Fiscal Unification Going Unnoticed?

Trends in the European Union's Involvement in National Tax Policies in the Onset of the Euro Crisis

by

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Abstract

The aim of this thesis is twofold. Through a critical review of both primary and secondary sources, I assess how the EU-level exerts control over member state tax policies, and what trends can be seen in this field – with a special emphasis on the effects of the euro crisis. The first hypothesis proposes that the crisis would accelerate EU involvement in member state tax policies through the adoption of functions of regulatory nature. As findings show an apparent central role of regulating tax policies in the strengthened structure of fiscal surveillance and an emerging 'fiscal stability union', this hypothesis is vindicated. The second hypothesis assumes that there are well-traceable conflicts of interests and interest coalitions between member state governments in the fields. After analyzing publicly announced member state positions and conducting interviews with Brussels-based EU officials, what emerged was a severely polarized political landscape with several conflict lines, both between the EU-level and member states, and between individual member states – while coalitions are typically only formed on an ad hoc basis. These findings suggest that further tax harmonization and systemic reforms in this field, which would both require the unanimity of member states is not probable in the near future, except for a smaller group of member states proceeding by using the 'enhanced cooperation' mechanism.

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Introduction

The question very often posed as the single most important one for a generation of Europeans is whether the crisis-torn European Union is moving towards further unification to become some kind of a superstate or, for the first time in the 50-odd years of history of integration, it will take a turn and start to reverse direction. The main driving force behind these discussions is the prolonging crisis of the common currency. Proponents of a *fiscal union*, a *stability union*, and even a *fiscal federation* came forward to push the euro area member states towards policy reforms that could pave the way out of the present turmoil caused by serious imbalances in fiscal overspending, sovereign debts, as well as in competitiveness and current accounts (European Council, 2012, Barroso in: EurActiv.com, 2012a). What emerged as the major underlying issue in the debate over the continent-wide crisis is the necessity of further integration on the fiscal side of economic governance. The need for tighter central coordination of fiscal policies was extended to the other 10, non-euro zone EU members as well, creating an overarching, Europe-wide vision of harmonized fiscal policies – which in turn met strengthening fears about the loss of national sovereignty (see, for instance: Pew Research Center, 2012). Also, the ever-present discontent with the democratic legitimacy, accountability and transparency of EU institutions was brought to the surface.

Arguably, of all governmental functions of modern polities, taxing power – the ability to directly raise revenues from the citizens – is the most symbolic one. Thinkers from Karl Marx to Joseph Schumpeter referred to it as the very essence of statehood (Marx, 1852 and Schumpeter, 1918 cited by: Genschel and Jachtenfuchs, 2011). It is also an indispensable part of national sovereignty – something European Union member states zealously guard. What logically follows from this argument is that the EU, which is, according to many sources an emerging federal

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state[1], will take a major step towards actual federal statehood if it centralizes the core governmental function of levying taxes.

Another argument to underscore the central significance of the issue is that since the American Declaration of Independence, taxation has also been intrinsically linked to democratic representation. Taxation is a momentous form of government intervention into citizens' lives; therefore, tax systems should be transparent, visible and understandable for citizens. Tax rates and the related distributional and ideological conflicts should be debated and then decided upon with the participation of the citizenry, either directly or through representatives. From this reasoning, it follows that an existing public sphere and a mature political community is a prerequisite of taxation – the citizenry has to be capable of setting salient questions on the political agenda, and it has to have a means through which their preferences can be included in the decision making process on any jurisdictional level of the polity. The issue is triggering heated discussions both among academics (for the counter-arguments, see: Uhl, 2006, while Le Cacheux, 2007 defends the case) and politicians (most famously, Farage, 2010 versus Cohn-Bendit and Verhofstadt, 2012).

These are the reasons why taxation has always been a policy field, where member state sovereignty still prevails and the European Union has very limited powers. Digging deeper into the question, however, one less recognized argument comes up immediately. Works of Genschel and Jachtenfuchs (2009, 2011), Ganghof and Genschel (2007), Graetz and Warren (2007), Kemmerling (2011) and many others demonstrate that although member states have formal autonomy in the field of taxation, the EU-level does exert effective control over tax policies of member states as a regulator with extended powers, and one of the pre-assumptions of my research is that this regulatory type of control has been expanding since the outbreak of the 2010 euro crisis. The term 'regulatory governance' is borrowed from Giandomenico Majone (1996,

[1] For the most famous utterance of the 'f-word', see: Barroso in: EurActiv.com, 2012a

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1997, 1999, 2009), who understands it as utilizing more technical, and therefore also politically less salient means for political influence, in contrast to 'positive governance', which incorporates the more interventionist duties of the state, having ideological or redistributive conflicts involved.

In case of taxation, an example for the European Union's regulatory type of intervention into member state tax policy making can be the regulation of tax bases, while the positive mode would be granting the EU the power to tax and spend. Since taxation itself is a textbook example of a positive state duty, identifying attempts to influence it through regulatory means may illuminate some of the fundamental structural controversies in the edifice of the European Union multilevel governance framework.

Detparting from the motivation discussed above, the two-fold aim of my thesis can be summarized as follows:

(1) I carefully examine which levels of the multilevel EU-polity are involved in tax policy making and how exactly do the separate levels exert power over tax policy with a special emphasis on the developments in the onset of the euro crisis.
(2) I assess cost-benefit structures of policymakers when deciding about further integration in the field of taxation. From the actors involved, I look at the EU-level, represented by the European Commission, and the member state-level, represented by the incumbent member state governments.

This already traces out the two approaches that I use in my thesis. The first looks at the structure of the polity (*structural analysis*), while the second approach looks at the actors within the structure, assesses their incentives and cost-benefit calculations, assuming rationality (*actor-based analysis*). Since taxation is a complex study field, encompassing economic, legal and political dimensions at once, I aim to incorporate the points of view of Economic, Legal and Political Sciences, with an obvious bias towards the last one.

