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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

# **Towards tax co-ordination in the European Union**

**A package to tackle harmful tax competition**



## **INTRODUCTION**

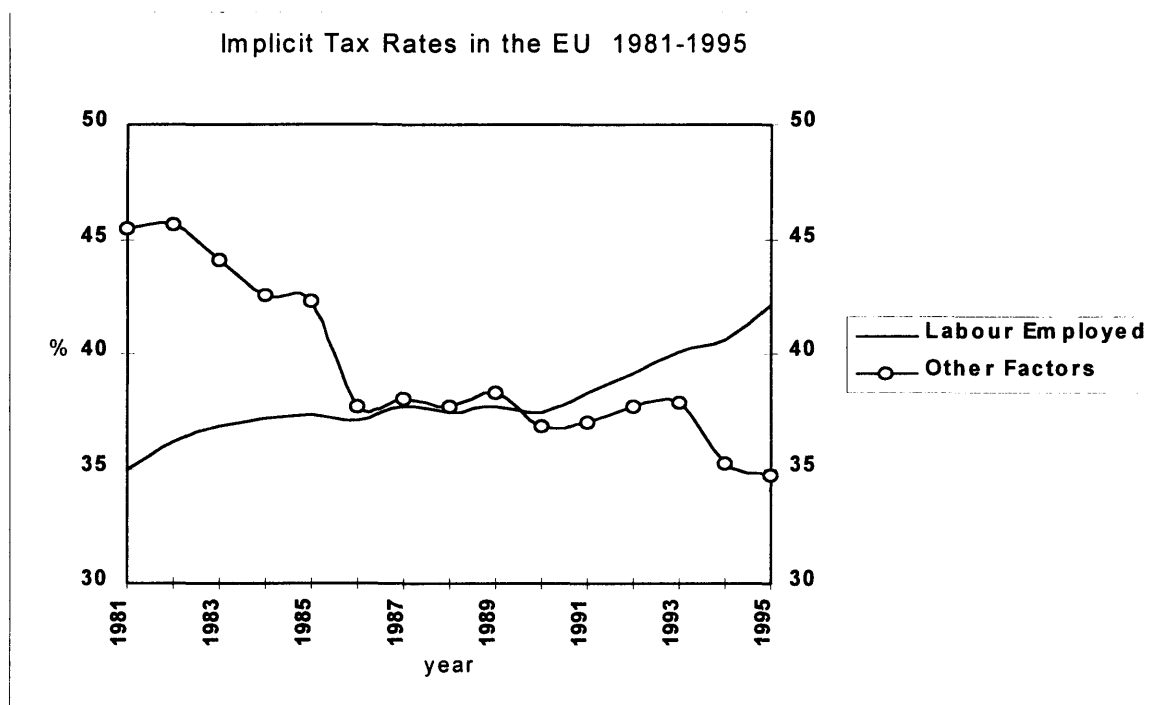
1. Following the informal meeting of ECOFIN Ministers in Mondorf-les-Bains on 13 September 1997, the Council Presidency has announced its intention to hold an orientation debate on taxation in the formal meeting of 13 October. At the invitation of the Presidency, the Commission is submitting this paper as a basis for discussion. It builds on the discussions in Mondorf-les-Bains and in the Taxation Policy Group by outlining a proposal for a tax package to curtail harmful tax competition including a code of conduct. A draft for a code, as it has emerged from discussions in the Taxation Policy Group, is annexed to this communication.

2. On the basis of the global approach to taxation policy that was launched in April 1996 at the informal ECOFIN meeting in Verona, the package seeks to develop a co-ordinated approach to harmful tax competition. There is a need for action at the European level in order to reduce distortions to the Single Market; to prevent significant losses of tax revenue; and to reverse the trend of an increasing tax burden on labour as compared to more mobile tax bases. Progress on the package would help to reverse this trend and so enable tax structures within the Community to develop in a more employment-friendly way. The special European Council on Employment on 20-21 November will be able to give particular attention to the implications for employment of trends in taxation systems. The Commission's Guidelines for Employment which will be discussed at the Employment Summit in November will also include recommendations on making taxation systems more employment friendly.

