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Dimitris Psarrakis
Financial Economist

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ΕΛΛΗΝΙΚΟ ΙΔΡΥΜΑ ΕΥΡΩΠΑΪΚΗΣ & ΕΞΩΤΕΡΙΚΗΣ ΠΟΛΙΤΙΚΗΣ
HELLENIC FOUNDATION FOR EUROPEAN & FOREIGN POLICY

Hellenic Foundation for European and Foreign Policy (ELIAMEP)
49, Vas. Sofias Avenue, 106 76 Athens Greece
Tel.: +30 210 7257 110 | Fax: +30 210 7257 114 | www.eliamep.gr | eliamep@eliamep.gr
CRISIS OBSERVATORY | www.crisisobs.eu | info@crisisobs.gr

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Dimitris Psarrakis

Dimitris Psarrakis is Financial Economist, with specialization in institutional investment portfolios and financial risk analysis. He is professional financial risk specialist in the field of risk management in Banking and the regulatory transformation procedure of Basel III in the Netherlands and Luxembourg. In the period of financial crisis of Greece (2010-2012) he was advisor of the Committee of Financial Affairs of the Greek Parliament. He studied Finance (Master in Finance - Harvard University), and has followed executive education programs in financial risk management (Stanford University, Wharton Business School and Columbia University) His research interests include the monetary policies of the Eurozone System, the regulatory framework of Basel III, money market analysis, and the analysis of the capital market of fixed income securities.

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Abstract

The financial crisis revealed the need for a sound fiscal policy in the EU. Taxation is a critical component for fiscal deepening in the common market. The LuxLeacks cases made clear that it is impossible for the common market to function without distortions unless a more coherent rule-based approach is in place. According to the European Scoreboard of Macroeconomic Imbalances, the EU corporate investments attractiveness in the post-crisis period was reduced spectacularly for the member-states which are placed under a fiscal consolidation programme, like Greece and Portugal, whereas Luxembourg is 216% more attractive. This is a clear signal of harmful tax competition which facilitates tax evasion, tax avoidance and aggressive tax planning. It also indicates that in the field of tax transparency, the tax coordination method, the prevailing governance method in addressing the intra-market tax issues, has failed. Thus, a more harmonised approach is needed. However, the proponents of tax harmonisation, who view it as an alternative governance method to tax coordination, face fierce political resistance by the Council, the Commission and the conservative wing of the European Parliament. In this article the issue of tax harmonisation is examined in terms of its operational merit as a necessary welfare maximising tool for the control of market inefficiencies and not as a norm for wealth redistribution.

EU Taxation Policy: the contest for the governance method

In the Fall of 2014, the Commissioner-designate Pier Moskovici joined the Committee of Economic and Monetary Affairs (ECON) of the European Parliament to follow the Hearings procedure. In his speech before the Members of the European Parliament, Moskovici expressed his surprise that J. C. Juncker decided to "unify" the Economic policy portfolio with the Taxation policy. It was a significant message of Juncker's new Commission that Fiscal Policy could play a more important role in the Economic Governance of the post-crisis EU. Moreover, Moskovici made one more step ahead by calling for more "harmonization" in the taxation policies of the EU.

The argument for more harmonization in fiscal issues divides the EU. It is a story of governance. As it happens with the most of the EU policy items, the Europeans should decide about the scope and level of intervention of the EU in the policies of the member-states (MS). According to the Treaty of the European Union (TEU) the question of who has the responsibility in a policy domain is defined by the principle of subsidiarity. The Union intervenes and undertakes the responsibility of a policy only if the MS cannot efficiently achieve the requirements of a proposed policy action. Practically, the application of the subsidiarity test was rather problematic in the past. To bring more clarity, the Treaty on the Functioning of the European Union (TFEU) separated the policy areas into three distinct categories: (a) policy areas that the EU has exclusive competency, (b) policy areas that only the MS are empowered to act, and (c) policy areas that the policy implementation is a shared competence. The tax policy belongs to the category of the "shared competence".

