

## The Single Market and beyond: challenges for tax policy in the European Union

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Taxation is an integral part of our lives. It is, of course, the source of revenue from which the state provides its citizens with public infrastructure and social benefits. Beyond this, tax policies affect a number of social and economic objectives. They have a vital role to play in the European Union in creating the smoothly functioning Single Market that is essential for our future prosperity. And they must also be viewed in the context of the Community's shared objectives of promoting employment, stimulating enterprise and protecting the environment.

This is the background against which the Commission and the Member States have been reflecting on the tax systems in the European Union. Beginning on 13 April 1996 with the informal meeting of Economic and Finance Ministers in Verona,<sup>1</sup> and continuing in the High Level Group of personal representatives which I chaired between June and October of last year, we have looked together at the role of taxation in facing up to these challenges. The Commission has drawn certain conclusions from this work, and has set these out in its recent Report of 22 October 1996.<sup>2</sup> This Report, and the recommendations it makes, have since been considered by EU Finance Ministers at the ECOFIN of 11 November, and by the Heads of Government meeting in the Dublin European Council of 13-14 December 1996.

Throughout this process we have taken a comprehensive view of all forms of taxation. It is well known that the tax devil is often in the detail, but it is equally vital to have an overview of tax policy as a whole. I am convinced that significant progress can only come about when the detailed technical analysis is matched with a clear awareness of this broader picture. I am equally convinced that the way forward will require pragmatic policy responses to specific tax problems, both at Community and at national level.

I am therefore pleased that both the ECOFIN Council of 11 November and December's European Council welcomed the Commission's proposal to set up a new permanent Taxation Policy Group to take a strategic overview of tax policy in the European Union. While fully supporting the principle that Community action is only needed where measures cannot best be taken at national level, the Commission believes that closer and better coordination is vital. This is also necessary to prevent the rapid liberalization of trade and investment flows from further eroding the

effective sovereignty of Member States in favour of the markets. I believe that this new Taxation Policy Group, which the Commission will again chair, will provide the strategic forum and impulse for the exchange of analyses and experience. It will also oversee the work that is currently being done by various other committees at Community level, both for direct and for indirect taxes.

The time to act is now. The approach of Stage III of Economic and Monetary Union, under which exchange rate distortions will disappear, makes it all the more urgent to ensure that the Single Market is fully functioning, without barriers or distortions. Unless a Single Currency is supported by the full and undistorted mobility of goods, services, capital and people, it may not be conducive to optimal economic performance. The original programme for the Single Market has undoubtedly had positive effects for the Community in terms of growth, employment, trade and competitiveness, but there are areas where it must still work better. One such area is taxation: substantial progress is needed, for example, to tackle the wide differentials in capital income taxation that impair the efficient mobility of capital, or to remove tax obstacles to the effective mobility of labour.

Eliminating tax obstacles to cross-border income and capital flows will reduce the complexity and the costs of doing business in Europe. This is vital to enable the Union to be competitive in a global economy, and to remain an attractive place for investment. Creating a tax-neutral climate that is conducive to enterprise and wealth creation will, however, demand coordinated action from Member States. The Commission will, for its part, propose a number of practical steps towards completing the Single Market. It is taking forward its work programme for a new common VAT system; and it will make new proposals for the taxation of cross-border economic activity, beginning with the elimination of withholding taxes on interest and royalty payments between associated companies. It will also intensify its efforts to find a common way forward for the taxation of

<sup>1</sup> On the basis of the Commission's reflection document 'Taxation in the European Union' of 20 March 1996 (SEC(96)487).

<sup>2</sup> *Taxation in the European Union - Report on the Development of Tax Systems*, COM(96)546.

savings, where a Single Currency will increase the sensitivity to tax differentials still further.

We must also continue to pay attention to the threat of fiscal erosion, an underlying concern that came up time and again during the work of the High Level Group. Unfair or harmful competition for tax revenues can erode certain tax bases, resulting both in a loss of revenue and in the distortion of tax systems. This particularly, although not exclusively, affects the taxation of internationally mobile capital and business. The downward pressure it exerts on tax rates for the more mobile factors of production can increase the tax burden on the less mobile ones, with damaging knock-on effects for employment. It is striking that between 1980 and 1994 the average implicit tax rate on employed labour in the European Union rose from 34.7 per cent to 40.5 per cent, while that on other factors of production fell from 44.1 per cent to 35.2 per cent.

Tax competition is a worldwide phenomenon, and valuable work on it is already under way at the OECD.<sup>3</sup> But it is of particular concern to the European Union, where the close economic links make the risk of economic misallocations even higher. In addition, the legally binding competition rules in the EC treaty must be applied to fiscal measures as they are to other sorts of measure.<sup>4</sup> I hope that the work undertaken in the new Taxation Policy Group will allow us to understand better what types of measure are harmful in a Community context, and to agree on ways of limiting their effects. Joint action here will be essential to stabilize revenue-collecting capacities, and to give greater room for manoeuvre in tailoring individual tax systems to policy needs.

One clear example of the need for joint action is in the field of environmental and energy taxes. The Commission will shortly be making new proposals for an overall approach to the taxation of energy products.

These will aim at providing a common framework within which Member States can vary their own tax systems in the light of national circumstances.

But the number one goal for the Community today is promoting employment. Taxation could be an integral element of a strategy to achieve this. In December, the Dublin European Council particularly emphasized the importance of undertaking further work on the effects of tax policies on employment, stressing the need to make taxation and social protection systems more employment friendly. I believe that the continued exchange of information and experience in the new tax policy group will prove invaluable in helping to reverse the unfavourable taxation trend that we have seen against employed labour. For the longer term, economic agents must be convinced that taxation structures will from now on be better geared to promoting employment.

I look forward to tackling these challenges over the coming years. I recognize that the first task of tax systems is to raise revenues, and would not underestimate either the sensitivities or the difficulties involved. But it is vital also to recognize the fundamental contribution that tax policies can make to the future economic and social well-being of the European Union, beginning with the proper functioning of the Single Market. That is the challenge that lies ahead of us.

<sup>3</sup> The 1996 OECD Ministerial and the 1996 G7 Summit in Lyon both underlined the dangers of harmful tax competition. A Special Session of the OECD Committee on Fiscal Affairs is currently studying internationally mobile business activities.

<sup>4</sup> Notably the State Aid rules in Arts. 92-94 of the EC Treaty. The European Economic Area Agreement extends substantially the same rules to Norway, Iceland and Liechtenstein.