## **A GREATER NEED FOR CO-ORDINATION**

3. Tax competition in itself is generally to be welcomed, as a means of benefiting citizens and of imposing downward pressure on government spending. However, unrestrained competition for mobile factors can both bias tax systems against employment and make an orderly and structured reduction in the overall tax burden more difficult. It also reduces the room for manoeuvre to meet other Community objectives, such as the protection of the environment. Furthermore, tax competition can hamper efforts to reduce budget deficits, which is not only a necessary end in itself but is also needed in order to comply both with the Maastricht criteria and with the Stability and Growth Pact. Market integration, without any accompanying tax co-ordination, is putting increasing constraints on Member States' freedom to choose the appropriate tax structure, including by broadening the tax base and lowering the rates.

4. As was noted in Mondorf-les-Bains, trends over the last 15 years show an increasing tax burden on labour. The implicit tax rate (that is, tax revenues divided by the appropriate base) on employed labour has increased by more than 7 percentage points, whereas the same rate for other factors of production (capital, self-employed labour, energy, natural resources) has decreased by more than 10 percentage points (figure 1). Within the labour factor, the burden of taxation is shifting to the least skilled and less mobile employees, while highly-skilled employees are increasingly mobile and responsive to tax differentials. Furthermore, small firms and craft industries - which are so important for job creation - are penalised compared to larger enterprises which have easier access to the opportunities provided by tax differentials and tax competition.



Source: Eurostat

Figure 1

5. Tax competition may be one important factor in this shift in the tax burden to the less mobile base of labour. The high rate of mobility of certain bases may have forced Member States to reduce taxation on such bases below the levels that they consider desirable, and necessitated corresponding increases in taxation on less mobile bases. This trend in tax structures should be reversed. A growing body of evidence now points to a strong negative effect of high labour taxes on the level of employment and growth in Europe. It has been estimated that several percentage points of the current rate of unemployment are due to this increase in the taxation of labour.

6. While capital liberalisation is beneficial, the abolition of barriers to capital movement, together with exemptions from taxation, enhance opportunities to avoid reporting revenues. Cross-frontier fraud affects all taxes, including consumption taxes although these are harmonised to a much greater extent than are direct taxes.

7. The contribution of tax policies to Community objectives must increasingly be seen within the context of the developing Single Market. The Single Market and EMU are essential for growth and prosperity; however, they also increase the importance of taxation as a competitive factor. As regulatory barriers in the Single Market are dismantled, taxation is increasingly identifiable as a key factor influencing economic decisions. And as the introduction of the single currency eliminates exchange rate risks and reduces transaction costs, the differences between national tax systems will become more visible and will have an even greater influence on decisions on the allocation of capital, and therefore the efficiency of those decisions.

8. Achieving a properly functioning Single Market remains an overriding priority for Community action in the field of taxation. There is, however, also an urgent need to consider how taxation policies can contribute to job creation in Europe at a time when the fight against unemployment is the Union's key priority.

9. Within the framework of European models of a social market economy, views may differ as to the emphasis to be given to the "social" and "market" elements. Unless there is some tax co-ordination there will be increasing threats: both with regard to the social dimension, because of the redistributive effect of the increasing taxation of labour, in particular of less-skilled labour; and with regard to the market element, because of the effect of tax distortions to the Single Market.

10. It is also clear that tax policies must take account of the Union's global competitiveness and of international obligations under World Trade Organisation rules. Globalisation and vastly expanded trade and capital flows magnify the risks of harmful tax competition. At the same time, technological innovation and the development of electronic commerce enhance the mobility of certain forms of economic activity, particularly in the services sector and in the movement of capital, and may increase the impact of tax differentials on business decisions.

