Memo to the commissioner responsible for tax policy

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European Union tax policy faces stringent limitations because taxation lies at the core of national sovereignty. There are many examples of EU tax proposals that have either failed or are likely to fail. Nevertheless, backsliding on tax harmonisation in a less-favourable international context needs to be countered, and taxes can play a role in finding new resources for the EU budget. Priorities include tax simplification, taxation of high net worth individuals and digital nomads, and better taxation of capital income. You must also plan for the potential failure of Pillar 1 of the global tax deal, think more broadly on EU budget resources and reset the EU-Africa tax relationship.

Address undertaxed bases and tax competition

Promote simplification

Engage on Pillar 1 and digital services taxes

State of affairs

Tax policy at European Union level faces stringent legal and political limitations. This reflects the fact that taxation lies at the core of national sovereignty and consent to taxes is a core constitutional principle in all EU countries. Their tax profiles vary widely, with tax-to-GDP ratios ranging from 21 percent (Ireland) to 48 percent (France), with an EU average around 40 percent.

There is some basis for EU harmonisation of value-added taxes and excise duties (Treaty on the Functioning of the EU, Article 113), but no unambiguous basis for direct taxation such as income or wealth taxes (Article 115 TFEU provides only for an indirect basis, to "*limit distortions in the internal market*"). All tax decisions require unanimity.

Unanimity requirements and different member-state tax policies have made harmonisation very difficult

Some harmonisation has been agreed in the field of indirect taxes, notably on the definition of the base, and procedures and limitations in EU countries' freedom to fix rates (for example VAT and energy taxes). But over the past decade, the tax policy debate in the EU has focussed primarily on direct taxation, particularly corporate income tax (CIT), which is most likely to distort competition within the internal market. The combination of unanimity requirements and very different member-state level tax policies has made harmonisation very difficult. Low corporate income taxes in small open economies have historically coexisted with much higher tax pressure on companies in larger economies. This is true for CIT rates (10 percent in Bulgaria, 12.5 percent in Ireland compared to 25 percent in France and Germany) but even more so for the tax base.

Some progress was made during the 1990s and early 2000s in limiting withholding taxes on some intra-group cross-border flows within the internal market, with the Parent-Subsidiary Directive on dividends (2011/96/EU), the Interest and Royalty Directive (2003/49/EC) and the Merger Directive on taxation applicable to cross-border mergers and acquisitions (2009/133/EC). Despite calls to harmonise corporate income tax (European Commission, 1992), which later led to the Commission proposal for a common consolidated corporate tax base, no real progress was made on the legislative front until the early 2010s. Instead, beginning in the 1990s, some harmonisation was imposed by the European Court of Justice, which ruled that, while taxing non-residents differently from residents was allowed in principle, it should not constitute hidden discrimination based

on nationality[1]. This improved the consistency of domestic tax regimes, but EU countries remained unable to agree on common rules.

Since the 2008 global financial crisis however, the EU has made unprecedented progress on the back of global efforts, brokered by the Organisation for Economic Co-operation and Development, to reduce tax evasion and avoidance. Since 2015, the EU has implemented eight directives on administrative cooperation between tax authorities to fight tax evasion, and two anti-tax avoidance directives (ATAD) to limit profit shifting and corporate tax avoidance. The latter involved anti-abuse measures including controlled foreign company taxes and limitations on the deduction of interest payments.

On the procedural side, the EU adopted a dispute resolution directive in 2017 (Directive (EU) 2017/1852), increasing the scope and availability of tax certainty to taxpayers in the EU. The most recent and meaningful addition to the rulebook is the implementation of a global minimum tax, part of on the OECD's two-pillar solution agreed in October 2021, which will guarantee that multinationals pay at least 15 percent on their profits. In less than 15 years, bank secrecy has largely ended, with exchange of information on request and automatic exchange of information, and base erosion and profit shifting (BEPS) have been tackled seriously. The EU was the first adopter of the minimum tax. An essential condition that allowed the EU to overcome the unanimity requirements in these cases was member-state interest in the global agreements that preceded them, which were viewed as critical to level the international playing field.

