Chapter 1
The Role of National Tax Policies in the European Union

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1.1 Introduction

Taxes are used not only to collect revenues for public programs but also to try to improve the functioning of the market economy. At the same time, in a world where in most cases, taxes – and not only those used for internalizing social costs in private behaviour – are not neutral, they result in changed behaviour by households and corporations. Policymakers have therefore for decades tried to strike a balance between different objectives. The economy must function well and the tax burden must be shared in an equitable way. The level of sophistication of policy makers varies over time and from country to country. Some politicians emphasize the increase in net income over time resulting from faster growth while others emphasize the allocation of tax payments in a given year.

Despite the already complex situation, policymakers now face an even more intricate problem – the division of national tax policy and supranational tax policies in an economic union like the European Union (EU). For those countries participating in the European Economic and Monetary Union (EMU) as well, an evaluation of the role of national tax policies may seem even more important. The efficiency arguments now extend to the allocation of resources, production and investment, throughout the Union. At the same time, taxes are collected at the national level and revenues are to a very large extent used in the domestic economy.

Governments are faced with a policy dilemma. An efficient and prosperous economic union, which governments have endorsed in the Lisbon accord, seems to call for the elimination of tax obstacles. At the same time, elections are national and to ensure re-election of governments, the domestic economy must be a winner in the global competitive race between countries. Furthermore, an ageing population may call for further public programs and a demand for revenues. Hence, national tax policy is restricted by the need to safeguard sufficient tax revenue and social security revenue to finance the welfare state. To ensure such revenues, the national economy must be in good shape. Externalities may have to be handled by using the tax instrument, while incentives to work, save and invest must be maintained or enhanced further.

From a legal point of view, taxation to a large extent (with the major exception of VAT) still falls within the competence of the Member State. This is particularly true for direct taxation, for personal and corporate income tax. Within the European Union national tax policy is frequently driven by tax competition, as can easily be seen by the considerable decline in statutory tax rates among Member States during the last decades and by the efforts to achieve fairness in tax competition. The Member States however, even though being in principle autonomous in their tax policy, face considerable restrictions that result from the Treaty of Rome and political aim to eliminate tax obstacles to make the EU an efficient economic union. Those restrictions are mirrored in primary and secondary EU Law, in jurisdiction by the European Court of Justice (ECJ) and also, with a longer tradition, in bilateral double tax conventions. Additionally, national tax policy is restricted by the need to safeguard sufficient tax and social security revenues to finance government spending.

1.2 Taxation and the Changing Economic and Legal Environment

Will it then be possible for national governments to pursue adequate national tax policies while at the same time eliminating tax obstacles to make the EU an efficient economic union? Which are the economic incentives for governments to continue to strive for national tax policies and what legal room do they have to pursue them in a globally competitive environment, being members of an economic union – the EU? To what degree does the EU restrict Member States' discretionary freedom to pursue national tax polices? These questions arise from several economic and legal developments in the European Union. In particular at a union level:

- the setting of an open economy
- the use of taxes to internalize costs
- the lack of democratic legitimacy in the European Union for taxation
- different views on the role of the government
- the degree of (de-)centralization of tax legislation
- the degree of (de-)centralization of social security

Tax Policy in a Closed Economy Versus in an Open Economy

In a closed economy the design of tax policy is to some extent easier to handle and leaves more leeway. Whether a tax is levied on investments or savings may yield the same net result. Certainly, high levels of taxation will still impact incentives to work, save and invest, and the tax bases may therefore be eroded by excessive levels of taxation, but the tax base will not migrate out of the country. Only if people leave the country, are they able to fully circumvent taxation.