11. In this changing environment, harmful tax competition will become an increasing source of conflict among Member States unless greater co-ordination can be achieved within the EU. This co-ordination should in principle be achieved at a world-wide level and, indeed, the OECD and G7 are currently considering the issue. However, the chances of a satisfactory solution being reached at the OECD will be greatly improved if EU Member States act in a more co-ordinated way. And the closer degree of economic integration, EMU, and the existence of Community rules on competition and state aids create a fundamental need to ensure better co-operation within the Union.

## **A PACKAGE TO TACKLE HARMFUL TAX COMPETITION**

12. The informal meeting in Mondorf-les-Bains considered how best to respond to the need for progress and greater co-ordination. As a result, the Commission has been invited to present the outline of a tax package which would enable progress to be made in parallel on a number of fronts. The Commission is making these proposals having full regard to the principle of subsidiarity and to the particular difficulties posed in the area of taxation by the requirement for unanimity between Member States. These considerations mean that any package that is proposed must balance as far as possible the interests of different Member States. This implies a spirit of openness and compromise. In the light of the discussions in Mondorf-les-Bains and of the Taxation Policy Group meeting on 18 September, this communication therefore sets out possible components for such a package on the basis of which a political agreement may be reached by the end of the year, as indicated by the Presidency.

13. The possible components of the package are the following:

- a code of conduct for business taxation and in parallel a Commission communication on fiscal state aids;
- measures to eliminate distortions to the taxation of capital income;
- measures to eliminate withholding taxes on cross-border interest and royalty payments between companies; and
- measures designed to eliminate significant distortions in the area of indirect taxation.

Each of these components is described below.

### ***A Code of Conduct for business taxation***

14. A code of conduct for business taxation will be a key element of the package. This will help to prevent economic distortions and an erosion of tax bases within the Community. It will take the form of a non legally-binding instrument that engages Member States at a political level to respect principles of fair competition, and to refrain from tax measures that are harmful. The code would incorporate a review and monitoring process, and would be capable of later development and refinement in the light of experience. This will also help to evaluate the need for other instruments in the field of business taxation.

15. Following the informal discussions in Mondorf-les-Bains, which noted the substantial progress that had been made on this issue, the Presidency invited the Commission to provide the Council with a text for the code of the conduct. The draft code annexed to this paper has been developed through the intensive and constructive work of the Taxation Policy Group in its four meetings so far this year, most recently at its meeting of 18 September. Although this text is put forward in its own name, the Commission would like to acknowledge the considerable debt that it owes to co-operative efforts of the Member States in that Group.

16. There is a wide degree of support for the approach suggested by the Commission, and for a code to be adopted in the form of a non legally binding instrument. However, if the code is to perform its role in effectively tackling harmful tax competition, it needs to be supported by a strong political commitment from the Member States. That commitment could be made in a Council resolution endorsing the code submitted to it by the Commission. In order to allow for an agreement on the code at the December ECOFIN Council, the Commission invites Ministers to give clear orientations on the draft at the 13 October meeting; further technical work could, if necessary, be undertaken by the Commission through appropriate contacts with Member States in the run-up to the December meeting.

17. As a matching commitment to the political agreement of Member States to the code, many Member States have urged the Commission to re-examine its policy in the field of fiscal state aid and to make full use of its powers under the Treaty rules, in order to help combat harmful tax competition. As announced in the Action Plan for the Single Market, the Commission will continue vigorously to apply the state aid rules, including for fiscal aids. In the tax area, it will, in considering the common interest, take into account negative effects of aid that are brought to light by the Taxation Policy Group. In accordance with the Treaty, the Commission will, in co-operation with Member States, review its past decisions and may, if necessary, propose that Member States amend or abolish aid as required by the development or the functioning of the Single Market. In addition, the Commission will respond positively and associate itself with the commitment entered into by the Member States in the code of conduct, notably by presenting separately and under its own initiative a communication that clarifies and refines its policy on the application of the state aid rules to fiscal measures in the light of developments in the Single Market. In this way the Commission intends to make this policy as transparent as possible, so ensuring that its decisions are predictable and that equal treatment is guaranteed.