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In order to give a detailed picture about the present state of taxation in the multilevel governance structure of the EU, and thereby also give an overview of the actors involved, I will rely on a thorough review of the existing literature, monitoring of the news media and some qualitative research of my own. I conducted 3 interviews with Brussels-based EU officials (they wished to remain anonymous), who are involved in the joint policy making process between national governments and the European Commission (two of them from the side of the domestic government, at the Hungarian Permanent Representation, Economic and Financial Unit and one of them from the side of the Commission at the Directorate General for Taxation and Customs Union).

In the actor-centered analysis, I attempt to trace back member state motives by the analysis of publicly announced positions and with the help of some background information from the interviews. The approach I use is a standard Political Economy perspective as understood by Alan Drazen (2004) which aims to show how economic policies are made in face of political constraints. The actors I identify are the European Commission, representing the EU-level, and incumbent member state governments. Due to pressing reasons for simplicity, I only briefly touch upon the conflicts of interest *within* member states – between governments and oppositions, or different interest groups, for instance. I also exclude important other players, such as the European Parliament or the European Central Bank. The reason for this is that the focus of my research is on an area, where decisions are typically made with an intergovernmental method (rather than co-decision or Community method) – by a unanimous vote of the European Council, the European Parliament in only a consultative, not in a decisive role, while the ECB only indirectly affecting the process (for more on this, see Puetter, 2012).

My contribution lies in the analytical framework I build up by linking concepts and theories from the vast literature that has been written in the subject field and using it for the critical evaluation of post-crisis developments. I also conduct qualitative research by means of document

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analysis and interviews to trace back actor motives when dealing with tax-related functions of the EU.

The main research questions I address in my thesis and the hypotheses I aim to assess are as follows:

Q_1: How does the EU-level influence member state tax policy making in the present structure of EU multilevel governance, and what trends can be seen in this field?

Here, I depart from the hypothesis that the euro crisis accelerated EU involvement in member state tax policies, and this involvement is extending through the adoption of functions of regulatory nature.

Q_2: What motives drive member state governments when deciding upon delegating certain tax-related governmental functions to the European level?

In the case of member state motives, my initial assumption was that there are well-traceable conflicts of interests, which map out coalitions of member states and result in a polarized political structure.

In Chapter 1, I set down the theoretical foundations of my research. After a thorough review of the literature, I build up a conceptual framework to accurately pin down the approaches, assumptions and concepts that will guide my argument throughout my thesis. The central concepts of the framework are the multilevel regulatory model of EU governance and the problems related to the structural deficits and democracy deficits it, different theories of policy convergence within the EU, and finally, the theories of fiscal federalism and fiscal competition.

In Chapter 2, based on the theoretical bases laid out in Chapter 1, I turn to the case of the European Union and discuss the main alternatives that emerged from the present debate over fiscal integration and the creation of a fiscal union. As the real content of the different

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alternatives is still unclear, I give an overview of all the different proposals and their understandings.

In Chapter 3, I assess the present state of EU involvement in taxation-related functions, including developments since the outbreak of the crisis. Based on an analysis of the legal framework and findings of Ganghof and Genschel (2007), Genschel and Jachtenfuchs (2011), Uhl (2006), Kemmerling (2011) and others I conclude that the EU exercises substantive power over tax policies of member states through secondary legislation of the Commission and Court of Justice of the European Union (CJEU) jurisdiction. I devote a lengthier section to the analysis of the recent developments in EU involvement into member state tax policy making by means of soft law, within the strengthened fiscal coordination framework called the European Semester. Here, I have the initial assumption that the Europe-wide crisis gave a push to the EU affecting national tax policies by regulatory means.

In Chapter 4, I shift the focus of my research from the structural approach studying the polity as a whole to the individual actors (member states and groups of member states). I assess how their cost-benefit structures look like and what incentives drive them in their political choice of delegating certain (regulatory or positive) governmental functions of taxation to the central level or not. I thoroughly assess the costs and benefits of different member states when deciding upon the question above (staying in the status quo or opting for delegation to the European level). In order to trace back the motives behind policy makers' decisions, I rely on multiple sources of available data – and map out the attitudes towards either forms of cooperation in the field of taxation (both regulatory and positive). Based on the mapping of interests in the previous chapters, I attempt to model the decision of policy makers in both questions.

In Chapter 5, I conclude by summarizing the main findings of my research and proposing areas of further research.

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Chapter 1 – Conceptual framework

In this chapter, I develop a conceptual framework that I will use to throughout my thesis. I elaborate the elements of this by giving an overview of the relevant strands within the immense literature on European Union governance, and derive my concepts from the most important debates shaping academic discourse on the subject. I put an increased emphasis on careful and exact definitions, since I see it as a general problem of EU-related public (and in part, academic) discussions that they do not accurately define the concepts which are being used. Since these frameworks orient thinking without being noticed, using inappropriate conceptual tools can easily lead to biased inferences.

In the exceptionally complex, multidimensional study field of EU governance, it is an essential first step to disentangle the major theories, concepts and approaches that are relevant for my research. The most important strands of theoretical literature I will discuss in the followings are:

- the governance approach to European integration
- the European Union as a multilevel polity
- the dichotomy of positive and regulatory governance
- dilemmas over democratic legitimacy and accountability within the EU
- the extensive literature on policy transfer in case of tax policy making
- and theories of taxation in a multilevel polity (fiscal federalism and fiscal competition).

Since all the above points have generated heavy volumes of literature, my endeavor here is to give a brief overview on each and integrate the concepts into a theoretical model that can be used throughout my research.

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1.1 Theories of EU multilevel regulatory governance

1.1.1 Governance approach to European integration

As Simon Hix, Markus Jachtenfuchs and many others pointed out – when approaching present day problems of the European Union attention should be shifted away from both neofunctionalism and intergovernmentalism (the fist one supposing a more or less linear centralization tendency, the second one a relapse into an international organization), the two major accounts of classical integration theory. Besides looking at the forces creating and shaping the Euro-polity, which these classical theories aimed to do, the focus of the inquiry has to move to the polity itself, and the governance structures thereof. This is the so-called governance approach to European integration (Hix, 1998; Jachtenfuchs, 2001). Hence, the question is not whether the integration process moves forward or backward, but how existing institutional conditions of the EU shape incentives of policy makers on the respective levels of the polity, how this affects policy outcomes (in other words, how "Europeanized" policy making is).

