Taxation – Lecture 3

DIRECT TAX SYSTEM: INTRODUCTION

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- Tax system in EU - EU today and EU tax system from 1970 up today
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Tax system in EU – general info

- **EU - an economic and political partnership between**, currently, **28 countries**, which are generally **referred to as the EU member states**. The **first steps towards the European Union** as it exists today were taken **at the end of the World War II**. At first, the **founding six countries strived for an economic cooperation** in certain areas to avoid future conflict. To which effect, the countries **France, Germany, and Italy concluded the Treaty of Rome in 1957.** The **economic cooperation** has since **developed into an internal market.** Within the internal market, the European Union strives to realize **free movement of goods, services, persons and capital.** These are also referred to as **the four freedoms**. Also, the European Union strives to achieve **normal conditions for competition**, what is also called **a level playing field**. And **harmonization of national law**, in so far as it hinders the functioning of the internal markets. **In 1993, the economic cooperation took on a political and monetary dimension when the Maastricht Treaty entered into force, and the European Union and Euro are created.**

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- **EU institutions** - EU operates through its institutions:
  - **the Council of the European Union (EU Council)** - the institution **representing governments of the EU member states**. In the EU council, **national ministers** from each country within the EU**, meet to adopt laws and coordinate policies.** The EU council is divided into several different configurations, based on policy areas. In regard of tax issue important role is played by the **Economic and Financial Affairs Configuration (Ecofin), which is composed of the Economic Finance Ministers of the EU member states.**
  - **the European Commission (EC)** - **the executive body of the European Union.** The European Commission **represents and upholds the interests of the European Union as a whole**. It's responsible for **proposing and drafting legislation and manages the day-to-day business of implementing EU policies and spending EU funds**. The **members of the EC**

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are 28 in total, one from each member state. For purposes of this course, the commissioners for taxation and competition are particularly important. Currently, the posts are held by **Pierre Moscovici, a French national, and Margrethe Vestager, a Danish national, respectively.**

- **the Court of Justice of the European Union** - the highest court in the EU, in matters of EU law.

- **EU tax system**
  - **EU tax policies and directives today** – modern EU tax policy in the European Union falls into two categories:
    - **the area of indirect taxation**, which **has been harmonized to a large extent**.
    - **the area of direct taxation, which remains almost the sole responsibility of the member states**. In this respect, the **EU strives to implement the consolidated corporate tax base** to address the underlying tax obstacles which

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exist **for companies operating in more than one member state.** Yet, t**he creation of directives and regulations in the area of direct taxation is, in principle, subject to a unanimous approval of all member states**. **As a result of lack of consensus, harmonization through statute instruments**, so-called, **positive harmonization, in the area of direct taxation has been limited.** Some steps for positive harmonization within the EU have been taken though. The major DT tax-related directives:

- ✓ **the parent-subsidiary directive**, which seeks to abolish withholding facts of outgoing payments, and to prevent economic double taxation within an EU based corporate group structure.
- ✓ **the merger directive** seeks to facilitate tax neutral corporate mergers, divisions, transfers of shares and

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exchanges of shares between EU based companies.

- ✓ **the interest and royalty directive** seeks to abolish withholding tax on intra-group interest and royalty payments.

In light of the limited positive harmonization measures, the **EU Court of Justice** has over the past decades taken a leading role of developing the internal market from a direct tax perspective based on so-called, **negative integration by prohibiting member states, tax provisions, which are contrary to internal market principles of the EU.**

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- **EU vs world** – the European experiences may be briefly summarized as follows: l**ooking at the structure and evolution of the European tax systems over the past 30 years, the EU area confirms its peculiarities compared with the main international experiences outside Europe (US and Japan) and, more generally, compared with the OECD area. Major differences:**
  - **in the EU area**, **the tax burden is, on average, higher than in the OECD area** - The **ratio of taxes to GDP** is a useful scaling factor and a signal of the country's preference for the size of the public sector. According to OECD **in the past 40 years tax ratios generally increased in OECD countries (by 9.1 percentage points) and EU countries (by 11.2 percentage points).**
  - **European countries rely more on social security contributions and less on consumption taxes**; **taxes on labor and their contribution** to total tax revenues

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are higher in Europe than in the OECD area. However, the European averages show **marked differences across individual countries.**

- **Inside EU** – a **comprehensive picture of what has happened and is happening in European fiscal systems is not at all easy to find. The tax systems of the European countries** (given by tax ratios, tax structured by legal and economic categories and the allocation of revenues across levels of government) **are still widely different from one another and, in general, there seems to have been relatively little movement toward tax harmonization except in a few areas.** Furthermore, **there is no obvious, ideal, or theoretical system that is acting as a reference point for tax reforms**. In some way the situation has changed for the worse in recent decades. While three or four decades ago there was some convergence of views among tax experts on how a good tax system should look, **there in now no system that gets the approval of the majority of**

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tax specialists. This explains why tax systems continue to be so widely different among countries.