## ***Taxation of capital income***

18. Capital income is the most mobile tax base of all. Action at the Community level is needed in order to counter current and potential distortions to the Single Market, and to prevent significant losses of tax revenue. The Council recognised these risks at the time of discussions on the 1988 Directive on the Liberalisation of Capital Movements, giving rise to the Commission's 1989 proposal for the taxation of income from individual savings. The adoption of the Euro will soon remove one remaining disincentive to cross-border investment, so increasing still further the need for action.

19. There is a clear call from all sides for renewed action on the taxation of income from savings. However, progress in this difficult and sensitive area will require a spirit of compromise. The Commission therefore proposes an evolutionary approach. As a first step, it calls upon Member States to make a political commitment in the December ECOFIN meeting based on a number of agreed key principles, coupled with a commitment to enter swiftly into constructive discussions on a proposal which would be based on these principles. The Commission for its part undertakes to come forward with such a proposal at an appropriate time. The principles to which Member States could be invited to subscribe would be based on the following elements:

- I. A common solution is needed in order to prevent undesirable distortions. A minimum solution in the form of a directive is preferable to the current situation, which can lead to non-taxation.
- II. That solution should be limited to interest paid in a Member State to individuals who are not resident for tax purposes in that State but who are resident in another Member State.
- III. As a first step, Member States should accept the so-called "co-existence model" in order to ensure at least some degree of effective taxation of non-residents' income from savings within the Community. Every Member State should either operate a minimum withholding tax or provide information on savings income to other Member States. (This would not, however, prevent a Member State from having both systems).
- IV. All arrangements should take into account the need to preserve the competitiveness of European financial markets in a global context. The Community should also promote an extension of the agreed solution beyond its borders.
- V. Withholding tax on interest payments made to residents of other Member States should, in principle, be levied by the paying agent. Although some refinement of this principle might be necessary, this rule would allow easier identification of the beneficiaries. The arrangements for checking the fiscal residence of beneficiaries should not be too cumbersome, again in order to maintain global competitiveness.



- VI. Where a Member State does not use the exchange of information option, it should apply the withholding tax at least at a minimum level. This minimum tax rate should be specified at a level which is sufficient to ensure an acceptable level of taxation of crossborder savings.

### ***Interest and royalties***

20. As noted in the Action Plan for the Single Market, withholding taxes on interest and royalty payments between companies create difficulties for economic operators engaged in cross-border business. They can involve time-consuming formalities, result in cash flow losses, and sometimes lead to double taxation. Priority should therefore be given to their elimination. In the light of the discussions at the informal meeting in Mondorf-les-Bains and in the Taxation Policy Group, the Commission believes that the elimination of withholding taxes on interest and royalty payments between companies should form part of the taxation package. As part of the package, Member States could make a political commitment to work towards the early adoption of a directive for which the Commission will make a new proposal.

### ***Indirect tax elements***

21. The Commission is fully aware that a number of Member States are not convinced of the usefulness of including indirect taxation measures in the package. However, some Member States have equally stressed the need for some parallel action in indirect taxation areas if the approach to the resolution of taxation problems in the EU is to be a balanced one. Harmful tax competition between Member States in the VAT area is possible insofar as divergences in the application of the current transitional VAT system impact on transnational economic activities or on activities in a neighbouring Member State. Operators can exploit these divergences by using clever "tax engineering". The large disparities between Member States in the tax treatment of energy products also create tax distortions and curtail Member States' freedom of action in taxation policy. The Commission puts forward the following proposals for consideration firstly because they will in their own right contribute to the elimination of tax distortions and secondly because they can contribute towards balancing the package. At the same time the Commission is flexible as regards those measures and leaves it to the Council to determine whether this broad approach is a useful method of achieving a compromise. If the Council agrees, principles could be elaborated for discussion at the next meeting of the Taxation Policy Group, with a view to allowing a political engagement to be made by the end of the year.

