

## Time to Tax – the EU Road to a Sustainable Tax System

Economies become increasingly integrated, capital and goods cross many borders, and corporations span more and more countries. Still, economic policies are broadly determined at national level. This seems especially true for taxation. While tax planning is often international, tax policies are national. Research gives clear indications and evidence for international spillovers of national policies and is very welcome to guide efforts for European and international coordination.

Living in a world characterized by a race to the bottom in (corporate) tax rates, a growing inequality in terms of income and wealth, and a transition to a sustainable economy, it is by the interaction of these three factors that we find the most pressing challenges in the area of international taxation. How can we deal with the downwards pressure on taxes on mobile bases that render our tax system increasingly regressive? How do we fight climate change in a globalized economy where increased carbon taxes might lead to carbon leakage? And how can we ensure that the transition to a sustainable economy brings along even the most vulnerable in our societies? Still, in EU tax policy formulating answers to such questions is necessary but not always enough. It is also essential to understand the EU institutional setting and the different pathways available to enact policies. This article will therefore first address the key policy questions that lie ahead of us and conclude with a brief overview of some of the institutional questions facing EU policy in the area of tax.

### I THE GROWING SNOWBALL OF TAX REFORM

In politics one needs patience: progress is often slow, almost frustratingly so. From migration of workers and refugees to the sustainability of our welfare state, many of the issues that were salient when I started as a member of the Dutch parliament in 2007 still dominate the political discourse. How different does it feel in the area of taxation? In 2007 corporate tax evasion was, at least in the Netherlands, a non-issue. No one knew – or wanted to know – of the Netherlands' central place in the international industry of tax avoidance. Tax havens were the places where the rich stalled their money – Switzerland, Monaco, Barbados – but were not associated with the anonymous office blocks with letterboxes in Amsterdam

or Luxemburg. Now, we are on the verge of an international agreement that may drastically change the global corporate tax system and end some of the worst practices of tax avoidance. Political momentum on taxation has felt like a snowball rolling off a hill, continuously growing in size and speed, until halting it becomes all but impossible.

This snowball has been set off by a fruitful cross-fertilization of academia, media and politics. In the latter category, the European Parliament has taken a leading role. It started a temporary special committee in 2015, after the Luxleaks revelations showed that the Luxemburg tax authorities authorized sweetheart deals with companies located in their jurisdiction. This was followed by the 'TAXE2' temporary committee and the 'PANA' inquiry committee set up after the Panama papers scandal. In each case media reported on a scandal, with the Parliament calling on experts to draft a response and provide solutions to be implemented in EU law. Through the creation of a permanent subcommittee on tax matters ('FISC'), the European Parliament has given this fruitful cooperation a permanent status.

One year since its creation, I think we can say this has proven to be a success. We have hosted some fifty academics, policymakers and practitioners to discuss tax issues ranging from the OECD tax negotiations to green taxation, from CUM-EX to new tax schemes the Parliament should pay attention to. Based on expert input we have drafted reports on the EU list of tax havens, taxation in a digital economy, and harmful tax practices, and we discussed these also with national parliaments. We started work on reports calling for a European withholding tax and analysing national tax reforms. This has, to be frank, not always been easy. Taxation has proven to be both politically unifying and divisive. On the need to halt tax avoidance and evasion, there is a broad consensus in the parliament. From the extreme-right to the centre to the far-left, all political groups are in broad agreement to condemn it and support further EU action in this field. The discussion becomes much more divisive, however, when talking about the redistributive potential of tax, or the potential of taxation to promote sustainable economies. Whereas the left is keen to discuss more comprehensive wealth taxation and higher taxes on carbon emissions as a way to make our economies both fairer

and more sustainable, the right sees the first as an exclusively national competence, and the second as punitive measures for middle classes.