In less than fifteen years, bank secrecy has largely ended

Despite the Commission's efforts, the EU has only rarely gone beyond OECD standards. Examples include country-by-country reports, which multinationals will have to publish from 2025[2], and the adoption by the EU Code of Conduct group of a list of non-cooperative jurisdictions that is more stringent than the OECD, but

1 This was referred to as 'negative harmonisation'. EU countries complained that these decisions were undermining the consistency their tax systems, but the Court responded that domestic tax systems could not contradict the EU Treaty and that it was not responsible for the inability of member states to agree common rules.

2 Pushed by the European Parliament, this was considered a non-tax issue and was adopted with a qualified majority.

has also raised some diplomatic issues. The ATAD Directives also went beyond the OECD by introducing so-called 'general anti-abuse rules' and an exit tax.

Member states have been lukewarm on the European Commission's efforts to leverage this progress. Your predecessors tabled several proposals which have either failed or are likely to fail – a 2018 proposal to establish a digital service tax, for example. In 2023, the Commission tabled a draft directive to reboot the common consolidated corporate tax base into BEFIT (Business in Europe: Framework for Income Taxation). BEFIT is stalling as member states remain reluctant to give up control in this area. Even a draft directive on transfer pricing, proposed at the same time as BEFIT[3], which would just translate agreed OECD rules into EU legislation to bridge a gap revealed in some state-aid cases, faces some challenges. It would result in EU countries transferring their international tax competence to the Commission, which they are reluctant to do. A few other proposals on fighting tax evasion and avoidance have not progressed (eg preventing the misuse of shell entities for tax purposes – UNSHELL – or securing the activity framework of enablers – SAFE). Overall, it seems clear that EU countries do not want to transfer tax competences to the Commission and the control of the EU Court of Justice.

You will have to handle the sensitive and important debate on own resources for the EU budget

Finally, you will have to handle the sensitive and important debate on 'own resources' to meet the growing demands on the EU budget. In December 2021, the Commission proposed three new own resources: 15 percent of the revenues from the EU emissions trading system (ETS); 75 percent of of the revenues from the new carbon border adjustment mechanism (CBAM), and a 15 percent share of the revenue expected from the application of the OECD agreement on the taxation of the residual profits of large multinationals (Box 1). In June 2023, in an update to the plan, the Commission proposed increasing the ETS contribution rate to 30 percent and suggested a new statistically based own resource on a proxy for corporate profits.

These proposals have failed to trigger much discussion among

3 Also at the same time as the BEFIT proposal, the Commission proposed a head-office tax system for small and medium companies, under which those companies would deal with only one tax administration.

EU countries, despite a call for them "*to accelerate the negotiations*", aiming at a unanimous decision by 1 July 2025 and the introduction of the new own resources in January 2026. Addressing this will be one of your priority issue, shared with the commissioner in charge of the budget.

Challenges

You have six main challenges to navigate. They also represent opportunities.

Avoiding backsliding on tax harmonisation in a less-favourable international context

The momentum for harmonising taxation and eliminating loopholes, driven by the G20 and deployed at the OECD, which has allowed the EU to adopt an unprecedented number of directives, is receding. The G20 is in crisis and geopolitical fragmentation makes new initiatives less likely. The OECD has broadly delivered on fighting tax fraud and evasion and new projects are unlikely to get enough international support. With the US failing to implement its international tax commitments, the G7 is unlikely to fill the gap.

Indeed, an EU-US conflict over tax policy appears likely. Starting in 2025, the EU will start collecting the minimum 15 percent on US companies that operate in Europe but have profits in third countries that tax them at less than 15 percent. Furthermore, the likely failure of Pillar 1 of the OECD's two-pillar agreement may lead to an EU digital services tax, which would hit mostly US companies (Box 1).

Box 1: US-EU tax tensions

The US Congress has not, at time of writing, adopted the global minimum tax and it is unclear whether the next administration will be more successful. This is a source of tension with the EU, as the minimum tax includes an interlocking mechanism by which, if a country does not collect the tax from its own multinationals, other

countries may do so. Starting in 2025, EU countries will start collecting the minimum 15 percent from US companies that operate in Europe but book profits in third jurisdictions where they are taxed below 15 percent (such as Bermuda or the Cayman Islands). This is in line with rules, but a Republican majority in the US might threaten the EU with trade sanctions for doing so (not understanding that it would require an unlikely unanimity to change the EU directive).

