eJournal of Tax Research

Volume 11, Number 3 December 201[illegible]

Special Edition: 10th Anniversary Edition

CONTENTS

245 Editorial announcement

Binh Tran-Nam

246 Introduction to the 10th anniversary issue of the eJournal of Tax Research

Binh Tran-Nam, C John Taylor

259 Buenas notches: lines and notches in tax system design

Joel Slemrod

284 Designing tax policy: constraints and objectives in an open econ[illegible]

Richard M. Bird, J. Scott Wilkie

321 The European Union constitution and the development of tax poli[illegible]

Nigar Hashimzade and Gareth Myles

342 Far east tax policy lessons: good and bad stories from Hong Kon[illegible]

Richard Cullen

375 Crossed lines: two cases of tax policy incoherence

Sheila Killian

386 Conduit companies, beneficial ownership, and the test of substan[illegible] business activity in claims for relief under double tax treaties

Saurabh Jain, John Prebble, Kristina Bunting

434

Atax

UNSW

The major objectives of the Constitution were stated precisely in Article I-3:

> The Union shall offer its citizens an area of freedom, security and justice without internal frontiers, and an internal market where competition is free and undistorted.

> 7KH 8QLRQ VKDOO ZRUN IRU >«@ D KLJKO\ FRPSH only.

The Constitution also allowed for Member States to sustain a degree of independence in their policy choices. This was granted by the principle of subsidiarity which featured throughout the Constitution. For example, the intention of the Union to respect subsidiarity was promised in Article I-11:

> The use of Union competencies is governed by the principles of subsidiarity and proportionality.

Even though the Constitution granted subsidiarity, it also envisaged some limits upon the application of this p

component of economic governance. The study of tax policy brings into stark focus how conflict can arise between the coordinating role of the Union and the rights of Member States to pursue their own distinguished policies under the principle of subsidiarity.

The paper begins by reviewing what was proposed in the Constitution about tax policy by assessing a number of its articles. The focus will be on how they could have been applied to provide remedies for the problems created by subsidiarity in a single market. The third section reviews the VAT harmonisation process that was begun by the EU in the late 1980s. This short history provides an illustration of many of the issues involved in tax governance. The remainder of the paper then focuses upon some of the further challenges facing the Union in connection with tax policy. The fourth section studies the taxation of commodities and links the issues surrounding subsidiarity with the principles of international taxation. The fifth section focuses on the taxation of capital as an example of the process of tax competition. The final section provides conclusions.

2. TAX POLICY UNDER THE PROPOSED CONSTITUTION

The purpose of this section is to review the articles of the proposed Constitution which had significant bearing upon tax policy. In preparing these comments the wording of the Constitution has been taken literally, as opposed to trying to see through the wording to what might be implied.

The most fundamental requirements of economic activity were enshrined in Article I-4 which guaranteed:

> The free movement of persons, services, goods and capital

and that:

> Within the scope of the Constitution … any discrimination on grounds of nationality shall be prohibited.

The need for free movement is fundamental to the development of the EU economy as a single market with a competitive basis and an efficient outcome. With taxation organized as at present, an increase in mobility is not without a cost since it necessarily enhances the incentive for Member States to engage in tax competition. As a consequence the EU will continue to face the prospect of tax competition undermining efficient tax policy if it does not revise its processes as mobility increases.

The articles committing to non-discrimination are interesting if they were applied to products in addition to people. One of the proposals that had been discussed in the EU for many years in connection with revised tax governance is the use of origin rather than destination taxation. However, the basis for the operation of an origin system is that it does discriminate between products on the grounds of nationality. That is, a product that is produced in several different Member States will be taxed at different rates in any country of final consumption.

This point can be emphasized by considering Article III-170 which dealt with the equal treatment of commodities in trade:

> No Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products.
>
> Where products are exported by a Member State to the territory of another Memberstate, any repayment of internal taxation shall not exceed the internal taxation imposed on them whether directly or indirectly.

Suppose a Member State wishes to use an origin subsidy on its product whereas other Member States employ a tax. Does the use of a zero tax class as an internal tax in excess of the subsidy on the domestic product? Is this discrimination because of nationality? This is a point where the equal-treatment principle may be in conflict with the wish to move to origin taxation.

The issue of the encouragement of mobility was repeated in several further Articles. In Article III-133 the right of workers to move freely was stressed:

> Workers shall have the right to move freely within the Union.

More specific methods to achieve this mobility were described in Article III-136:

> In the field of social security, European laws or framework laws shall establish such measures as are necessary to bring about freedom of movement for workers by making arrangements to secure for employed and self-employed migrant workers and their dependents:
>
> (a) aggregation, for the purpose of acquiring and retaining the right to benefit and of calculating the amount of benefit, of all periods taken into account under the laws of the different countries;
>
> (b) payment of benefits to persons resident in the territories of Member States.

The free movement of capital was also enshrined in two further Articles: first, by Article III-156:

> Within the framework of this Section, restrictions both on the movement of capital and on payments between Member States and between Member States and third countries shall be prohibited.

Second, in Article III-157 the freedom of movement of capital was extended to movement between Member States and third countries:

> The European Parliament and the Council shall endeavour to achieve the objective of free movement of capital between Member States and third countries to the greatest extent possible and without prejudice to other provisions of the Constitution.