It is beyond the scope of this essay to explain the reasons why the EU intervention is justified in tax issues. We only stick to the fact that tax policy is a shared competence, which means that some level of EU intervention is justified and established. Having the intervention requirement established, the EU has to decide how to give shape to that intervention. This is the question of the "governance method". The governance method is all about the selection of the tools needed to carry out a policy. Some tools are more restrictive for the MS whereas others give considerable space for the MS to maneuver. There is a big list of tools-methods, but in the case of taxation we will focus on two:

(1) the network method, or the "coordination" as it is spelt out in the EU jargon. This is a typical tool employed when a policy area is a shared competence and allows significant space for the MS to move independently, and

(2) the regulatory method, or "harmonization" in the EU jargon. This tool is usually employed when the EU has exclusive responsibility or extended competences in a policy area and restricts the MS.

The two methods of governance are just "tools". They do not dictate policy preferences. The TEU informs the decision on the governance method selection with the principle of proportionality. This principle says that "the content and form of Union action shall not

exceed what is necessary to achieve the objectives of the Treaties". This wording gives room for normative speculations rather than positive interpretations. Practically, the politicians are, again, the ones who decide "how much governance is enough". Of course, we cannot overlook the fact that, though the method of governance does not dictate policy preferences, however it "signals" the policy preferences of those who employ it. So, what is the ideal method of governance in the field of taxation?

Thus far, taxation is considered as a sensitive subject because it is straightforwardly linked to the sovereign rights of the MS. Having that in mind, we can understand the reluctance of the MS to bestow their tax competence to the EU Institutions. However, the necessities of the common market may compel the MS to accept some concessions on tax issues. But these concessions, first, do not go beyond the level of the coordination method of governance and second, they are granted only for those tax issues that create significant negative externalities in the common market, or significant market distortions. In order the MS to accept to move a step forward and "harmonize" their tax policy through the regulatory method of governance, one condition has to be proved: that the coordination method of governance in a specific tax issue does not suffice to reduce the negative externalities and eliminate the distortions in the common market.

This sounds "economically rational", but in political terms, for every advocate for more tax harmonization you can find as many (or more) resisting advocates for tax coordination. This sounds also "economically rational" as long as the negative externalities for someone are the positive externalities (rents is the correct term) for someone else.

"Explaining" vs. "understanding" in the EU Tax regime formation

The European Parliament (EP) is not necessarily the most significant Institution of the EU in terms of Economic Policy, but it is, for sure, a microcosm of the economic views we meet in the EU as a whole. Every year the EP drafts the Annual Tax Report. This is a report that advices the European Commission (EC) and the Council about the ideas of the EP on taxation policy, it urges the other EU Institutions to take specific steps toward certain directions and urges them to fulfill policy commitments previously undertaken but not yet materialized. The cartography of the policy preferences between "coordination" and "harmonization" on taxation issues are mirrored in the prevailing views of the EP political families: European People's Party (EPP), European Conservatives and Reformists (ECR) and Alliance of Liberals and Democrats (ALDE) prefer coordination, whereas Socialists and Democrats (S&D), Greens and the European Unitarian Left (GUE) advocate for harmonization.

This year's Annual Tax Report (drafted by Eva Kaili, S&D, Greece), gave similar directions to the EC and the Council. It was divided into three parts: the first one underscored the need for using tax policy as a tool for economic growth, the second part stressed the need for a coherent view in the fight of tax evasion, tax avoidance, and aggressive tax planning, and the third underlined the need for further tax policy deepening through the European Semester.

In November 2014 this report gained a political momentum not previously experienced. The revelation of the Luxleacks cases casted light upon the practice of tax rulings. Tax ruling is a tax facilitation that a MS may grand to companies, capital owners and people, so as to attract them. This is not an illegal practice. However, the MS employing tax rulings are advised to inform the other MS about it. Luxembourg, under J. C. Juncker who was prime minister of the Grand Duchy in that period, advised the employing of tax rulings for some companies but failed to inform the other MS. This also was not illegal because the MS are only advised, and not obliged, to provide relevant information to the other MS.