Pillar 1 is unlikely to succeed

In addition, and more importantly, Pillar 1 is unlikely to succeed. It would reallocate to market jurisdictions some of the profits of the world's largest (above €20 billion in revenues) and most profitable (above 10 percent profitability on sales) companies. A quarter of their rent (defined as exceeding 10 percent profitability) would be allocated to market jurisdictions based on a revenue key, whether or not the company has a physical presence in that jurisdiction.

Pillar 1 largely responds to the call by some EU countries to tax digital transactions in the countries where customers are located. The removal of digital services taxes in countries including France, Italy and Spain was conditional on the implementation of Pillar 1, and EU countries have agreed that without implementation of Pillar 1, a European digital services tax will be implemented. Pillar 1 requires a multilateral convention that has not yet been approved or signed. Even if it is, it is unlikely to be ratified, since this would require a two-thirds majority in the US Senate. The issue of the taxation of tech companies will therefore remain unresolved, implying tensions between the EU and US in the next five years.

Making taxation more growth-friendly

Europe is perceived as an aggressive regulatory environment, including on taxation. The past decade of strengthening tax cooperation, closing loopholes, putting in place anti-abuse measures and increasing tax revenues was long overdue. However, pro-growth measures have been missing, including in VAT where an upgrade of rules – VAT in the digital age – is perceived as adding another layer of compliance cost by innovative companies.

The Commission attempts to introduce business friendly measures have not been successful. A draft directive expediting withholding tax relief has been watered down by member countries even though it would remove obstacles to financial flows within the EU[4]. Tax administrations' fears of fraud are a serious obstacle to progress that would make the EU financial market more attractive. A Commission proposal to equalise tax treatment of equity and debt has also been ignored. Moving from the current 'anti-abuse agenda' to a pro-growth agenda will hence be challenging.

Pushing for EU-level decisions on individual taxation

Digital mobility has facilitated the emergence of 'digital nomads' for whom traditional definitions of tax jurisdiction are no longer fit for purpose

You should do this when it is more efficient than decisions at the national level. Digital mobility, particularly post-COVID-19, has facilitated the emergence of 'digital nomads' for whom traditional definitions of residence or tax jurisdiction are no longer fit for purpose. The resulting tax uncertainty for both individuals and companies (do companies have a permanent establishment in a country because some of their employees telework from there?) can be an obstacle for growth and should be addressed. The unprecedented level of income inequality between individuals also calls for action (Alstadsæter *et al*, 2023). Addressing these personal tax issues at EU level is both a challenge and an opportunity to reboot the EU tax agenda in a balanced manner.

Reinvigorating the EU's relationship on tax matters with developing countries, particularly in Africa

The role of the OECD in setting the international tax agenda is being contested by large emerging and developing countries. Following a campaign by African countries, the United Nations has established an intergovernmental group to develop terms of reference for a new international tax framework. This work is likely to challenge the OECD leadership on these issues. The EU has been

4 EU finance ministers agreed the rule in May 2024, but added exemptions that would mean some countries can opt out. The draft directive was aimed at tackling a situation in which relief procedures to eliminate double taxation are not harmonised, are still based on paperwork in some countries and waste time and money for investors. See Council of the EU press release of 14 May 2024, 'Taxation: Council agrees on new rules for withholding tax procedures (FASTER)', https://www.consilium.europa.eu/en/press/press-releases/2024/05/14/taxation-council-agrees-on-new-rules-for-withholding-tax-procedures-faster/.

outvoted on this issue at the UN and is criticised for not supporting developing countries. One of the reasons for the bitterness of developing countries is that the EU imposed 'good governance' principles (adoption of OECD standards on transparency and on BEPS) on many African countries which were not tax havens and no threat to the level playing field. CBAM, though not technically a tax issue, has just worsened the relationship.

Given the critical role of these countries as EU partners and the importance of domestic resource mobilisation in sustainable development, the EU should restore its reputation and influence with the Global South. The debate on innovative sources of financing for the energy transition may provide the EU with an opportunity to support the South[5].