In this context, it is essential that members of the subcommittee have at their disposal accurate data to form informed opinions and convince each other. Scientists and experts still carry weight in the European Parliament and after every expert hearing, I can see opinions from different sides converge. The hearing on new tax schemes, for example, showed many members that with an increasingly mobile global workforce, a race to the bottom in income tax might be upon us, while hearings on the OECD negotiations convinced members of the need to talk about minimum *effective* tax rates. Well directed energy from experts in the field of taxation can thus have a real impact on the ideas and vision of politicians. It is for this reason, that I would here like to set out some of the biggest challenges in the area of taxation that will shape the work of the FISC subcommittee in the next year.

## 2 FIGHTING CLIMATE CHANGE AND INEQUALITY IN A WORLD OF TAX COMPETITION

I see three main developments that interact to shape the challenges our societies face in the area of taxation.

The first development is the downwards pressure inherent in international tax competition, which intensifies as corporate tax bases become more mobile. With the increasing ability of firms to decide themselves where they locate their profits, i.e., the increased mobility of profits, tax rates have only become more important to attract capital, thereby intensifying the competition in tax rates. Beer et al.<sup>1</sup> conclude for a meta-analysis that a 1%-point lower corporate tax rate will expand reported profits by 1 %. Of course, this implies that when other, neighbouring countries decrease their rate, this directly affects the tax income of a country. This leads to a configuration that countries are almost forced to decrease their rates. Indeed, the International Monetary Fund (IMF)<sup>2</sup> showed that statutory rates in the EU have

decreased from an average of 35% in 1995 to 21% now while competition with effective tax rates results in a loss of taxable revenues of on average 1.6% of a country's Gross Domestic Product (GDP). The race to the bottom is not restricted to corporate tax rates. Top rate personal income taxes in OECD countries have decreased from an average of 65.7% in 1980 to 41.7% in 2010.<sup>3</sup> Such decreases are at least partly a way to attract high-earning individuals, with some countries even offering reduced income tax-rates for expats.<sup>4</sup> With the rise of working digitally after the covid pandemic, we can expect this dynamic to strengthen even further.

The second development is the growing inequality in our societies. According to the World Inequality Database,<sup>5</sup> the percentage of total income earned by richest 1% in the EU has gone up from 7.5% in 1980 to 11.9% in 2019. This has come at the cost of middle classes. The OECD finds that, over the past thirty years, median incomes increased a third less than the average income of the top decile.<sup>6</sup> With house prices going up three times as fast as median income over the last two decades, middle class purchasing power has all but stagnated.<sup>7</sup> Part of the struggle of middle classes is the result of changing relative tax burdens. Tax avoidance and tax competition have led to lower (effective) tax rates on corporate profits, returns on wealth and high labour income.<sup>8</sup> These are exactly the types of income that disproportionately accrue to the wealthiest.

The third development is the EU's fight against global warming. With a legally binding pledge to reduce CO<sub>2</sub> emissions with 55% by 2030 and reach climate neutrality by 2050, it is clear that all EU policy areas need to be geared towards achieving this aim. Carbon emissions are still under-priced compared to the negative externalities they cause and are even subsidized in the EU – often via tax expenditures – to a tune of between EUR 39 and EUR 200 billion per year.<sup>9</sup> Most notoriously, kerosene is currently exempt under the Energy Tax Directive. At the same time, the EU's fight against global warming necessitates governmental tax and spend to guarantee sufficient resources for investments in renewable energy, isolating buildings and developing new technologies. Indeed, the

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<sup>1</sup> S. Beer, R. de Mooij & L. Liu, *International Corporate Tax Avoidance: A Review of the Channels, Magnitudes, and Blind Spots*, 34(3) J. Econ. Surveys (2019).

<sup>2</sup> IMF European and Fiscal Affairs Departments, *Taxing Multinationals in Europe* (25 May 2021), <https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers-Issues/2021/05/25/Taxing-Multinationals-in-Europe-50129> (accessed 3 Sept. 2021).

<sup>3</sup> OECD, *Tax: The Average Tax Burden on Earnings in OECD Countries Continues to Rise* (25 Apr. 2012), <https://www.oecd.org/ctp/tax-policy/taxtheaveragetaxburdenonearning-sinoecdcountriescontinuestorise.htm> (accessed 12 Aug. 2021).