Supposing a linear model of integration, in which progression and retrogression are the only options available, is an important obstacle in the way of making sense of structural problems within the EU. A more useful way of grasping the problem is to think in terms of an institutional equilibrium, which is upheld by a set of incentives of the actors within. A simplified application of Lipsey and Lancaster's 'theory of second best' (borrowed from welfare economics) may be used here to support this view and explain why one more step towards tighter integration is not necessarily a Pareto improvement, even if we presuppose that more integration is optimal.

If one aims to achieve an improvement in the system, where there is a constraint and only one Pareto optimality condition cannot be attained, it is possible that one has to depart from all other optimality conditions in order to get to a new equilibrium, and simply lifting the constraint does not lead to a Pareto improvement (Lipsey and Lancaster, 1956-57: 11). In our example, it

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might follow that it is possible to get to an equilibrium position that is better from the point of view of integration by moving a few steps backwards, since a welfare increase can only be achieved by moving forward not only in one field, but in a set of different fields at the same time.

While using the theory of second best, the emphasis in this case is somewhat different than in its most frequent application in the particular matter of taxation (see, for instance, Frenkel et al., 1991). However, the simplified model can well be employed in the context of general European integration theory as well, suggesting that integration in one policy field does not necessarily make a community better off than the starting position, if it is fulfilling only one of the optimality conditions instead of fulfilling all of them simultaneously. This may constitute an argument against the narrow perspective of looking at "how far along" the integration process has come, and prompts us to examine the institutional equilibrium in its complexity, by posing the questions: what forces are at play which maintain the equilibrium, and what are those working against it.

The above discussed ineffectiveness of looking at assignment of functions as a linear integration process can also be derived from the complexity of the government functions spread among multiple levels of the EU polity. This will be discussed in the next section.

1.1.2 The EU as a multilevel polity

Throughout my research, I consider the European Union a multilevel polity, as discussed by Hooghe and Marks (2001) and others.

It is another useful conceptual clarification, since the institutional form of the EU is diversely conceptualized – the notions ranging from intergovernmental institution to unfinished federation. The notion of multilevel governance is closely connected to that of a federal state. While the latter denotes a system of constitutionally guaranteed power sharing between a federal level and subfederal jurisdictions (Marks et al., 1996), the former notion is a looser form of the

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latter one: a mode of policy making through negotiation and cooperation process between constitutive levels and in which "supranational, national, regional, and local governments are enmeshed in territorially overarching policy networks" (Marks et al., 1993: 402). By using the multilevel governance model, the frequent problem of using empty, unclear political slogans ('fiscal union', 'fiscal federation', 'political union') can be tackled.

The case of the European Union as a multilevel polity is quite a special one. Those competences constitutive of modern (federal) statehood like security, revenue collection and redistribution, education or health care strictly reside with the member states (Moravcsik, 2002). The EU-level has quite a strong legal mandate, however, in creation and regulation of the single market, more precisely the removal of barriers so that "the free movement of goods, persons, services and capital is ensured" (Art. 26 (2) TFEU). This set of regulatory competences empowers the EU to influence the otherwise exclusive member state competence of taxation as well, since it is able to prohibit or abolish certain taxes by legislative and judicial means. These powers of the EU will be of central importance later.

Governance in the multilevel polity framework is often studied through the notion of delegation. In case of the EU, there is no constitutional blueprint establishing which competences are assigned to which levels of jurisdiction. The treaties do provide some ink lines determining the distribution of competences[2], the most remarkable being the principle of subsidiarity – which subscribes each function to the lowest possible level where there is competence and information to execute it (Art 3(b) TEU). But as the whole governance structure is still in movement, the question most of the time is still whether member states should delegate a particular governmental function to the EU-level or continue executing the function independently. Delegation is often put as a transfer of powers to the European level.

[2] it was an explicit goal of the Lisbon Treaty to make an improvement in this field, see, for instance, europa.eu, 2009

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Another aspect that must not be excluded from the analysis is that the distribution of competences is never quite straightforward. Rather, a general trend of the 'Europeanization' of policies is assumed (see, for instance: Risse and Börzel, 2000; Jachtenfuchs, 2001; Héritier, 2002), which means there is a general trend towards the affectedness of all policies by the EU-level, but the competences are not mutually exclusive, and the outcome of these partly overlapping competences result in a *policy patchwork* (Héritier, 2002).

1.1.3 Positive and regulatory models

Another important conceptual tool used in my present research is the dichotomy of positive and regulatory statehood, theorized by Giandomenico Majone (1996, 1997, 1999, 2009). Positive statehood incorporates interventionist duties of the state, like the provision of internal and external security (also: national defense) and prosperity. In modern welfare states, these positive objectives of internal and external security and prosperity are understood in a substantive sense, seeing the state as an active, adamant promoter of both stability and economic growth by state intervention (Beer, 1993).

The 3 basic forms of state intervention, according to Majone are income redistribution, macroeconomic stabilization and market regulation (Majone, 1997). Redistribution is the classic positive duty of the "taxing state" – the transfer of resources from one group to another. Macroeconomic management is also a crucial tool in hands of interventionist governments – Keynesian demand management and counter-cyclical, expansive fiscal policy being the prime examples. Market regulation is the activity of the state to create the basic prerequisites for free competition, and to intervene in case of market failures.

The European Union has no means to act as a positive state, since it lacks the power to raise taxes or to borrow and operates no redistributory scheme independent from member states (has independence neither on the revenue, nor on the expenses side). However, it does indeed act

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as a regulatory state. Through its mandate to act in furtherance of the single market, it has extensive powers in the field of market creation and market regulation, as well as in the designing of protective norms in areas such as labor, health care or environmental policy (Eberlein and Grande, 2005; Genschel and Jachtenfuchs, 2011).