- **Convergence** – **up to the mid-1980s, country divergences increased considerably**, **while over the last 30 years the separation between individual countries has largely been reversed**, most likely as a consequence of some common pressures.
  - **1970s** - in the early part of the 1970s E**uropean countries were almost all mid-to-high fiscal pressure countries**. The total figure (**taxes and social contributions) was about 33 percent of GDP**, and was already **over that of both the US (about 27 percent) and Japan (still at about 22 percent)**:
    - **Nordic countries**: **the fiscal pressure was very high**. It was made up **in large amount by direct and** (at a smaller size) **indirect taxes**, **to pay for a comprehensive and advanced welfare state.**

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- **Rhine countries**: **the fiscal pressure was somewhat higher than the European average**. **Direct taxes prevailed in some countries, indirect ones' elsewhere**. Throughout the area, however, social contributions raised to a high level, in order to finance a generous Bismarckian welfare state.
- **Anglo-Saxon countries**: **the fiscal pressure was still close to the European average**. **Taxes' share was far larger than the share of social contributions. The public health service was paid out from general tax revenues**. The public Beveridgean pension schemes were tightened to only dispense low-amount social security treatments.
- **Mediterranean countries**: the development's delay kept total fiscal pressure at a low level. **Tax systems had social contributions close to the European average.**

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Taxes (especially direct ones) still stood well below European standards.

The shift to the "dual income tax system" did not significantly change the fiscal structure of Nordic countries. In the **Rhine area**, fiscal pressure **grew yet more.** Personal income tax jumped up and social contributions effected a further upward turn. **The Anglo-Saxon countries were left at the starting post:** fiscal pressure did not increase, nor was its structure dramatically changed. **Mediterranean countries marked the main change:** The total fiscal pressure of the European development newcomers **increased by about 10–15 points. Tax structure changed markedly in favor of direct** (in Spain, also indirect) taxes.

- **1980s** - **no radical tax reforms** occurred in 1980s, but **some common issues have arisen in the discussion of tax design** in European experiences:

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- **Equity** - conducted reforms have addressed the issue of equity, which has been rather neglected during the 1970s' season of reforms. In this respect, **new tax measures tried to introduce limited horizontal equity objectives and reinforce progressivity.** However, they have mainly concerned tax rate cuts not only for the bottom income levels, but also for the top levels.
- **Competitiveness** - is one of the main objectives of many planned reforms, which aim at **introducing tax measures specifically targeted to increase national competitiveness with respect to financial capital, real capital and other production factors** (mainly labor).
- **Innovation - tax bases have been broadened in order to introduce tax incentives to selectively stimulate innovation and growth** in four areas (SMEs, R&D investments, venture capital and stock options).

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- **1990s and 2000s** -
  - **From 1990 to 2000, the implicit rate increased by about two further points, equally distributed between social contributions and income tax**. As to social contributions, just small cuts were introduced, by no more than a few points, generally only at the lower end of the wage scale and not in all European countries.
  - **Tax cuts of the income tax were similar, but usually they were extended also to the top rate**, sometimes in quite a reasonable way, in other cases they were planned for a provocatively heavy amount.
  - **The enlargement of the no-tax area was certainly welcome**, mostly as much as producing higher equity, incentives on the labor supply being instead so minute as to be, in fact, uncertain. Unfortunately the price paid to implement this cut was a large increase of marginal

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rates over the no-tax area. To (partially) correct this effect, new decreasing deductions had to be introduced, complicating further a tax structure that any committed country would seek to simplify. Furthermore the no-tax area should have been enlarged up to a threshold able to cover the equivalent household level of poverty; this has rarely been achieved, especially for the households with many dependents, i.e. by adopting a poor equivalence scale.