<sup>4</sup> R. Houben, A. Van de Vijver, N. Appermont & G. Verachttert, *Tax Gaps in Professional Football*, Presentation to European Parliament Subcommittee on Tax Matters (FISC) (29 June 2021), [https://www.europarl.europa.eu/cmsdata/237318/TaxGaps\\_EP.pdf](https://www.europarl.europa.eu/cmsdata/237318/TaxGaps_EP.pdf) (accessed 12 Aug. 2021).

<sup>5</sup> World Inequality Database (2021), [https://wibidworld/world/#sptinc\\_p99p100\\_z/QY/last/eu/k/p/yearly/s/false/7.0815/12/curve/false/country](https://wibidworld/world/#sptinc_p99p100_z/QY/last/eu/k/p/yearly/s/false/7.0815/12/curve/false/country) (accessed 12 Aug. 2021).

<sup>6</sup> OECD, *Under Pressure: The Squeezed Middle Class* 13 (OECD Publishing 2019).

<sup>7</sup> *Ibid.*, at 24.

<sup>8</sup> *Ibid.*, at 29.

<sup>9</sup> S. Hayer, *Fossil Fuel Subsidies*, European Parliament, Policy Department A (Jan. 2017), [https://www.europarl.europa.eu/RegData/etudes/IDAN/2017/595372/IPOL\\_IDA\(2017\)595372\\_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/IDAN/2017/595372/IPOL_IDA(2017)595372_EN.pdf) (accessed 12 Aug. 2021).

EU's recovery and resilience facility – which in a large part finances investments in a sustainable economy – will be paid in part through new EU Own Resources, including a levy on the use of non-reusable plastic, a digital levy and a revision of the EU's Emissions Trading System.

### 3 A PROGRESSIVE TAX SYSTEM

While each of these developments imply significant challenges on their own, their interaction results in some of the most politically salient issues our societies currently face in the area of taxation. Let's start with the interaction between the first two developments: the intensified race to the bottom and growing inequality. As shown above, the race to the bottom is the most intense for taxes that have mobile bases such as wealth, top incomes and corporate profits. These also happen to be the taxes that are intended to be progressive. As such, the status quo in the international tax system has an inherent momentum to decrease rates of progressive taxes, increasing inequality.

An international agreement to set a minimum tax rate of 15% on the profits of multinationals does something to alleviate the race to the bottom for corporate tax rates, yet it is not enough. Firstly, the introduction of substance carve-outs mean that competition can continue to take place with tax rates on profits that are the result of physical investments in capital and labour, allowing countries to maintain a low tax on (part of) the profits made by companies with factories or R&D facilities in their territory. While such a carve-out can be justified as they do not concern the highly mobile tax-bases at the origin of much tax avoidance, it still leaves room for a continued race to the bottom. Secondly, the agreed minimum of 15% is too low, in comparison to tax rates on other forms of income. With many countries currently being above this threshold, we may still see a reduction in global corporate income tax rates to 15% so as to attract – or at least not lose – mobile corporate profits. A rate of 15% will only cement the discrepancy in tax rates between labour and other sources of income, as most employees pay income taxes significantly higher than 15%.

It should thus be clear that an OECD agreement would only be the very beginning of a reversal of the regressive global tax system. Important questions are thus related to the next steps to reshape it. How could the OECD agreement be improved upon after its implementation? Could we create a similar mechanism to coordinate global income or wealth taxes? Or what other ways exist to create

a fair and progressive tax system in a world dominated by the race to the bottom? It is the last question where most creativity is required, but also where most gains can be achieved. It is possible to create new taxes on immobile assets that increase the progressivity of our tax system. Think of higher real estate taxes for large houses and a land tax (reviving the legacy of Henry George). Similarly, inheritance taxes could play a bigger role in our tax systems. In the 60s and early 70s they accounted for an average of 1% of tax revenue in the OECD. Yet rates have decreased while thresholds and exemptions increased, meaning they now account for under 0.4%.<sup>10</sup> To create a more progressive tax system in a world still captive by a global race to the bottom, we need innovative and well-researched solutions.