According to Majone, the European Union emerging as a regulatory state can be linked to two reasons. On the one hand, the move from interventionist to regulatory state was a general trend in modern industrial states, as "the beneficent role of the positive state – as planner, direct producer of goods and services, and employer of last resort – began to crumble in the 1970's" (Majone, 1996: 4). General trends in market liberalization and public sector privatization were also pointed out by many (Scharpf, 1999). International competition and European integration triggered a change in the mode of government: from taxing and spending to rule making (Majone, 1997:1). What reinforced these trends was the European Commission's strategy of gaining influence by expanding powers in the regulatory field – as it was neither politically nor legally feasible to do so in the interventionist one. As Majone argues, the EU institutional framework is not suitable to handle matters of high political salience, such as taxation and spending, as it lacks the transparent, democratic processes, through which ideological conflicts could be channeled. Positive action needs to be authorized by a democratically legitimate set of institutions (Majone, 2009).

One basic difference between a positive state and a regulatory state is that a positive/ interventionist state has a strongly centralized administration and policy-making apparatus, while in a regulatory state powers are mostly apolitical and of technical nature, so they are typically delegated to independent, depoliticized, non-majoritarian institutions (Majone, 1997). These non-majoritarian institutions may pose the problem of the lack of democratic legitimacy as well as the lack of effective mechanisms for accountability and scrutiny.

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Scharpf refers to a new aspect of the problem, by introducing the dichotomy positive and negative integration. He argues that most regulatory activities the European Union takes on are based on negative actions – the abolishment of barriers to create the common market, judicial annihilation of member state taxes if they are in conflict with the free movement of goods, persons, services and capital. This, according to him, constitutes a bias in policies towards deregulation and market liberalization (Scharpf in: Marks et al., 1996). Although in our examined case of taxation, this thesis cannot be vindicated, as there are a lot of non-judicial regulations as well, it is important to bear in mind the characteristics and possible consequences of negative integration driven by the Court of Justice of the European Union (CJEU).

Authors like Genschel and Jachtenfuchs (2011), Uhl (2006), Ganghof and Genschel (2007), Follesdahl and Hix (2006) and others point out that there are limits to the validity of the positive-regulatory model and in some cases these two modes of governance cannot be separated as clearly as Majone suggests. Although regulative and technical in nature, measures aiming at the creation and regulation of the common market can exert a substantial impact on governmental functions as well. In case of taxation, for instance, EU involvement is advancing through seemingly technical, apolitical, regulatory means, but this process influences member state revenues and taxing structures, while potentially also having redistributive consequences (Ganghof and Genschel, 2007). Therefore – these authors argue – a serious problem with regulatory governance is that it conceals the distributive, politically salient sides of the measures taken, and thus these measures also escape political contestation (Genschel and Jachtenfuchs, 2011:306). A hybrid model emerging from the processes outlined above is an important element of the analysis I perform in the following chapters.

1.1.4 Democracy deficit in multilevel regulatory polities

From the point of view of citizen participation, democratic legitimacy and transparency, multilevel governance has inherent dilemmas. Proponents of the democracy deficit argument

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point out that while there is an erosion of the autonomy of the nation-states, EU-level participatory institutions are not catching up to take their place. Erosion here refers to the trend that the control of some processes are out of reach for national parliaments, while supra-national institutions are not yet (and according to some, never will be) able to accommodate democratic participation and accountability (DeBardeleben and Hurrelmann, 2007). Some point out that the ever tighter cooperation has been accompanied by an increase of the power of the executive branch – executives in the EU not effectively scrutinized by the legislative, nor the EP nor national parliaments (Follesdal and Hix, 2006).

The European Parliament, a popularly elected legislative body could serve as a balance here, but the EP itself also suffers from low levels of legitimacy. The party system of the EP is often said to be underdeveloped, still dominated by national issues, European ones not on the agenda (Hix et al., 2003). According to some further critiques, EP elections resemble "second-order national contests" (Reif and Schmitt in: Hix et al., 2003). The institutional operations are also dysfunctional, because of the difference between the length of mandate for the Parliament and the Commission – and the mid-term budget debate. In order to create channels of accountability, these should be harmonized (Le Chacheaux, 2007).

Therefore, the European Parliament cannot serve as a public sphere for European citizenry. The effective political debate over salient topics, hosted by the most frequented political forums and ideological strongholds of each position are sorely missing. Another vital tool for public discussions – common European media outlets are not widespread either. (For more on this, see Wessler et. al. in: DeBardeleben and Hurrelmann, 2007).

Optimistic views see this problem as a structural deficit, which can eventually be overcome by reforms in institutional design, more skeptical observers point to the fact that the problem lies deeper, namely the lack of a 'European demos' with a common identity and some degree of

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solidarity, and the feasibility of these in a rather heterogeneous union of nation state is doubtful (DeBardeleben and Hurrelmann, 2007).

The previous section discussing regulatory and positive modes of governance also has direct relevance here. Partly because of the cumbersome political process, integration proceeding by politically less salient regulatory means, depoliticization of processes, creation of non-majoritarian, non-elected decision-making bodies (discussed in length by Moravcsik, Majone, Hix and others) has become a dominant way of policy–making.

Among others, Fritz Scharpf famously criticised the EU for the lack of 'input legitimacy', meaning elected and accountable decision makers, democratic electoral systems and transparent channels of scrutiny. However, the European public still appreciated the 'output legitimacy' side, meaning positive responses from international market actors, and consequently, good economic performance (Scharpf, 2011). But with the continent-wide crisis causing output legitimacy to slowly evaporate, the need to address the problems of EU-level democratic deficits will be more acute than ever.

Scharpf also argued that the possibilities to effectively hold decision makers accountable are seriously restrained, as the actual decisions are not entirely controlled by the domestic levels, they are strongly influenced by the EU as well. This, in turn is in stark conflict with the strong competences already delegated to the EU level (Ibid.). Creating channels for political decision making, which enable citizens to actively shape those happenings which have a direct impact on their lives, is a pressing urge in the face of processes outlined in the present research. The success of reform measures is highly dependent on a broad support from the citizenry. If European citizenry is not democratically empowered to influence the course of events on the supranational level, and parallel to that, has not developed a sense of European identity and some level of solidarity towards their fellow citizens in other member states, it is also not likely that they will be ready for the sacrifices which are necessary to keep an interdependent scheme working.

