Community action were

measures relating to financial services, particularly life insurance and pensions; the income taxation and social security treatment of cross-border workers; excise duties; and the possible development of common tax definitions.

- 3.10 There was considerable discussion of the role of double taxation treaties between Member States (and with third countries) in contributing most effectively to meeting Single Market needs. Even though bilateral treaties based on the OECD Model Treaty have gone a long way towards facilitating international trade world-wide, many representatives called for action to improve their functioning. It was suggested that certain areas of potential double taxation should be identified, and their treatment agreed upon at the Community level. This would provide a common pattern to streamline the system.
- 3.11 The need to develop and reinforce co-operation between tax authorities against fraud and evasion within the Single Market was stressed by a number of representatives as being among their highest priorities. Tax systems should be non-discriminatory, but they also needed to be robust against the loss of revenue from tax evasion. Co-operation would extend not only to sharing experience of the best ways to tackle evasion, but also to improving control and mutual assistance measures taken between the tax authorities of the Member States. The possibility of developing joint tax audits in respect of cross-border economic activity was also mentioned.

Tax competition

- 3.12 Discussions in the Group showed that the extent to which the perceived threat of unfair or harmful competition for the revenues from internationally-mobile business affects tax policy making varies from country to country. Moreover, there was no standard and objective understanding of what constitutes an unfair measure. Some representatives stressed their concerns that the effects of fiscal erosion could ultimately endanger the achievement of vital Community objectives, and, as a result, called for a common approach within the Union.
- 3.13 A number of representatives laid great emphasis on the need to apply the EC competition rules, notably on State Aids, consistently and transparently. Others, while supporting the call for transparency, also pointed out that tax measures were only one way in which governments could help businesses, and that the treatment of tax incentives should be consistent with wider competition policy, including the recognition of regional policy objectives. The general wish of the group was for closer co-ordination between the Commission and the Member States in this area.
- 3.14 The High Level Group generally gave little support to minimum corporation tax rates or bases at this stage, even within the framework of the overall objective of ensuring some minimum degree of effective taxation within the Union.
- 3.15 Many representatives, however, favoured continuing with initiatives specifically targeted at restraining or eliminating unfair competition in this area, in conjunction with the work currently being undertaken at the OECD. Representatives also suggested a number of further initiatives, including ones aimed at clarifying the interpretation of existing law, at defining acceptable and unacceptable conduct in a

Community context, and at sharing information more closely on other Member States' taxation policies and measures.

Taxation of capital income

- 3.16 Many personal representatives drew particular attention to the problem of capital income taxation, both within the Union and world-wide. Capital income, particularly interest income from savings, forms the most mobile base of all, and differences in taxation can cause serious distortions to capital allocation and flows. A number of personal representatives suggested that the elimination of currency risks and the reduction of interest rate differentials in Stage III of EMU would increase this sensitivity to tax differences.
- 3.17 In response to this problem, many representatives called for a minimum level of taxation on interest income from savings to be ensured throughout the Union in order to prevent economic disruptions and revenue losses. Some favoured a minimum withholding tax; while others favoured the exchange of information between administrations on the interest income of non-residents, and were reluctant to see a withholding tax in the Union if there were no lifting of bank secrecy legislation. Still others believed that the co-existence of these two approaches might be the basis for a possible way to resolve the impasse.

IV. EMPLOYMENT

Background

- 4.1 Fighting unemployment is the biggest challenge facing the Community today. As shown above, the long term trends in taxation in the Community have been unfavourable to labour. Greater substitution of capital for labour has been encouraged through the structural bias in taxation systems against labour.
- 4.2 A significant reduction in taxes on labour to promote employment (1-2% of GDP) as recommended by the Commission in its White Paper on *Growth, Competitiveness, Employment* has not yet taken place. The main reason is the difficulty experienced by Member States of finding suitable and sufficient budgetary compensation to offset the revenue losses.

The role of taxation

- 4.3 There was broad consensus in the High Level Group that taxes on labour need to be reduced. Some personal representatives favoured a targeted approach, where taxes on labour would be cut for particular categories of workers (e.g. the long term unemployed, youth unemployed) in order to maximise the impact on employment. Other personal representatives emphasised the need to create the

right tax environment for job creation, by reducing the tax burden overall, including for businesses. Shifting taxes away from labour and on to alternative tax bases was favoured by some representatives. For others, employment creation could be enhanced more by reducing the overall tax burden and by controlling or reducing public expenditure.