- **2010s - need for further changes** - Three current key factors which heavily impinge on European tax systems and any future changes hoped for:
  - ✓ Several years of tax competition and harmonization efforts have, up to now, failed to set out **a basic common framework for a "European" tax system,**

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- **i.e. a system suitable for the present mixed "Confederation"- to-"Federation" EU institutional setting, and really enabling a mobility of people, goods and capitals, within the single market and free from fiscal distortions.**
- **The European economy's growth rate decrease seems at this point almost endless**. Prospects for future recovery are continuously postponed. **Could fiscal reforms really contribute to enhancing economic growth?** Furthermore, **how should the tax system be shaped in order to keep up the level of welfare** of the Pigouvian "national dividend," **by matching the decreasing growth rate with increased levels of fairness?**
- **The rebuilding of the European institutional setting is just beginning.** Common historical heritage of the

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federal states leads to a prediction of profound changes in the allocation of government tiers' taxing and spending powers. **Constitutional guarantees for the satisfaction of basic needs are likely to be strengthened.**

A reduction of fiscal pressure is crucial for boosting the declining growth and employment. To sustain this proposal, a recurring argument is the comparison with the USA, whose growth is higher but taxes much lower. Fiscal competition in an increasingly integrated world affected tax rates and structures of the most mobile bases. Common opinion calls for **more efficiency, thus stressing the need for making taxes more simple and neutral.** Political factors, however, such as the pressure of lobby groups, prevented this process from going very far.

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- Today in Europe the **current tax mix, on average, is composed of:**
  - **taxes on goods and services** (**30 percent**),
  - **social security contributions** (**28.4 percent**),
  - **personal income tax** (**25.6 percent**),
  - corporate income tax (9.2 percent)
  - property taxes (5 percent).

In the last two decades a shift has occurred from the personal income tax and social security contributions to the corporate income tax and the property tax.

A closer look at the incidence of **individual tax revenues by economic categories (labor, capital and consumption) gives a more useful explanation about the structure of the European tax systems and their evolution**: on average, **taxes on labor contribute for more than half the total tax revenue, consumption**

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taxes for about one-third and taxes on capital for just about 15 percentage points. This tax mix has remained quite stable during the 1990s and 2000s.

- **PIT (DT) -**
  - **EU vs world** - t**he average effective tax rate on labor in the EU area appears to be higher than in the OECD area, even if during the 1990s and 2000s many EU countries introduced measures to lower the tax burden**, mainly financed **through the shifting of the tax burden from labor to capital** or to broader tax and to activities that cause pollution.

    Looking at the total tax wedge on labor in the selected EU countries during last 15 years, the tax burden:

    - has **decreased in France, Italy and the UK** and more markedly in **Ireland and the Netherlands**,
    - **remained constant in Germany and Spain**.

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If, in general, **labor is taxed more heavily in Europe than in the OECD area, the issue appears to be most relevant for lower-paid labor: c**oncerns about **high tax burdens on lower-paid labor and possible substitution of (low-skill) labor with other production factors or relocation abroad of productive activities** prompted initiatives in several EU countries (France, the Netherlands, Spain and the UK) **to reduce effective tax wedges on low-paid workers.**

- **Inside EU** – all EU countries turn **from the model of the pure comprehensive personal income tax in favor of some hybrid taxation models** where **elements of expenditure tax** are present.
  - Large **differences exist in the treatment of the tax base** (taxable incomes and tax expenditures). Diversities are mainly due to the **different use of the tax systems to pay social benefit**, for instance tax breaks for private pensions. Moreover not all income from capital is included in the

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personal income tax base.

- As a general trend, **a growing number of countries introduced lower, flat rates for certain types of capital income** (interest, dividends and capital gains).
- **Family status is taken into account** in the selected countries in three major ways:
  - through the application of a **tax schedule that varies according to family status.** In this respect the **tax unit** is the **individual** in Italy, the Netherlands and the UK, while it is the **family** in France, Germany, Ireland and (by option) in Spain;
  - by **providing tax credits and allowances** related to **marital status** and **the presence of dependent children**. For instance, a tax credit is provided for children in Germany, Italy, the Netherlands and the UK;
  - by **supplying cash transfers or benefit** outside the tax

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System (e.g. c**ash transfers for dependent children).