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Because of the redistributive and ideological conflicts involved, taxation has always been one of the most salient questions for the electorate, therefore above discussed problems about a well-functioning institutional design appear particularly harshly in this field. There are severe criticisms against the present forms of EU involvement in member states' tax sovereignty through regulatory means, for instance, from Susanne Uhl (2006), who urges for a new "Tea Party" in response to the no taxation without representation principle being violated.

1.2 Theories of policy convergence within the EU

Ways how the EU-level affects national policy making are also discussed at length by Public Policy theorists. There is an extensive set of theories and concepts aiming to explain the mechanisms at work while policies evolve as an outcome of the complex interrelationships between the multiple levels of the EU polity. What follows is a very brief account of some slices within this immense literature, so that I can specify the concepts that will be used in the later chapters of my thesis.

International policy convergence and diffusion, through imposition, harmonization, regulatory competition and communication or policy learning, as described by Holzinger and Knill (2005) constitutes a powerful framework for the analysis of taxation in individual member states and the EU:

- Imposition or coercion is the open use of political power to impose one's will on policy makers – the prime example for that is conditional lending to countries. In case of the EU at present, Greece, Portugal or Ireland are so-called "programme countries", which receive financial support conditioned to an adjustment program and structural reforms, which may also contain reforms in the tax systems

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- Harmonization usually means a legislative process, when national legislators are obliged to shape policies in a pre-determined fashion – VAT and excise directives of the EU are fitting examples for that
- Regulatory competition is the mutual adjustment process of countries under competitive pressure – theories about fiscal competition will be discussed in a later section of this chapter
- Communication and policy learning may incorporate several mechanisms such as transnational problem-solving (led by epistemic communities), or the promotion of best practices. (Holzinger and Knill, 2005)

The empirical study of Achim Kemmerling (2011) finds the presence of all mechanisms at work in case of EU tax policy diffusion.

Dobbin, Simmons and Garrett (2007) use a very similar typology by pointing to constructivism (the impact of policy norms from epistemic communities), coercion theory, competition theory and learning theory as the frameworks explaining what they call 'global policy diffusion'.

Radaelli (2000) uses the notion of institutional isomorphism (borrowed from organizational theory, based on the works of Di Maggio and Powell, 1991). One remarkable part of this theoretical framework is that it emphasizes the differences between legitimizing mechanisms between different strategies utilized in policy diffusion. This competition for legitimization is substitute for the coordinating mechanism of market competition in case of firms – the original subjects of the theory. This legitimacy element will be of vital importance in the later discussion of EU involvement in national tax policies.

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1.3 Theories of taxation in a multilevel state

Fiscal policy governance involving multiple levels of jurisdictions received significant attention in the last decades in many academic fields, such as Political Economy or Public Finance (see, for instance Wellisch, 2000). Although this work only deals with a narrow part of this vast amount of theoretical literature, I see it necessary to give a brief overview of the most important theories of taxation (and fiscal policy in general) in federal or multilevel settings. In the following section, I discuss fiscal federalism (Musgrave, 1959, Oates, 1972, Weingast, 2009) and theories of fiscal competition with implications for EU taxation.

In a broad understanding, fiscal federalism (most famously theorized by Richard Musgrave, 1959 and Wallace E. Oates, 1972) deals with determining whether to centralize or decentralize certain governmental functions in a multilevel polity to achieve an optimal allocation of resources – its classical research questions include the assignment of responsibilities, interjurisdictional fiscal transfers, fiscal competition etc. (Boadway and Shah, 2009). The distribution of governmental functions (expenditure side) between the different levels traces out the pattern according to which fiscal instruments (revenue side) are assigned to each function. Fiscal federalism has become a widely used framework in the increasingly globalized policy making environment, where the trends of supranationalization and the strengthening of local governments run parallel to each other (Ibid.).

First Generation Fiscal Federalism (FGFF) assumes that each level of government seeks to maximize social welfare (there is a "benevolent social planner") and directs attention to the potential gains that could be drawn from lower level governments executing certain functions. Second Generation Fiscal Federalist (SGFF) theories (such as Weingast, 2009) create a complementary theory to FGFF – they do not presuppose a benevolent planner, but substitute it with self-seeking politicians, and also include the context of incentives. The claim of SGFF is that

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there are cases, when delegation of functions to lower level jurisdictions does not lead to the outcome that was supposed in the context of welfare maximization (Weingast, 2009: 290). Perverse incentives can trigger rent-seeking behavior or create the possibility of moral hazard.

Thus, it is crucial to clarify, that although the concept is often associated with a normative commitment to either fiscal decentralization or centralization (depending on which trend is dominating the political agenda and what the starting situation of the polity in question is – is it going towards centralization or decentralization), the actual normative claim the theory of fiscal federalism makes is that competences should be assigned to particular levels in a way that best allows the public sector to efficiently provide the demanded output (Oates in: Alves and Alfonso 2008: 8) and does not take a general normative stand on either decentralization or centralization.

Local governments are thought to fare better in face of the information asymmetry problem (they know preferences of their residents better than the central government does), they might have a higher level of legitimacy and they can also grant varying levels of public goods – something that the central government may fail to do because of political constraints. This can be matched to the abovementioned principle of subsidiarity (applied in the European Union). But Oates also emphasizes the constraints of decentralization, which are, most notably, macroeconomic stabilization and redistribution. Because of open economies and the mobility of tax bases, these two functions should be assigned to the central government (Ibid.). Besides, a merit of fiscal centralization is that constitutive lower level jurisdictions can benefit from a more cost effective provision of the public service arising from economies of scale, sharing fixed costs, social risk pooling, internalization of interjurisdictional externalities and extended markets, so they might also be prompted to bear the political cost of giving up some autonomy and join a centralized scheme (Congleton, 2008).

In the particular case of taxation, the literature of fiscal federalism most famously refers to the several models of fiscal competition, which will be discussed below.