- I. *VAT Committee.* The Commission proposes that the alteration already proposed to the status of the VAT Committee, making it a regulatory committee assisting the Commission in adopting implementation measures of the 6th VAT directive, could, in so far as situations of double taxation or non-taxation will be dealt with according to this new procedure, be part of the package.

- II. *Taxation of investment gold.* A solution to the problem of distortions in the gold trade in the Community, caused by the great divergence in VAT treatment of gold transactions across the Community, could be found by providing for an exemption from VAT for transactions in gold for investment purposes, and taxation of other gold, especially of that used for industrial purposes.
- III. *Passenger transport.* This has also been mentioned by some Member States as an area of concern.
- IV. *Taxation of energy products.* A political agreement between Member States could allow the application of certain elements of the existing draft directive (COM (97) 30 final). This could involve agreement on revisions to existing minimum levels of taxation for mineral oils and the introduction of minimum levels of taxation for energy products other than mineral oils. It could equally encompass the derogations provided for in the draft directive, for example for natural gas in the case of emerging markets.
- V. *FISCALIS.* The Commission proposes that agreement be reached on the establishment of the FISCALIS programme of co-operation between the Member States against fraud in the indirect taxation area.

## WAY FORWARD AND CONCLUSION

22. There is clearly a pressing need to make progress in the field of taxation and to ensure a more effective co-ordination of taxation policies, both in the light of the development of the Single Market and of the need to reduce the level of unemployment within the Community. Tackling the issue of harmful tax competition, which threatens both to reduce revenues and to distort taxation structures, should be central to this process. Within this context, and as requested by the Council Presidency, the code of conduct is being put forward, together with other elements to form a taxation package, in order to facilitate reaching political agreement at the ECOFIN meeting on 1 December. The Commission believes that such a political agreement will be a crucial first step in the evolving process of co-ordination.

23. Finance Ministers are therefore requested

- to confirm the scope of the taxation package to tackle harmful tax competition that should go forward for a political agreement before the end of this year;
- to endorse the draft code of conduct that is attached to this paper with a view to its adoption in December 1997;

- to give a first reaction to the principles put forward for a minimum solution on the taxation of savings; and
- to instruct their personal representatives in the Taxation Policy Group to continue to work constructively in order to enable the Commission to develop all the elements of the taxation package to be submitted to the ECOFIN Council for a political agreement in December.

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## DRAFT CODE OF CONDUCT FOR BUSINESS TAXATION

### *Political Commitment*

- A. While recognising the positive effects of fair competition, and the need to maintain world-wide competitiveness, the Council notes that unrestrained tax competition for mobile forms of business increasingly threatens to cause economic distortions and to erode tax bases within the Community. It underlines its concern in this area, especially in relation to measures that provide operating support to international finance and services activities. The Council condemns the use of tax measures that harm the Community interest, including the effective operation of the Single Market, and it accordingly encourages Member States neither to introduce nor to retain such measures.
- B. To this end, it requests the Member States to adopt and implement the following principles and rules of behaviour. These rules, which fully respect the principle of subsidiarity, are wholly without prejudice to the application of Community law. They identify tax measures that are potentially harmful; and provide a framework within which Member States can commit themselves to follow the principles of fair competition.

### *Scope*

- C. This code covers those business tax measures which affect, or which may affect, the location of business activity in the Community in a significant way. Business activity in this respect includes all activities carried out within a group of companies. The code also covers those special tax regimes for employees which have a similar effect on the location of business activity. The tax measures covered by the code include legislative provisions, regulations and administrative practices.
- D. Within this field of application, the Council recognises certain types of tax measure as potentially harmful. These have one or more of the characteristics described in §E below. Although not every measure that is indicated in that paragraph will be harmful, each of the characteristics merits consideration.