- Looking at the **structure of personal income tax**, countries differ in the way they give **relief to low-income individuals:**
  - **A certain amount of income may be exempted** from tax (France, Spain and the UK) **or taxed at 0 percent** (France and Germany).
  - In other countries, basic tax relief is granted through **tax credits** (Ireland and the Netherlands).
- Apart from Germany, which applies several tax formulae, in the other countries**, income is sliced into brackets, ranging from two** (Ireland) **to seven** (France). Income in the first bracket is taxed at a low rate in the Netherlands (2.95 percent), while Ireland and Italy apply higher tax rates

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(20 percent and 18 percent). **Top marginal tax rates range from 39.6 percent (Spain) to 52.75 percent (France).**

- **CIT (DT) –**
  - **Inside EU –** although majority of EU countries have adopted a flat corporate income tax, **within the European Union, corporate income taxes have not been harmonized** (note: generally these measures – adoption of flat CIT – are targeted to stimulate entrepreneurship and to correct financial market failures that can create obstacles to SMEs in raising new capital)

    It has been recognized, though early on, that **corporate income tax could easily distort the functioning of the EU's internal market by affecting, for example, investment or employment decisions:**
    - a person who engages in cross-border economic activity may be **subject to international juridical double tax-n**

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(removed to a large extent by the EU court of justice - law on EU free movement)

- a person who engages in cross-border economic activity may be **discriminated in the state in which he chooses to do business**. Because that state may have taken **protectionist tax measures**. (removed to a large extent by the EU court of justice - law on EU free movement)
- a person who engages in cross-border economic activity and becomes subject to the tax rules of another tax jurisdiction, **may suffer an advantage or a disadvantage**. In comparison with the tax rules of his state of departure.

These disparities in the tax systems of EU member states **are a direct result of the fact that they have retained their fiscal sovereignty.** The fact that these disparities exist makes it possible for EU member states to engage in so-called **tax competition.** Many of them are looking at **ways to attract and**

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retain investment into their jurisdictions. In this respect, the **member states have become competitors – they compete with each other by offering the lowest effective corporate income tax**. Often, such **schemes have been used by companies for tax planning purposes**. From an internal market perspective, tax competition can be counterproductive and even harmful. Absent any real power to address harmful tax competition at the EU level. Due to the unanimity requirement in the area of direct taxation.

- **Initiatives to reduce tax competition - s**everal initiatives have been developer to address harmful tax competition by other means.
  - On December 1st, 1997, the member states adopted the **Code of Conduct for business taxation to address harmful tax competition.** The Code of Conduct **is not a legally binding instrument, but has political force**. In the Code of Conduct, member states agreed to roll back

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existing measures that constitute harmful tax competition. And to refrain from introducing new measures which constitute harmful tax competition in the future.

- In 1998 to assess the tax measures the **Code of Conduct Group** was established. In 1999, **the group identified 66 tax measures with harmful features**.
- **Communication on Preventing and Combating Financial and Corporate Malpractice** - provides a **strategy for coordinated action to reduce the risk of financial malpractice.** The European Commission suggests more transparency. And information exchange in the field of corporate taxation.

Tax system in CEE – general info

- **CEE - a group of countries that underwent a transformation, or a transition, from being centrally planned to becoming market economies.** While transforming CEE tax systems from centrally planed pattern to free market one, in some ways, their tax systems have been adapting themselves to moving targets. It is to be expected that **this process will continue for a few more years until the economies of these countries become fully market oriented**, with characteristics, structures, and institutions similar to those of the other European countries. **That this is not yet the case can be seen, in part, from the levels of their per capita incomes that are still much lower than those of the group of countries that they joined.**

Tax system in CEE – USSR

- At the beginning of 1990s much of the **wealth of these New EU countries was owned by the state.** The **citizens were not expected to save and accumulate assets** because the state, often through the public enterprises in which most citizens worked, would take care of them in old age or in illness. **They did not need to save as a precaution for being unemployed**, because there was no official unemployment. The state enterprises were required to absorb any citizen who wanted a job. A large part of the income received by the workers was in kind. The part received in cash was only a small fraction of the income produced by a worker and there were a lot of constraints, imposed by scarcity, on how this cash could be used. Thus, to a great extent, **the state determined both the level and the pattern of the consumption by individuals. Individual decisions had little influence on the allocation of resources**. This was done through state planning.
- In some ways classical central planning was an effective and esthetically attractive social instrument that fascinated many western

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social scientists. Unfortunately, **by limiting individual liberties and by killing individual incentives, it carried an enormous cost in terms of economic efficiency and political liberty**. As time passed, **the centrally planned economies became increasingly inefficient and unable to satisfy the consumption needs of their populations.**