Long term and short term measures

- 4.4 Many personal representatives recognised that reversing the long term trend of increasing taxes on labour was necessary, although difficult in practice mainly because of the limited room for manoeuvre in financing significant reductions in taxes on labour. Reversing this trend was more likely than short term measures to have an impact on hiring decisions in the medium and long term. Most personal representatives identified a key issue as being whether employers receive a clear signal that the long term trend of taxation structures would now be reversed, and incorporate this signal into their expectations.
- 4.5 Some personal representatives highlighted the importance of shorter term measures which have been implemented in some Member States. These tend to be temporary reductions in non-wage labour costs and to be targeted, and are more likely to have an impact on hiring decisions in the short term, during the life of the measures. A key issue is the responsiveness of the demand for labour to these short term reductions in its cost. Some personal representatives underlined the risks of these short term measures, for example high deadweight cost.

Financing reductions in taxes on labour

- 4.6 The options for financing reductions in taxes on labour (both in the short term and in the long term) are public expenditure reductions and increased taxation elsewhere. The alternative tax bases could be consumption, or factors of production other than labour. Financing such reductions is easier in a context of higher economic growth.
- 4.7 For some personal representatives, reductions in public expenditure should be pursued as a matter of priority. These could give scope either for funding reductions in taxes on labour, or for reducing the overall tax burden more generally. Some personal representatives highlighted the existing trend in their Member States to shift taxes from those falling on income, including income from employment, to those falling on expenditure or consumption. On the particular option of using additional receipts from adjusting the standard rate of VAT in the new common system, personal representatives generally recognised that this was more of a medium or long term option. Some of them underlined the neutrality of VAT increases with regard to EU competitiveness. The option of introducing or increasing environmental taxes, including energy taxes, to finance reductions in taxes on labour, and hence help to correct the current under-use of labour resources and over-use of scarce environmental resources, was highlighted by some personal representatives (see section V below). Finally, regarding taxation of factors of production other than labour, particularly mobile capital, some personal

representatives highlighted the importance of reaching agreement on "safety nets" either to provide stable alternative tax bases to labour, or to prevent further fiscal erosion in these tax bases leading to increased taxation of labour.

- 4.8 Faced with increasing pressures on their social security systems, some Member States have introduced alternative ways of financing social expenditure, for example by broadening the financing base so that the full burden no longer falls only on employed labour, or by encouraging greater private provision. Some personal representatives stressed the link between social contributions and social benefits. Others emphasised that, with the ageing of the population and relative narrowing of the base of employed labour, alternative ways of funding social expenditure had to be pursued. Some personal representatives outlined recent reforms in this area.

V. THE ENVIRONMENT

Background

- 5.1 One of the tasks of the Community is to promote sustainable economic growth which respects the environment. To ensure that high environmental standards do not interfere unnecessarily with other goals, such as a high level of employment which requires inter alia high economic performance and a competitive European industry, it is essential to find cost-effective solutions to environmental problems. Taxation, by affecting the price of goods, is one economic instrument which can be deployed to encourage a more balanced use of scarce natural resources and to internalise the external costs of their use.
- 5.2 Environmentally related taxes, charged for example on the use of limited natural resources and on energy, can be broadly defined as all taxes whose base has a specific negative impact on the environment. Apart from the function of raising revenues, they also serve as an incentive for behavioural changes. They are thus often envisaged as an efficient economic instrument for environmental protection. Experience in areas such as the use of unleaded petrol has shown that the environmental objectives can often best be achieved when taxation instruments are combined with other measures which are used consistently to change behaviour.
- 5.3 The use of environmentally related taxes, including taxes on energy, has not on average increased significantly between 1980 and 1994. For the EU as a whole, taxes on the environment and energy amounted to 2.6% of GDP in 1980 and to 2.9% in 1994. The results for 1995 and 1996 may show some increase as several Member States have introduced new environmental taxes, which are not reflected in the above mentioned figures. Some of the personal representatives outlined these recent "green" tax reforms in their countries.