The concealing of tax rulings to attract investments creates significant intra-market distortions in competition and negative externalities. In the post-crisis period MS, especially in the EU South, were placed under scrutiny and compelled to follow fiscal consolidation programs and irrational tax increases. According to the European Scoreboard of Macroeconomic Imbalances, for 2013, these increases made the EU 35% (in average) less attractive for corporate investments, whereas at the same time, Luxembourg was 216% more attractive. It was an issue of unfair tax competition. Though there is not necessarily consensus about tax competition in the EU, the writer of this essay believes that tax competition is positive as long as it is not harmful. We do not define "harmful tax competition" it fiscal terms only, but also in terms of transparency. As was indicated by the LuxLeaks, the EU consensus to fight tax evasion and tax avoidance and to restrict aggressive tax planning through the method of coordination failed.

This spectacular failure triggered those who advocate for more harmonization, the S&D and the Greens among them, to undertake significant political initiatives. The supporters of coordination on the other hand were in predicament and could not publicly oppose these initiatives. In March 2015 the EP decided to form a special ad hoc Taxation Committee (TAXE WG) and to draft a legislative proposal on the subject (Elisa Ferreira, S&D, Portugal with Michael Theurer, ALDE, Germany). At the same time, the Commission responded with further initiatives as well. First, it announced the intention to make the Common Consolidated Corporate Tax Base (CCCTB) mandatory and second it published a Proposal for a transparent tax regime in the EU.

The question in this case is straightforward: can these developments in late 2014 and early 2015 be evaluated as indicators of a gradual shift toward a "more" harmonized tax policy in the EU?

We need to explain the word "more". "More" implies that the shift to harmonization cannot be viewed as a general policy choice, at least not for the time being. Coordination is the step that the most MS feel comfortable and only in certain areas of taxation, e.g. transparency, is possible to move to harmonized policies. This means that the EU Tax regime can only be limited (interestingly, in the theory of International Regimes, a "limited regime" is also called "transparent regime"). We can reason about it not by trying to explain how policy-making actually happens in the EU, but only by understanding it. The distinction between "explaining" and "understanding" is crucial in this respect. We explain things in terms of "Economics", but we understand them in terms of "Political Economy".

"Economics" and "Political Economy" are two distinctive Schools in the study of Economic Policy. The "Economics" interpretation treats the policy-maker as an "outside observer" who examines the evidence and strives to find public economic decisions effective enough to influence private economic behaviors. This means that economic policies are regarded as exogenous, aiming to impact variables, e.g. the extent of tax evasion, but they are not influenced by them. On the other hand, the "Political Economy" interpretation also views the economic policy-maker as an "outside observer", but in this case the economic policies are regarded, contrary to the "Economics" perspective, as endogenous. Policies are determined by the economy itself. Consequently, according to the "Political Economy" view, the Government (the EU in our case) does not play the role of the "deus ex machina", as the "Economics" view holds, but as a machine per se directed by the politicians, their motives and their constraints.

If the "Economics" interpretation of the EU taxation policy-making was correct, we could follow this pattern of reasoning: (1) The common market requires a transparent tax regime so as to protect the market from the distortions and negative externalities of harmful tax competition → (2) we implemented the coordination method of governance to achieve this end → (3) the coordination failed → (4) so we proceed to restrictive regulations and obligations.

The reality is very different from that. The old Greek dictum that "politics is all about things we say and never do, and things we do and never say", is valid in the EU too. The discrepancy between intention and rhetoric cannot be overlooked on the formation of the Tax regime in the EU. Governments or institutions may take steps toward a certain tax policy direction with the aim not to implement it but to freeze its momentum. We have already observed it in the case of the Energy Tax, and the Financial Transaction Tax. Similar observations are made regarding the discussion for a mandatory CCCTB. EC may adopt it knowing that the Council will reject it. Moreover, we see that the EC publishes its Proposal on Tax Transparency and the fight against tax avoidance setting requirements for automatic exchange of information, but says nothing about the sanctions to the non complying MS.

The economic policies in the EU, and the taxation policies are not exempted from this rule, cannot be "explained" in "Economics" terms, but only be "understood" in "Political Economy" terms.