### 4 PREVENTING CARBON LEAKAGE

The second challenge we face is to address climate change in a world dominated by the race to the bottom and mobile companies. It is clear governments need to put a price on carbon, yet policymakers are confronted with the risk of 'carbon leakage' if they do so. Production in a country with carbon emission price would, so the argument goes, shift to countries without a carbon price. In response, the EU's Emission Trading Scheme (ETS) gives free allowances to companies in sectors that face a high risk of carbon leakage. Since this means that the tax burden of emitting is imposed more on the less mobile factors in the economy, this clearly undermines the principle of fairness in the fight against climate change. In a forthcoming study, the Institute of European Environmental Policy (IEEP) calculates that EU industry internalizes a mere 26% of the external costs of its air pollution, while households overinternalize this cost at 127%.<sup>11</sup> Similarly, the EU's Energy Taxation Directive has many exclusions for highly competitive sectors. For example, it doesn't impose an excise duty on kerosene so as to avoid unfair competition between EU carriers and foreign carriers who would not need to pay this surcharge.

To counter the risk of carbon leakage and widen the segment of the economy paying a fair carbon price, the European Commission recently proposed a Carbon Border Adjustment Mechanism (CBAM), which would levy a price on carbon-intensive imports equal to the price of EU emissions rights so as to create a level playing field for domestic and foreign producers. This would allow for the end of free allowances, thereby better incentivizing innovation in high emitting industries and installing a higher

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<sup>10</sup> OECD, *Inheritance Taxation in OECD Countries* (2021), [https://www.oecd-ilibrary.org/sites/e2879a7d-en/1/3/3/index.html?itemId=/content/publication/e2879a7d-en&\\_csp\\_629b9a65616a4d96ca81e8985e607a2f&itemIGO=oecd&itemContentType=book#section-d1e6665](https://www.oecd-ilibrary.org/sites/e2879a7d-en/1/3/3/index.html?itemId=/content/publication/e2879a7d-en&_csp_629b9a65616a4d96ca81e8985e607a2f&itemIGO=oecd&itemContentType=book#section-d1e6665) (accessed 12 Aug. 2021).

<sup>11</sup> IEEP, *Greening Taxation, Getting the Prices Right: How Green Taxation Can Help Build Fairer, More Resilient Economies* (4 Feb. 2021), <https://ieep.eu/uploads/articles/attachments/05c5ff2d-cb97-424f-95f8-5efb10d3da2b/Green%20taxation%20to%20build%20fairer,%20more%20resilient%20economies.pdf?v=63779736268> (accessed 12 Aug. 2021).

degree of fairness in our economy. Combined with an expansion of the sectors covered by the ETS and an update of the Energy Taxation Directive, the Commission proposals would extend the EU-wide carbon pricing from some 22% of EU emissions to over 66% by 2030.<sup>12</sup>

There are, however, significant obstacles in the way for its successful implementation. First of all, the industry lobby is strong in seeking to push for both a CBAM and a continuation of free allowances. In its proposal, the Commission has partly given in to industry demands with a slow phase out of free allowances between 2026 and 2036. It will be up to the European Parliament to push back on this. Secondly, it is a diplomatically difficult proposal. Countries from Russia to the US have expressed strong opposition to this tax, with Kerry warning that a carbon border tax has 'serious implications for economies, and for relationships' between the EU and US<sup>13</sup> EU trading partners negatively affected by this border tax will likely take it to the World Trade Organisation. Without a full equality between the carbon price on domestic and foreign products, which EU industry is keen to avoid, the WTO is not at all certain to rule in the EU's favour. Thirdly, carbon border levies are inherently limited in scope. A decrease in demand for, for example, oil from the EU in response to the introduction of a high carbon price will lead to a price reduction which will partly be offset by an increase in demand from other markets. This form of carbon leakage cannot be addressed by a CBAM. In addition, a CBAM only addresses foreign carbon emissions when they are imported to the EU. Energy production in the US and China, for example, would not be targeted. This is why McKibbin and Wilcoxon<sup>14</sup> find that border adjustments 'would reduce leakage of emissions reduction very modestly, and would do little to protect import-competing industries'. While certainly better than the status quo and currently the only unilaterally available course of action, a CBAM is far from the optimal outcome.