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Tibout's classical model of 1956 demonstrated that competition between local governments in public goods provision is efficiency enhancing. If factor mobility is ensured, individuals and corporations can "vote with their feet" to express their preferences in the bundle of public goods for a tax price. Competition might also have the positive effect of fostering innovation and extorting accountability (Tibout, 1956 and Oates, 1988 in: Alfonso et al., 2012). Innovation, a consequence of policy experimentation, which is made possible in such federal settings is praised by Oates (2001) and many others. Oates also argued that this benefit also makes up for eventual suboptimal outcomes and most definitely leads to a better outcome than largely wasteful public spending schemes of the central government financed by federal taxes – in other words, it can be a successful anti-Leviathan force (Oates, 2001: 138- 139; see also: Boss, 1999; Janeba and Schjeldrup, 2004).

The so-called competitive model suggests that in case of factor mobility, member states will join in a competition to attract businesses. This phenomenon is denoted as a "race to the bottom" and may result in *suboptimal* levels of output as well, as local governments are not able to provide the necessary amount of public goods (Oates and Schwab, 1988 in: Oates, 2001). What these latter models suggest is a policy prescription for the European Union that supports harmonized taxes. Harmonized taxes are also supported by those applying a game theoretic analysis, like Fourcans and Warin. In a game theoretic setting, harmonization changes the non-cooperative game to a cooperative game, thus inducing an overall increase in pay-offs (Fourcans and Warin, 2001).

However, there is little empirical support to the race to the bottom hypothesis. Here, I rely on Signe Kogstrup's empirical study (2004) and his thorough review of the empirical literature on the subject (2002). The author and a few others did find an empirical connection between capital mobility and lower corporate tax rates, but the downward pressure is small in magnitude, and cannot be characterized as a race to the bottom. It is also influenced by other factors – the

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presence of agglomeration economies, for instance (Kogstrup, 2002: 27, for more on this, see the works of Baldwin and Krugman, 2002[3]).

The creation of the European common market with free movement of goods, services, labor and capital (and later on, the creation of the common currency) largely increased the mobility of tax bases, which in turn increased tax competition. There are heated debates in both the academic and political spheres whether tax competition has positive or negative effects. 'Harmful tax competition' can approximately be defined as tax structures adopted to deliberately exploit attempts for tax avoidance. As the notion gained momentum in the EU in the late 1990s, the ECOFIN adopted a code of conduct in 1997, whereby member states agreed to refrain from such harmful practices with the objective of preventing losses of tax revenues, among others. The same document also acknowledges the possible positive effects of "fair" competition (ECOFIN, 98/C 2/01).

The borderline between efficiency-enhancing, fair tax competition and loss-generating, harmful tax competition has never been quite clear. Nevertheless, fears about "tax dumping" and the subsequent crisis of European welfare states has been one of the motives behind the EU's tax harmonization agenda set as a priority in several subsequent official communications (COM (2001) 260, to name an example – European Commission, 2001). The another motive was to eliminate barriers arising from the different tax structures of member states, which may stand in the way of factor mobility and the efficient functioning of the single market. One important point against tax harmonization is, however, is that EU member states largely differ along many dimensions – in their preferences for public goods as well as in their levels of tax evasion and fraud or efficiency of public goods provision, which also means they do not have a uniform system that is optimal for all of them (Ibid.).

[3] Putting it simply, agglomeration theory points out that in regions, where there is a concentration of capital, the returns to scale of newly inflowing capital is increasing. That is why "The presence of agglomeration forces makes the economy "lumpy" in the sense that industry tends to stay together, either all in one region or all in the other." (Baldwin and Krugman, 2002: 21)

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What I see as an important message of the literature summarized above, is that depending on the initial assumptions and characteristics of the jurisdictions in question, there are economic arguments for both sides of the competition versus harmonization debate. Those opposing competition and the resulting higher levels of taxes usually see the government as a benevolent promoter of the common good, and fear that downward pressures on its revenues caused by tax competition limit its ability to provide the necessary level of public goods. Those who see the government as a self-seeking Leviathan point out that by reducing tax revenues, the state's rent-seeking behavior can be checked and public welfare increased (Brühlhart and Jametti, 2007). These approaches can also be attached to ideological standpoints – pro-low tax regimes are mostly associated with right-wing or (neo)liberal thoughts, while promoters of high tax regimes are more left-oriented.

1.4 An own analytical framework based on the literature

The following figure summarizes the concepts and theories I combined to create an analytical framework for the assessment of my research questions. Looking at the governance structures of the EU multilevel polity, my analysis is focusing on the interrelationships between the different levels of the polity and see how the EU exerts power over member state tax policies. The two basic types of influence I identify are positive and regulatory ones, while the tools used by the EU might be coercion, harmonization and communication or learning. There are different legitimizing mechanisms attached to the different types of intervention. The most important ones are the democratic legitimization, which can typically stem from the electorate's delegation of authority (the lack of it is discussed using the notion of a democracy deficit), and EU influence can also be backed by a technocratic type of legitimacy, which encompasses economic reasons for a function being exercised on a certain jurisdictional level and which are discussed in the frameworks of fiscal federalism and fiscal competition. Member states' mutual influence on each other's policies (mainly through competition and learning) will also be discussed.