Pushing for taxation decisions based on qualified majority rather than unanimity, taking advantage of likely EU enlargement

The more countries that join the EU, the more difficult it will be to agree tax rules unanimously

The more countries that join the EU, the more difficult it will be to agree tax rules unanimously. The history of enlargement has not facilitated a good tax dynamic, with low-tax countries joining the Union (Malta and Cyprus most recently). Eastern European countries have also challenged the group dynamic, even when rules had been agreed at OECD level (Poland and Hungary delayed by a year the adoption by the EU of the minimum tax, though they approved it at the OECD). Welcoming a cohort of new countries, with relatively low tax-to-GDP ratios, may increase the risk that progress on taxation becomes more difficult if not impossible. But changing the decision-making rule is not trivial, nor is it a technical issue. It raises the question of the nature of the institution, with a move to qualified majorities meaning a move to a federal system. As such, it is unlikely to resonate positively with the membership in the current political circumstances.

Negotiating a successful compromise on own resources

You will need to do this taking into account tensions between

5 The Commission is a member of the International Tax Taskforce, established at the COP28 climate summit at the end of 2023. The taskforce's goal is to find new sources of development and climate finance. See https://internationaltaxtaskforce.org/about.

frugal states and those supporting more action from the EU. On the proposals tabled by your predecessors, there will be a debate on who bears the cost. The currently open own resources proposals would tend to rebalance the burden from Eastern European countries (more impacted by the ETS) to larger member countries and small open economies including Ireland and Luxembourg, which would be most impacted by the proposed own resource based on a proxy for corporate profits.

Recommendations

Address tax competition for high net worth individuals and digital nomads

You should explore the possibility of establishing a code of conduct on personal income taxation

For this purpose, you should explore the possibility of establishing a code of conduct on personal income taxation. This would allow for a soft form of cooperation to take shape at EU level and would create a basis for discussing common approaches. There should be a recurrent opportunity for EU countries to inform the others on their personal income tax systems, allow for a review process to identify the most harmful schemes, and discuss common standards that could be agreed. The EU has already had good experiences with the Code of Conduct Group on Business Taxation, which should be taken as the template for personal income taxation.

Explore better taxation of capital income

For instance, political momentum exists for a new individual capital gains tax, which should however be ideally harmonised at EU level. The personal income tax base is currently not fully aligned across EU countries, distorting the allocation of capital in the EU. Triggering a debate on the principle of capital gains taxation within the EU could also provide the EU with a global leadership role on this issue.

Push for tax simplification as a priority

This should include more effort to achieve a Capital Market Union, with the possibility of introducing common tax incentives for pension savings. Following through on existing pro-growth

proposals, such as on withholding tax relief (see footnote 4), should also be a priority. And in line with the implementation of the global minimum tax, a comprehensive review of the ATAD anti-abuse rules might be necessary, to avoid duplication of administrative burdens related to the global minimum tax and other anti-abuse rules, if the rules end up having the roughly the same impact.

Engage with the US and seek an alternative solution if Pillar 1 fails

Digital service taxes are distortive and will ultimately be passed on to consumers

Digital service taxes are distortive and will ultimately be passed on to consumers, making them a 'European tax on the Europeans' rather than a tax on the American tech giants. In case of a roadblock in the negotiation, a very large base and low-rate tax could be a way out, in consultation with the US.

Promote the taxation of international bases that are currently untaxed

You should explore how aviation taxation could be strengthened internationally and take the lead to establish the necessary forum on taxing carbon emissions from the shipping industry, which so far has been out of scope of any international agreement. You could also explore progressive carbon taxation as a way to increase the legitimacy and acceptance of those measures among the broader public.

Leverage the need for new own resources for the EU budget to build EU external tax borders

This would both strengthen the EU's capacity to raise revenue and increase coherence in the tax system. The ETS and CBAM should be revisited and enriched. Pigouvian taxes, that aim to raise revenue while penalising bad behaviour, should be explored.

Reset the EU's tax relationship with Africa

This can be done by reducing the scope of countries that are assessed for compliance with OECD and EU tax transparency and anti-evasion standards. This is currently much too broad and includes countries merely because they have economic links with the EU or because they are aid recipients, even if they are not tax

havens, like most African countries. The current metrics determining scope should be replaced by a risk-based approach, resulting in the removal from the assessment of most developing countries, particularly African countries. Prioritising concrete counter-measures against illicit financial flows, through a dialogue with the African Union, would help restore the relationship.

References

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