Environmental taxes and reductions in taxes on labour

- 5.4 As indicated above, revenue from increased use of environmental and energy taxes could be used to finance reductions in taxes on labour. In this perspective, some personal representatives were in favour of increasing energy related taxes and recalled that several Member States had already used this option. Energy taxes were seen as an area where significant amounts of revenue could be raised, although some Member States already had relatively high levels of taxes on energy. Other environmentally related taxes with smaller tax bases were unlikely to yield significant amounts, in particular if they were successful in influencing behaviour. Other personal representatives saw less prospect for using energy and environmental taxes to reduce taxes on labour, particularly if other countries did not adopt the same policy. It was also stressed that the potentially adverse effects on competitiveness of increasing taxes on industrial use of energy could be mitigated if a common framework for environmental taxes could be introduced in the EU.

VI. THE WAY FORWARD

A process for a greater co-ordination

- 6.1 In this final part of this Report, the Commission sets out its conclusions drawn from the four meetings of the High Level Group. These conclusions build on the paper prepared for the Verona informal ECOFIN meeting and the deliberations of the High Level Group, including the calls for action by ETUC, UNICE and Mr Onno Ruding.
- 6.2 The Commission emphasises that any proposal for Community action in taxation must take full account of the principles of subsidiarity and proportionality. It does not seek harmonisation of taxation systems for harmonisation's sake. Rather, it favours a pragmatic and realistic approach which aims to provide a more effective defence than hitherto against the loss of national fiscal sovereignty in favour of the markets experienced by Member States.
- 6.3 How can better co-operation at Community level be achieved? Personal representatives have expressed the view that there is a clear need for a group where Member States and the Commission can share information on, and review, taxation policies.
- 6.4 Such a group, which should be chaired by the Commission, could be used to provide a strategic overview of taxation policies and of the work of the existing specialised committees between the Commission and the Member States (covering indirect taxation; direct taxation; and the reduction of non-wage labour costs). It would have as its task to help identify those key initiatives, whether legislative or not, which, when looked at in a global way, could contribute to the realisation of essential Community objectives, such as those spelled out in Florence, while at the same time safeguarding the Member States' tax collecting capacities.
- 6.5 Sharing information more closely on policies and measures in other Member States should enable the group to address the question of tax competition. To that effect,

the Commission will take forward a number of initiatives, including a number of those suggested by personal representatives. These initiatives will be directed at:

- securing broad agreement on what types of measure are harmful in a Community context;
 - defining common standards across a range of areas (a “code of good conduct”);
 - introducing greater co-ordination of measures that are taken by the taxation authorities of Member States and designed to prevent tax competition from harming the common interest; and
 - reinforcing co-operation between tax authorities in the mutual fight against tax fraud and evasion.
- 6.6 Beyond these areas, the group could also provide a much needed opportunity to examine the major policy implications of certain specific issues. Examples of these, many of which were cited by personal representatives, include:
- the role, functioning, and possible co-ordination of double taxation treaties;
 - the simplification of the tax environment for SMEs and other businesses;
 - the interaction of taxes and social security contributions, in particular for cross-border workers; and
 - the taxation of international services and the impact of new technologies.
- 6.7 Finally, there is a need for further work on the interaction between taxation and shared Community goals as identified at Florence, namely: enterprise, employment, and the environment along the lines suggested below.

Enterprise and the Single Market

- 6.8 To harvest the full benefits of the Single Market and to stimulate *enterprise*, tax obstacles and disadvantages to doing business within the Union must be tackled head on. Eliminating obstacles to cross-border income and capital flows will reduce the complexity and therefore the costs of doing business. In the longer term, a tax-neutral environment conducive to business and wealth-creation is one of the most helpful ways to the competitiveness that is essential in an international context.
- 6.9 The Commission, while mindful of the sensitivities and difficulties, believes that action is necessary to remove such barriers. It is also convinced that a joint and co-operative effort is vital to build up non-distortionary and Single Market oriented tax systems. Until now, some of the obstacles to the free circulation and non-discrimination principles enshrined in the Treaties have been the subject of decisions by the European Court of Justice, when national courts have thought that taxation provisions could stand in the way of the proper functioning of the Single Market. If such a trend continues and is not supplemented by other action, it could well result in a piecemeal approach, which can never be a viable alternative to co-operation.

6.10 Against this background the Commission highlights four areas of action which are essential to develop the taxation conditions for an optimal Single Market. The Commission will:

- take forward its work programme for the introduction of a new common VAT system;
- bring forward new proposals to remove tax disadvantages to cross-border economic activity, beginning with the payment of interest and royalties between associated companies;
- clarify the scope and improve the consistent application of the Community competition rules, including the State Aid rules; and
- commit itself to enhancing possibilities for greater co-operation and mutual assistance between tax authorities, notably through specific proposals integrating tools for co-operation and reinforcing mutual assistance in the recovery of taxes.