- **In that central-planning environment, the role of the tax system was limited and there was hardly any need for a western-style tax administration**. **Taxes on labor income were collected directly from the state enterprises, by simply adjusting the cash transfers that they received from the central bank to pay the wage bill. There was no objective definition of enterprise income to determine precisely the taxes on profits.** The payment from an enterprise to the state was negotiated; it was not based on the actual profits. The depreciation allowances for the use of capital assets bore little or no relation to the useful life of the real assets used. There were **no laws that defined the turnover taxes**. These were

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determined arbitrarily in the plan and reflected both social considerations that favored particular items (children's clothes, art books, etc), as well as supply and demand conditions. **When there was excessive inventory of an item, the turnover tax was reduced to induce citizens to buy more of this item. Therefore, the turnover taxes could be in the thousands and changed frequently.**

- "The life of a tax administrator was easy (during central planning). He often had to deal with just one enterprise. Much revenue came from an occasional telephone call. Now you have to work for every cent" (Tanzi 1993, p. 7). Thus**, one thing that these countries had to learn was how to collect taxes from taxpayers that would rather evade paying them.**

Tax system in CEE – Transformation

- The reforms introduced by the New EU countries had to cope with economies in which prices and wages are free to fluctuate, private sector activities become important, there are no controls on the output of enter prises, so that their incomes are not known and payments can be made in various forms and no longer through just one ‘monobank’. **This new situation would demand both new tax systems and new tax administrations**. Furthermore, these had to be adjusted over the years to conform with the changes in the structure of the economy. It would not be imprudent to say that the tax systems of these countries have come a long way and that from now on they will need more fine tuning than radical surgery.

Tax system in CEE – today

- **Particularities of modern CEE tax systems**:
    - **The closeness of their current tax burdens** - in fact these tax burdens are all close to 40 percent of GDP, having come down from higher levels. A tax burden of 40 percent of GDP may be close to, or even lower than, the European average but **it is very high considering these countries' still low per capita incomes**. From an international statistical perspective, the tax burden of these countries could be expected to be somewhat lower. Thus, a question that needs to be raised is whether the current tax levels are sustainable over time. It would be reasonable to speculate that they are likely to fall as the transformation of these economies continues. This fall would require a reduction in public spending.
    - In spite of their high tax levels**, all of these countries**, with the exception of Estonia, **have developed high budgetary deficits, which have been growing in recent years**. This implies that these countries have not succeeded yet in

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reducing the role of the state to a level that can be financed through ordinary tax revenue. **The state is still expected to do too much despite various reforms aimed at reducing its role and responsibilities. This aspect could become a problem that would extend beyond the need to meet the Maastricht criteria. The fiscal gap must be closed by reducing public spending rather than by increasing the high level of taxation.**

- **The extent to which labor income is taxed.** This is partly due to the **large payments for social security contributions**, which in some of these countries, such as **the Czech Republic, are among the highest in the world.** This heavy burden on labor income must be reduced if the development of growing underground activities is to be prevented. This growth of underground economic activities is already under way in several of these countries and is likely to accelerate with the passing of time.

Tax system in CEE – today

- **The almost uniform move towards fiscal decentralization. Undoubtedly this is a political reaction against the powerful central governments of the past**. Once the communist regimes were replaced, the citizens of these countries were anxious to have more 'voice' and more control over decisions that affected their lives. However, **regardless of its political merit, this process of decentralization is likely to constrain future tax reform and to affect negatively future macroeconomic developments. Experience from around the world indicates that it is often more difficult to reduce fiscal deficits in a fiscally decentralized environment.**
- **The growing use of environmental taxes in these countries**. The centrally planned past had left these countries with major environmental problems that affected health and life expectancies. Many in these countries have low life expectancy, perhaps due to the quality of the environment.

Tax system in CEE – today

Thus, the attempt to reduce this problem through the use of tax instruments is one that deserves praise.

- **After labor income, consumption is the other tax base that carries much of the tax burden**. All these countries have introduced value added taxes, which with some adjustments will conform with the requirements of the European Union. However, **there are still too many excises and other small taxes. Some of these will have to disappear in future years.** Property taxes are still playing a marginal role. **This is not surprising since, until twenty five years ago, there was no or little private property. However, in future years, it would be preferable to give a growing importance to this tax base,** especially for financing the local governments, while reducing the reliance on revenue sharing arrangements that transfer to the local governments parts of the revenue from personal income taxes and corporate income taxes.

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