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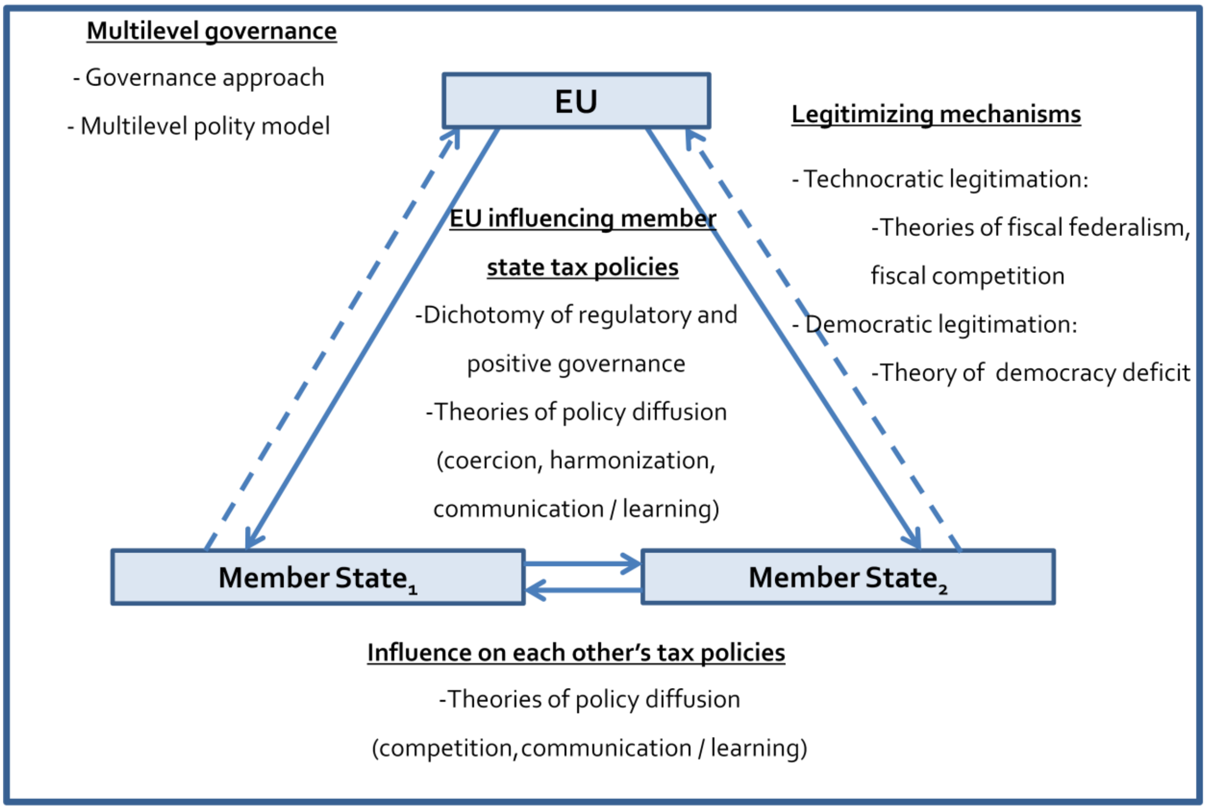
Figure 1

Summary of the concepts and theories used as an analytical framework



Source: created by author, based on Jachtenfuchs (2001), Hooghe and Marks (2001), Majone (2009), Holzinger and Knill (2005), Radaelli and Kraemer (2008), Kemmerling (2011), Oates (2011)

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Chapter 2 – Trends in fiscal unification

Based on the theoretical foundations laid out in the first chapter, I now turn to the case of the European Union, and outline different conceptualizations of a fiscal union, which came up in the very recent and still ongoing debates about the future of the crisis-torn Union. I base this account mostly on the overview given by Buiter and Rahbari (2011) and my own monitoring of the news media.

2.1 Conceptualizations of a fiscal union

As taxation fits into a larger scheme of further fiscal integration in the EU, it is useful to take a look at the different variants of a fiscal union which have been discussed during the debates about institutional reforms within the EU.

Few commentators are satisfied with the speed and efficiency of European decision makers coping with the continent-wide economic crisis, whether in public discourse or the academic sphere. Compared to the pace of EU institutional reforms that featured pre-crisis Europe, however, the crisis has noticeably speeded up thinking about fiscal reforms – and about ways to enforce old fiscal rules. It is useful to take a look at the different variants of a fiscal union which have been discussed during the debates about institutional reforms within the EU. The following table gives an overview of our own interpretations of the different concepts that are used throughout the public and academic discourse.

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Table 1

Varieties of a fiscal union,

Stability Union	A set of fiscal rules enforcing fiscal discipline and balanced budgeting in member states.
Fiscal Federation	The 'federal' (i.e. EU) level having revenue raising and spending capacities of its own
Transfer Union	Fiscal transfers between member states
Liability / Debt Union (issuance of Euro-bonds)	Different scenarios – 1) The federal level issuing bonds underwritten by all member states jointly (and potentially raising revenues) 2) Member states issuing Eurobonds, which are underwritten by other member states too 3) Mutualizing the existing stock of debt
ECB in a fiscal role	The ECB monetizing sovereign and/or bank debt (not sustainable)
(Banking Union[4]	The creation of a Europe- (or euro zone-) wide financial supervisory authority financial regulation, but has fiscal dimension – common deposit insurance)

Source: created by author, based on: Buiter and Rahbari (2011)

[4] put in brackets, since it is in part only a regulatory authority, not a part of further fiscal integration

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2.2 Towards a stability union

The most visible trend in the deepening fiscal integration process was the manifold strengthening of the centralized fiscal surveillance scheme – first through the creation of the 'European Semester', a new framework for effective coordination of national fiscal policies and second, through the reforms of the Stability and Growth Pact (SGP). From the many changes that has been made in this crisis-management period, I outline those ones which have direct relevance to tax policy[5].

All three sets of measures outlined below can be classified as moves towards a stability union – seen in the first row of the table among the different conceptualizations of a fiscal union.

2.2.1 The European Semester

The new framework for integrated economic policy coordination agreed upon in 2010 and introduced in 2011 is called the European Semester. The Semester itself is a yearly cycle of coordinated economic policy making in the EU member states. One of its major goals is to bring together the budgetary and economic policy advice that is given to member states, and thus ensure the consistency thereof. The process of the European Semester looks as follows (based on: European Commission, 2013a):

a. It starts with the adoption of the Annual Growth Survey (AGS) at the end of each year (from 2012 on, in November already), when the Commission sets out priorities within the broader goals of the Europe 2020 strategy – which are often summarized as "smart, sustainable and inclusive growth in areas such as employment, research, innovation, energy and social inclusion"

[5] thereby not analyzing the single policy changes in depth, only pointing out those details which are connected to the subject

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b. On the basis of the AGS, the European Council on its spring meeting in March, issues policy guidance to individual member states
c. member states need to consider this guidance when presenting their medium-term budgetary strategies in their Stability and Convergence Programs, and their growth- and employment-enhancing reform measures in their National Reform Programs (NRPs) in April
d. In May/June, the Commission provides policy advice as feedback to member states' National Reform Programs and Convergence Programs. These proposals are the so-called Country Specific Recommendations (CSRs). In their NRPs and Convergence Programs, member states are expected to include progress along the lines of the the previous year's CSRs[6]

(European Commission, 2013e)

2.2.2 The reformed Stability and Growth Pact

The SGP was created enforce fiscal discipline in member state budgeting by imposing rules and target numbers, and attach effective warnings and sanctions to them – while also keeping an eye on competitiveness and output growth. This results in a dual mandate and a difficult balancing exercise: keeping public finances sound without damaging growth, and enacting growth-enhancing policies without going into excessive deficit or debt.