Building an efficient EU tax regime: Emphasis on the positive assumptions

In the first part of this essay we stressed that the governance shift in the EU tax regime from the coordination to the harmonization method requires evidence that the coordination method does not work for the achievement of the EU ends. In the second part we underlined that even if you have the economic evidence in hand, this does not suffice to shift from one governance method to another because EU policy actors do not inform their policy decisions relying merely on the economic realities but on "other realities" also. We

have also identified that there are today in the EU Institutions forces who favor the harmonization as well as forces who disfavor it no matter the economic evidence.

The first thing we need to understand is that neither harmonization nor coordination are sacred policies. They are only methods of governance. Tools. And as tools, they are there to maximize the welfare of the EU Peoples. In the taxation policy, which is a wide area, indeed, there is no evidence that a monolithic employment of the harmonization method increases the overall welfare. At the same time there is no evidence that coordination always successfully serves the same end. To the contrary, it is apparent that sometimes coordination fails. And when coordination fails actions should be taken. Actions should be taken also when harmonization fails.

This discourse implies that changes in the EU tax regime should not be equivalent to a shift from coordination to harmonization, but from a less efficient tax environment to a more efficient one, no matter what is our governance method. It is important to emphasize, thus, that the group of those who may favor harmonization is not homogeneous. There is harmonization type 1, and harmonization type 2. There are those who view harmonization in taxation as part of a wider normative program, namely the redistribution of income. There are also others who view harmonization as an ad hoc instrument which may increase welfare if used wisely. The first category of people view harmonization as a system to “make the multinational corporations to pay their dues to the society”, the second category views the harmonization primarily as a tool to make the intra-party competition work. This is similar to what we observed two years ago with the Financial Transaction Tax (which now melts slowly in the “coffer” of the enhanced cooperation). The first category viewed this tax as a way to make the financial markets (inherently evil in their mentality) to pay for the society they damaged. The second category of people viewed it as it is, a Tobin type tax, aiming to rationalize the market by controlling the volume of the transactions.

Somebody could say that if you look to the world through the lenses of “harmonization type 1” you see a red world, whereas if you look to the world through the lenses of “harmonization type 2” you see a blue world. Same world, different colors. The truth is quite different. You actually see two different worlds.

In the writer’s view, what makes tax harmonization work in practice is its separation from any normative assumption. Tax harmonization is a tool for welfare maximization not a system for fairer redistribution of the wealth. This is a positive assumption. The merit of this assumption is that allows the political actors critical to harmonization, to focus on the best (or second-best) policy options in a rational cost-benefit analysis, rather to stick to suboptimal political options (in our case the coordination) just because they are more convenient in normative terms.

Conclusion

In the first part of this essay we spoke about the "contest for the method". In the last part we explained how the methods are transformed into norms and we underscored the need to reduce them again in what they actually are: just tools. The selection of method must be made not in the "spirit of Puritanism" but in the "spirit of Utilitarianism". Unfortunately, both "harmonizationists" and "coordinationists" follow the Puritan's spirit. Coordinationists believe that tax harmonization is "evil by default", whereas harmonizationists (note that this category includes only the advocates of the tax harmonization type 1), also believe that tax coordination is "evil by default". If harmonizationists and coordinationists happen to meet so as to write a text together, prevails the wording of those who have the majority (!)

We want to believe that supreme principle in tax policy is not the principle of the governance methodology but the principle of tax efficiency.

Today we have plenty of evidence that tax coordination has failed in some very important fields of the tax area. Luxleaks is a sound case of tax coordination failure. Market distortions inhibited competition in the common market, and the luck of transparency created significant negative externalities, especially for those who have transparent economic life. This can only be remedied with a swift and aggressive response at the regulatory level. Concrete measures must be taken, time horizons must be set and sanctions must be defined for those who do not comply with the regulations.

An efficient tax regime must be either fair and transparent, or it cannot be defined as efficient. The way to achieve tax transparency is through tax harmonization, at least ad hoc harmonization. Generalizations about the functionality of harmonization cannot be inferred, of course, for every tax area. There is no optimal level of harmonization as long as there is no optimal level of Europeanization. Both shift in time. But this does not mean that we cannot make optimal taxation decisions today using tax harmonization whenever it is necessary to do so.

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49, Vas. Sofias Ave. 10676 Athens, Greece | Tel. +30 210 7257 110 | Fax +30 210 7257 114 | E-mail eliamep@eliamep.gr