Realistic better options are still being developed. A good step in the right direction is developed by Nordhaus in the form of a 'climate club'.<sup>15</sup> He argues in favour of a group of countries jointly agreeing to put a minimum price on carbon emissions, granting countries the freedom to determine how to achieve this, and punishing outsiders with a uniform tariff of 2% on all their imports. This would incentivise non-members to join the club and create a global momentum for a carbon

price for all emissions. While theoretically the better option, it does upset the current international trade rule-book for its lack of proportionality and targeting. As such, a rewriting of global trade rules should be a long-term project, with a CBAM in the meantime that, as proposed by the Commission, excludes other countries with carbon taxes equivalent to the EUs.

## 5 A SOCIALLY AND ENVIRONMENTALLY SUSTAINABLE TRANSITION

Combining the two remaining developments, we reach the third big challenge facing the EU in the area of taxation: making the transition to a carbon-neutral economy without it leading to a further growth of inequality. Raising taxes on carbon quickly leads to higher prices for consumers, with especially the most vulnerable, for example those living outside cities and relying on their car for transport, taking the hit. We have already seen with the *gilets jaunes* demonstrations that the transition to a sustainable economy is not sustainable if it is not inclusive, i.e., if not everyone is brought along in the transition.

We've already seen that households are overcharged for their air pollution while industry is undercharged. Fixing this discrepancy through the measures outlined above would already go a long way in making for a fairer transition. Similarly, dealing with the unequal tax burdens between labour income and other forms of income would reduce inequalities and make the transition to a sustainable economy more palatable. It is thus an illusion that we can prioritize the fight against climate change over the creation of a more just society. Only in tandem can we hope to make the transition to a more sustainable economy.

However, there are also other possible avenues for a democratization of the transition. A frequently proposed option for this is a carbon-tax and dividend. As the objective of carbon pricing is environmental instead of fiscal there is an argument for making such taxes revenue neutral, with revenues being redirected to citizens. The most direct way of doing so is through a carbon dividend, paying every citizen an equal premium. In 2019 over 3,500 US economists, including four former Fed Chairs and 28 Nobel laureates, signed a statement in the Wall Street Journal calling for such a carbon dividend.<sup>16</sup> Indeed the US Treasury found in 2017 that redistributing a USD

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<sup>12</sup> IEEP, 'Fit for 55' Package Extends EU Carbon Price Signal to Over Two Thirds of Emissions by 2030 (2021), <https://ieep.eu/news/fit-for-55-package-extends-eu-carbon-price-signal-to-over-two-thirds-of-emissions-by-2030> (accessed 12 Aug. 2021).

<sup>13</sup> Financial Times, *John Kerry Warns EU Against Carbon Border Tax* (2021).

<sup>14</sup> W. J. McKibbin & P. J. Wilcoxon, *The Economic and Environmental Effects of Border Tax Adjustments for Climate Policy*, Working Paper in International Economics No. 1.09 (2009).

<sup>15</sup> W. Nordhaus, *Climate Clubs: Overcoming Free-Riding in International Climate Policy*, 105(4) Am. Econ. Rev. 1339–1370 (2015).

<sup>16</sup> G. Akerlof et al., 'Economists' Statement', *Climate Leadership Council*, The Wall Street Journal (17 Jan. 2019), <https://clcouncil.org/economists-statement/> (accessed 12 Aug. 2021).



49/tonne carbon tax directly to citizens would increase the after-tax income of all but the 30% richest families.<sup>17</sup> France's *conseil d'analyse économique* found that a differentiated carbon dividend depending on whether a region is urban or rural could help to ensure everyone in the bottom half of the income distribution would be better off, even those relying on private cars for transport.<sup>18</sup> Such research points in the right direction, but is far from exhaustive. Distributional effects from many environmental taxes are still uncertain and more targeted ways of support to citizens could still be found.