6.11 As for the taxation of savings, the Commission believes that the current situation is so disruptive that effective action must be taken. Introducing a minimum withholding tax along the lines of its 1989 proposal is, in the Commission's view, a valuable first step. This would not have the effect of enshrining the principle of bank secrecy, and it would ensure that there would at least be an effective minimum level of taxation applied to all interest income within the Union. It therefore urges the Council to restart its examination of the existing proposal on taxation of interest from savings.

Promoting employment

6.12 To promote *employment*, there is widespread agreement on the need to reverse the trend in taxation structures towards an increasing burden on labour compared to other tax bases. The Commission underlines that, in accordance with the principle of subsidiarity, Member States should have flexibility in choosing the method of reducing taxes on labour and the means of financing those reductions. There are constraints on all of the financing options: each needs to be considered, including a mix of options. The Commission sees great value in intensifying the exchange of information and experience which is currently taking place regarding these issues, following the publication of its report on the future of social protection in the Community.

6.13 In the short term, measures taken in many Member States to reduce non-wage labour costs, and targeted at specific categories of workers, such as the low-skilled, or new entrants to the labour markets, have not, in current economic conditions, yet led to sizeable reductions in unemployment. Experience, however, shows that their impact can be considerably enhanced if they are very carefully designed. These measures might be more effective if they are linked to job creation, and linked in a flexible way to experiments involving changes in work organisation or working time. Moreover, keeping the measures as simple as possible would help maximise take up and minimise compliance costs, especially for the smallest enterprises. Indeed, given that SMEs are the dominant source of new jobs in the Union, taxation policies should also facilitate and sustain their employment creating capacity.

Similarly, taking better account for business taxation purposes of expenditure on intangible investment would contribute to the development of qualifications, to the enhancement of capacities, and also to better innovation strategies.

- 6.14 For the longer term, the Commission believes that there are great benefits to be gained in co-ordinating tax measures and presenting them as part of a Community wide effort to reduce unemployment. It is crucial to persuade economic agents that taxation structures will, from now on, be geared towards promoting employment. Such co-ordination would be particularly valuable in the context of reversing the long term trend in taxation structures, and in helping to instil the necessary confidence as part of the European Confidence Pact.

The environment

- 6.15 For the *environment* the Commission acknowledges the need to explore an increased use of energy and environmentally related taxes. However, current practice shows that environmental objectives are often best achieved when taxation instruments are combined with other measures, used consistently to change behaviour. In deciding the choice of instruments, the effects on competitiveness, on employment and on the environment should be carefully assessed.
- 6.16 Although the appropriate mix of policy instruments for achieving environmental objectives may not be the same for all Member States, it is essential that differences are compatible with the smooth functioning of the Single Market. In this respect, the Commission will present shortly a communication giving guidelines for Member States on the use of environmental taxes on the basis of current Community law.
- 6.17 Although Member States will need to judge the degree to which fiscal instruments will be necessary to meet their environmental goals at a national level, there is one clear area where action has been identified as necessary at Community level. This concerns the taxation of energy products which, inter alia, has an important role to play in helping to achieve the objective of stabilising CO₂ emissions by the year 2000 at the 1990 level. In this context, the Commission will bring forward new proposals on the taxation of energy products before the end of the year. These proposals will provide a common framework, giving Member States flexibility to modulate their tax systems in the light of their own national circumstances while respecting the proper functioning of the Single Market.

Conclusions

- 6.18 Bearing in mind the analysis and the lines of action outlined above, the Commission considers that there is a pressing need to make progress, both with regard to individual issues and to the broad direction of tax policies. A taxation policy group could prove valuable in developing and assessing progress across all these areas. In the longer term, it might prepare the way for a general agreement to ensure that taxation policies are better geared towards achieving important Union objectives while at the same time protecting fiscal bases against harmful tax competition.

6.19 The Commission invites the Council:

- i) to take note of this report and to draw it to the attention of the European Council;
- ii) to devote one of its next sessions to the examination in their globality both of existing Commission proposals and of possible future actions; and
- iii) to endorse the taking up of work in the group and to agree on the broad lines of its agenda as proposed in this report.

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