- E. The Council recognises as being potentially harmful those tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than that which generally applies in the country in question. Such regimes may operate by virtue of the nominal tax rate, by virtue of the tax base, or otherwise. These measures should further be evaluated in the light of whether:
- (i) particular benefits are given only to non-residents of the country in question; or they are given only in respect of transactions carried out with non-residents;
  - (ii) benefits are otherwise ring-fenced from the domestic economy so they do not affect the national tax base;
  - (iii) benefits are available without there being any real economic activity;
  - (iv) the basis of profit determination in respect of activities within a multinational group of companies departs from internationally-accepted rules, notably those agreed upon within the OECD;
  - (v) the measure lacks transparency, including where benefits are given by relaxing statutory rules at administrative level in a way that is not public.

***Provision and review of information***

- F. In accordance with the principles of transparency and openness, Member States will inform each other of their existing and proposed tax measures which fall within the scope of the code as described at §C-E above. In addition, Member States may seek information from other Member States on any tax measure which appears potentially to fall within the scope of those paragraphs. The Council requests the Commission, to which Member States will also provide this information, to co-ordinate its exchange between the Member States.
- G. Member States will, moreover, have the opportunity to discuss and comment on the tax measures of other Member States within the framework of a follow-up Group, which will be open to all Member States. This review will enable consideration to be given to the effects that these measures may have within the Community. Such a process, which should take into account the factors identified at §E above, will enable Member States to make a better evaluation of whether particular tax measures are harmful. The Council requests the Commission to carry out the preparatory work for the meetings of the Group, which will take place as necessary, and to oversee the exchange and review process. The Group will transmit a report of the review of each measure to the Council for its consideration and, if it deems appropriate, for publication.
- H. The Council emphasises the need to assess carefully the effects which tax measures have on other Member States; and, in so far as they are used to support the economic development of particular areas, to evaluate the extent to which the measures are effective in achieving their aims.

### ***Standstill***

- I. Member States will respect the principles outlined above when determining their policy, and should have regard to the review process in assessing whether any new tax measures or practices are harmful. The Council accordingly calls on them, as part of the code of conduct, not to introduce new tax measures which are harmful to the Community interest, including the effective operation of the Single Market.

### ***Rollback***

- J. Member States will also review their existing laws and established practices, having regard to the principles outlined above and to the review process. The Council calls on them to amend such laws and practices as necessary, with a view to eliminating any harmful measures within [a determined period that is precisely defined but also allows for the reasonable expectations of business].

### ***Anti-avoidance and tax evasion***

- K. The Council stresses its commitment to full co-operation in the fight against tax evasion and avoidance, notably in the provision of information to other Member States in accordance with national legislation.
- L. The Council notes that anti-abuse provisions or countermeasures contained in tax laws and in double taxation conventions play a fundamental role in counteracting tax avoidance and evasion. Member States should apply such measures in accordance with Community law.

### ***State aids***

- M. The Council notes that some, although not all, of the tax measures covered by this code fall within the scope of the provisions on state aid in Articles 92-94 of the EC Treaty. It further notes that the implementation of the code should in practice reduce the need for Community intervention under the state aid rules in the tax field. Without prejudice to Community law, it requests the Commission to provide guidance on the application of the state aid rules to fiscal aids and to commit itself to their rigorous application, taking into account negative effects of aid that are brought to light in the application of this code.

### ***Geographical extension***

- N. The provisions of this code should apply within the Community, as defined in Article 227 of the EC Treaty. Furthermore, the Council considers that it would be beneficial if the principles supporting fair competition were adopted as widely as possible. To this end it encourages Member States to stimulate their adoption at an international level, and in particular to give active support to their adoption in their dependent or associated territories.

### ***Follow Up***

- O. In order to help to ensure the even and effective implementation of the code, the Council invites the Commission, acting in the capacity as described in §F-H above, to report to it annually.

### ***Revision clause***

- P. The Council shall review the provisions of this code when it has been in operation for two years. It will at that stage consider whether the provisions of §E should be extended to include a Member State's general business tax regime where the level of taxation is significantly lower than the Community average.
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