PISM | POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 112 (565), 22 October 2013 © PISM

Editors: Marcin Zaborowski (Editor-in-Chief) ● Katarzyna Staniewska (Managing Editor)
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Holes in the Purse: The EU's Struggle with Tax Leaks

Patryk Toporowski

At the end of 2013, EU Ministers of Finance will present progress in action against tax avoidance and tax evasion, following a May 2013 special European summit devoted to these issues. Fuel for this debate was information that huge amounts of money are lost to treasuries due to the unfair practices of multinational companies shifting profits among tax havens. However, they have their roots in the sheer inefficiency of European tax systems, and EU governments are under pressure to make their practices more competitive. The EU-28 must therefore find a means of reducing competition from tax havens without resorting themselves to negative practices, all while walking lightly in a highly political area.

Amongst politicians, the most widely-quoted figure for annual losses to EU Member State coffers through tax evasion and tax avoidance is €1 trillion—almost the same as the seven-year EU budget. For its part, the European Commission assessed losses in VAT in 2011 at just €193 billion (around 1.5% of EU GDP) and part of this lost tax is due to bankruptcies, hence the real impact of tax leaks is significantly less than €1 trillion. During the current economic crisis, however, states are trying to re-establish fiscal balance, and revelations of "aggressive tax-planning" practices by Starbucks, Google and other giant multinational corporations have attracted the attention of policymakers. This practice, termed by the treasuries and policymakers as "base erosion" and "profit-shifting" (BEPS), is not new, and in 2005 the EU applied the so called Savings Tax Directive (subsequently reviewed twice) with the goal of sharing information between the treasuries in order to close down cross-country tax evasion. The directive is estimated to have recouped €543.7 million in 2009 for EU Member States, but significant holes remain.

In May, a special European summit originally devoted to energy issues was enlarged to discuss tax leakage. Leaders agreed then to act more boldly against tax evasion via capital leaks to tax havens. The most important items concerned the immediate adoption of the so called Quick Reaction Mechanism directive, a call for the Commission to propose recommendations (especially for global action) on addressing profit-shifting, the elimination of harmful tax measures, and meeting the challenges of taxation in the digital economy. The majority of the summit's conclusions concerned cooperation with third countries, or are supposed to be globally applicable. In December 2013, EU finance ministers will report on progress made in these efforts to mitigate tax evasion and avoidance. This agenda was echoed in the September G20 summit (largely congruent with the G8 action plan) in St. Petersburg, where leaders agreed that the automatic exchange of taxation information (planned to start from 2015) must become the international standard when it comes to ensuring that tax is drawn in the jurisdiction where value is created. The summit participants also supported OECD proposals to counter multinationals' strategies to transfer profits to tax havens.

Tax Havens and Beyond. Most of the proposed EU and global actions have the aim of hitting tax havens. And yet there is still no common understanding of what qualifies as a tax haven. The term commonly applies to jurisdictions with low or no tax rates on particular economic or financial activities, and with legislative systems and measures enabling the (legal) avoidance of taxes from other jurisdictions. Firms choose tax havens for several reasons. Apart from the most obvious grounds—"tax optimisation"—these include asset protection, protection from creditors and confidentiality. By this definition, such jurisdictions are located across the world, including within Europe (Cyprus and the British crown dependencies). But still, it is often difficult to say that the practice of transferring profits to tax

havens is illegal, only that it causes losses to state budgets and that the ability to transfer profits creates uneven cost competition between the firms transferring profits abroad and the others, which leads to gradual branch monopolisation.

The Treasuries' Fair Share of Blame. The focus on tax havens is only partly motivated by the intensification of BEPS practices. The more important issue is that governments are under pressure to find any means to balance their budgets, and firms transferring profits abroad are an easy target. Tax-optimisation practices, however, (including transferring capital to tax havens) are overwhelmingly within the framework of the law, hence it is difficult to blame firms for it Moreover, even a sober look at European tax systems shows they are not business-friendly and that they rank as among the most highly levied areas in the world. A brief analysis of the global index of economic freedom for 2013 reveals that the first EU country in the "fiscal freedom" sub-index comes in at 13th position (Bulgaria), and the next is 19th (Lithuania). A slightly better picture emerges from the Doing Business Index, which, rather than focusing solely on the level of taxation, includes the time required to pay the taxes (tax system stability, complexity and transparency). Still, the best EU country in this case, Ireland, is 5th, while the next ranked EU country, Denmark, is 12th.

Moreover, the thesis that the so called broadening of the tax base (that is enlarging the scope of money to be taxed) would improve the fiscal situation in these states is rather dubious. In simple terms, the more funding that governments have, the more actions they want to finance. The proof has been clear since at least 2000: while revenues grew, state expenses followed and the fiscal balance did not improve markedly, even in times of prosperity when revenues were relatively high.

Conclusions and Recommendations. EU governments face a challenge to reconcile tax competitiveness, tax harmonisation being difficult for political reasons. Even cautious steps towards greater harmonisation could have a beneficial effect on the EU's own tax competitiveness—in a global perspective—reducing costs for firms that operate in several EU markets, and making the single market more attractive than rival areas with a range of discreet tax regimes. A modest first step towards harmonisation would be EU-wide identification of best tax practices among the various treasuries in terms of collecting and constructing the tax system. An EU-wide search for possible loopholes in tax systems is an obvious next step: a common information system on corporate taxes, for instance, would help to improve tax collection without requiring the creation of a comprehensive EU tax system and would be a sound basis for a European component within the broader G20 framework.

A deeper framework would include "equivalent" mechanisms of taxation introduced in the EU-28 in order to eliminate possible preferences for certain business activities in one Member State over the others. This does not mean that taxation policy should be unified, but rather that it address the fact that the EU states increasingly "compete together" with third countries rather than against one another, and thus good practices should be echoed across the various national systems. One simple element of this possible new EU-wide framework would be to create a single EU-tax ID number for businesses, which could facilitate paying taxes in the EU. Such a measure would be quite easily implemented and could be independent of the other taxation changes.

Besides sending a political signal about leaders' willingness to simplify the European tax system, the creation of the framework would also reflect the lesson that the "one size fits all" model does not work in the area of economic governance, allowing national tax systems to reflect country-specific features, such as the level of the country's development or the structure of its economy in order not to harm other countries' finances.

In short, taxation systems under any common EU framework should share one over-riding feature: they should be effective in collecting levies from the broadest base possible, but they should above all be attractive to firms in an international perspective. By creating a new coordinated tax system, national treasuries should try to convince businesses to pay taxes within their jurisdictions, and they should rely on arguments and tools more sophisticated than the simple fact of business location. At present, this would require a shift in political thinking even greater than towards the question of harmonisation itself. Businesses should be treated not as potential cheaters but as partners willing to pay for using a high standard of public goods located in a particular area (including infrastructure, human capital and a good regulatory framework), in order to operate most efficiently. Since it is increasingly easy to run a business globally, corporations will otherwise consider moving their activities abroad, not only when it comes to taxation, and this would be even more harmful for the local society than mere tax avoidance.