## 6 ENACTING REFORMS

The challenges are numerous yet clear, and with a continuing symbiosis between academia and politics, I am confident we will be able to formulate new answers to pressing questions. That leaves, however, the question of implementation. Taxation policies are notoriously hard to implement at the EU level, requiring unanimity among Member States to be implemented. In addition, many of the discussions on taxation take place behind closed doors, in the somewhat secretive 'Code of Conduct Group' of Member States. Not being able to closely monitor what is being discussed in these meetings, the Parliament faces difficulties exercising its role of democratic scrutiny. There are plenty of arguments to make as to why the focus on 'sovereignty' in tax matters undermines the ability of Member States to act according to the wishes of their citizens. And what is sovereignty if not the ability of governments to act upon the wishes of their citizens? However, even within the current EU constitutional framework, it is possible to find ways to improve EU tax policy. And in finding these ways, the parliament has often relied on experts to examine the intricacies of the EU system, finding ways to push for action in an institutional setting of unanimity and enforcing our ability to scrutinize EU-decision making.

An example of valuable research in this field was done by Nouwen<sup>19</sup> who looked into the possible use of Article 116 of the Treaty on the Functioning of the European Union (TFEU) to implement taxation policy with qualified majority where a Member States 'distort[s] the conditions of competition in the internal market'. Understanding better when a Commission proposal based on Article 116 will

withstand scrutiny before the European Court of Justice allows the Parliament to intensify pressure on the Commission to come forward with a proposal in this direction. Another example is the research done on the Code of Conduct Group. Different researchers, from Dourado to Picciotto and Nouwen have explained to the European Parliament the workings of this body, and provided input into the latest report on the reform of the Code of Conduct group which was adopted in Committee this July. This greatly helps the Parliament deal with harmful tax practices in the EU. While not having co-legislative power in this policy field, well-informed pressure by the European Parliament can play a decisive role in determining EU action. A prime example is the EU list of non-cooperative jurisdictions for tax purposes, which was established after long-time pressure from the Parliament. While initially coming without strong sanctions, this list is now being integrated in other pieces of legislation. EU funding and certain financial services are already restricted to tax havens. Institutional explanations and innovations are thus useful and impactful contributions to the work of the European Parliament.

Strong cooperation between science and policy is thus essential to maintain the momentum for tax reform in the European Union. To create a fairer and more sustainable economy, the race to the bottom in the most progressive elements of our tax system should be halted, solutions should be found to carbon leakage and the transition to a more sustainable economy should be accompanied with strong social measures to ensure everyone can find their place in the economy of the future. Finding accurate solutions, however, is not sufficient. To reach maximum impact, a detailed understanding of the EU's institutional setting is key, allowing the European Parliament to exercise maximum pressure where it can have the most impact. The FISC subcommittee is the place where experts and policy-makers can discuss these questions and look for answers. We are therefore keen to receive input and ideas from the research community and as Chair of the subcommittee I stand ready to put them before my colleagues in the European Parliament.

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<sup>17</sup> J. Horowitz, J. Cronin, H. Hawkins, L. Konda & A. Yuskave, *Methodologies for Analyzing a Carbon Tax*, US treasury office of Tax Analysis working paper 115 (2017), retrieved on 12 Aug. 2021 from, <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-115.pdf> (accessed 12 Aug. 2021).

<sup>18</sup> D. Bureau, F. Henriët & K. Schubert, *Pour le climat: une taxe juste, pas juste une taxe, conseil d'analyse économique*, Conseil d'analyse économique (2019), <https://www.cae-eco.fr/Pour-le-climat-une-taxe-juste-pas-juste-une-taxe> (accessed 12 Aug. 2021).

<sup>19</sup> M. F. Nouwen, *The Market Distortion Provisions of Articles 116–117 TFEU: An Alternative Route to Qualified Majority Voting in Tax Matters?*, 49(1) Intertax 14–28 (2021).