T.944 232.49 Tm 324-4( )-97(i)-lrttaxatiea2 ea2549 Tm [(t)-s pr7(ea2541( )-5A)5(r)7(t)-4Statea254( )-162(f)-362(and)] TJ

the tax treatment of income from interest on capital is a prime example. Harmonisation can also encourage trade by leading to simplified accounting.

The 1987 proposal on harmonisation was to restrict Member States to a two-rate system of VAT, a standard rate of 14-20% and a reduced rate of 4-9% for basic goods, combined with uniform excise duties. The proposal met with objections because of the substantial impact on some Members' tax revenues and the implications for tax rates on socially and distributionally-sensitive goods. Instead, a system of minimum tax rates was proposed in 1989 and introduced in 1993: minimum standard rate of VAT of 15% and one or two lower rates of at least 5%, but the existing zero-rating as in the UK (of food, children's clothes) was allowed to continue, and a set of minimum excise rates was also proposed. The approximation of tax rates remains a long-term goal.

Table 1[3] provides some data on the evolution of VAT rates in the Union since 1970. It can be seen from this data that little progress have been towards convergence until recently, when the Member States increased the rates in the last five years, which helped to overturn the falling trend in revenues during the global economic crisis. According to the Eurostat (2013), six Member States increased their standard VAT rates in 2009, eight in 2010, four in 2012, and nine in 2013, some after a temporary cut to boost demand.

Table 1: VAT rates of EU member countries

Germany

2013	Standard (normal)	19	19.6	22	20	25
	Reduced (essential)	7	5.5/7(2.1)	10/4	5	0

Variations in levels of excise duty and capital taxation in different EU Member States have also caused concern. As part of its internal market programme, the Commission also proposed the harmonisation of excise duties on mineral oils, tobacco products and alcoholic beverages. This was rejected by Member States, and a system of minimum rates was introduced in 1993. Despite this, as shown in Table 2[24] the dispersion of rates remains significant giving rise to substantial cross-border shopping flows.

Table 2: Excise Taxes in euro, 1 July 2013

Given the high mobility of capital, differences in corporate tax rates (and systems) could result in significant distortions. In the face of hostilims) 4(i)6(b0 [(hav)9(9(t)-4(or)7(t)-4(i)6(ons)

It is clear from these quotes that the harmonisation of tax rates within the EU has returned to the policy agenda. The quotes show an acceptance of the fact that the process had reached a hiatus in the early 2000s, and the beginning of a new drive for harmonisation from the middle of the decade. It is also noteworthy that the basis of the argument has shifted over time. The final quote shows a change in focus from the rather tenuous concept of 'neutrality in competition' to a more concrete argument on compliance costs for business.

4. THE TAXATION OF COMMODITIES

The discussion of harmonisation has described some of the issues that the EU faces in connection with the taxation of commodities. Amongst these, it was noted that the system in use results in extensive cross-border shopping. That this would happen upon the completion of the single market was well understood at the time the policy was implemented. To counteract it the EU had the intention of significantly revising the system for commodity taxation. As will be described below, this intention has not yet been realized.

It is first interesting to discuss why cross-border shopping can be viewed as unwelcome since this is contrary to the view expressed in some publications of the EU (the report 'Unlocking the Potential of Cross Border Shopping in the EU' published in 2002 expresses dissatisfaction that over the survey period of a year only 13% of the EU population engaged in cross-border shopping). The explanation can be found in the different forms that such shopping takes. It is economically efficient for consumers to purchase from the cheapest source and in an economy without distortions this is a necessary condition for efficiency. From this perspective, cross-border shopping should be encouraged.

The view of cross-border shopping as a problem in the EU arises from the fact that the market is not undistorted. Instead, much cross-border shopping is driven by differentials in the tax treatment of commodities in different Member States. This is a case of one distortionary activity generating a further distortionary response which causes additional deadweight loss.

There are four routes through which cross-border shopping is damaging. First, there is

to change. For example, if the one country has a lower rate of VAT than a trading partner then imported goods will bear a higher rate of tax after the switch. However, this change in relative taxes between the two principles is compensated for by adjustment in the relative wage rates in the trading countries. Even more surprising, if tax rates are not uniform within each country then the origin principle may even lead to higher economic welfare than the destination principle (Keen and Lahiri 1998; Hashimzade et al. 2005).

This literature suggests that a switch from destination taxation to origin taxation is feasible without major changes in tax revenues and more than likely would be beneficial. In particular, the effects of the switch would be minimized if undertaken once the labour market is liberalized.

Table 3: Adjusted top statutory tax rate on corporate income, in percent

	1995	2001	2013
Austria	61	34	25
Belgium	45	40	34
Finland	50	35	36
Germany	62	38	30
Greece	42	38	26
Ireland	12.5	12.5	12.5
Italy	38	40	31
Netherlands	48	35	25
Portugal	55	36	32
Sweden	61	28	22
UK	53	30	23

Taxation Trends (2013) ‚Taxation trends on the European Union: Data for the EU Member States, Iceland and Norway¶ Eurostat Statistical Books, European Commission.

Tiebout, C (1956) µA pure theory of local expenditures¶ Journal of Political Economy, 64, 416-- 424.

Tinbergen, J (1953) Report on the Problems Raised by Value Added Taxation in the Common Market. European Coal and Steel Community -- High Authority.