The SGP was first approved in 1997, with substantial reforms agreed to it in 2005 and 2011. It has a preventive and a corrective arm – the preventive one (based on Art 121 TFEU) aiming to ensure the surveillance and coordination of economic policies, the corrective one (based on Art 126 TFEU) attaching an enforcement instrument to it, which is the Excessive Deficit Procedure (EDP). The SGP did not prove to be an efficient way to ensure fiscal

[6] To demonstrate the apparent tax-related content of CSRs, the 2011 list of recommendations containing references tax reform proposals are included in the Appendix.

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discipline and sustainable output growth before the crisis. All but two member states, even the prudent ones let their budget deficits loose and fell under the EDP right ahead, and as the crisis unfolded, serious imbalances had been built up within the EU and the euro area (europa.eu, 2010).

The 2011 reform is known by the name of the "six pack", as it is a package of six legislative changes to the SGP to ensure credible commitment to the goals of fiscal consolidation and competitiveness – especially through more efficient enforcement instruments and stricter sanctions in case of non-compliance. The member states under the EDP need to take action to reduce their deficit and debt ratios under a closely monitored procedure or they face sanctions: interest-bearing deposits, which then can be converted into a fine in case of insufficient progress.

The SGP reform also introduced the Macroeconomic Imbalances Procedure (MIP) to prevent and correct macro-imbalances. The MIP reaches out from the field of budgetary inspection, and contains requirements concerning more general macroeconomic factors, such as current account imbalances, unsustainable external debt or asset price bubbles. Similarly to the SGP, the MIP also has a preventive arm, which is embedded in the European Semester, and a corrective arm called the Excessive Imbalance Procedure, which include sanctions that can be used against euro area member states. (eu2011.hu, 2011).

2.2.3 The Euro Plus Pact

Besides the "six pack" of legislative changes to the SGP, a "two pack" was also agreed among a smaller group of member states – originally to achieve a tighter coordination of economic policies in the euro area, but then joined by all other non-euro area member states as well, apart from the Czech Republic, Hungary, Sweden and the United Kingdom. The Pact is a follow-up of the infamous background agreement called the Competitiveness Pact, struck by Angela Merkel and Nicolas Sarkozy, which was a product of some controversial bilateral

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discussions amidst the multilateral crisis-management negotiations (see, for instance, The Economist, 2011). The Euro Plus Pact puts a particular emphasis on the coordination of competences that are on the national level and it addresses the area of taxation openly.

The tax-related provisions of the Pact are also following the dual goal of fiscal consolidation and economic growth – the latter encompassing fostering competitiveness and employment. Here, the agreement addresses the problem of excessive taxes on labor (which discourages employment), and in order to boost economic output in the whole of the EU, it urges member states to shift their tax structures towards less distortive taxes – like taxes on consumption, recurrent property taxes or environmental taxes.

The text acknowledges that direct taxation remains a member state competence, but calls for "structured discussions (…), the exchange of best practices, avoidance of harmful practices" and coordinated action to fight against tax fraud and evasion. It also stresses the importance of a Common Consolidated Corporate Tax Base, and includes "financial stability" as one of the aims of the coordinated action, thereby hinting at the commitment to a Financial Transaction Tax. (European Commission, 2011a: 16).

From the point of view of the research question addressed here, the Euro Plus Pact can hardly be seen as a significantly stronger move towards tax policy coordination than what was already agreed upon with the European Semester. Arguably, the Pact was more of a political statement inspired by the Franco-German core of the EU committed to stronger economic policy coordination, and also an opportunity for those counties opposing such tightening to enounce their revulsions publicly. An analysis of these policy moves towards a stability union will be accommodated in the analytical framework and will be thoroughly assessed in the next chapter. As the episode of the adoption of the Euro Plus Pact tells a lot about member states' motives in the field, I will return to it in the actor-based analysis in Chapter 4.

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2.3 Other proposals

Even though progress was most visible in case of the stability union, there are also other ideas which gained momentum under the umbrella term *fiscal union*. The EU is getting closer to the creation of a euro zone-wide banking supervision, many push for mutualizing sovereign debt of the euro zone countries (see for instance: De Grauwe, 2012). What also re-emerged on the policy agenda was the creation of an EU-level fiscal authority (an EU-level finance ministry) or even a transfer union with redistribution between member states (for a thorough discussion of the alternatives, see Buiter and Rahbari, 2011). The reform proposal outlining the most radical change was arguably the plan to create a bigger EU budget financed by EU taxes (Cazeneuve in: EurActiv.com, 2012b). This suggestion aimed to create a fiscal link between the EU-level and the citizen, thus granting the EU the power to levy taxes[7] – something that until now, only national governments were allowed to do. The EU having independent taxing and spending powers would ultimately mean a shift towards a fiscal federation – where tax policy making would also be federalized.

What can be concluded from the long list of different understandings of a fiscal union is that the exact definitions are still quite unclear. There are many conceptualizations of it, based on the interests and visions of the different actors. The most advanced proposal is the fiscal stability union – a credible and enforceable rule-based framework to ensure stability in member state budgeting, with the power to levy taxes and spend would stay at the member states' level. Although the idea of a fiscal stability union received by far the most attention and was also the most successful set of proposals, one can argue that it is only a dusting-off and correction of the old and somewhat discredited rule-based framework, and by no means a shift of paradigm towards fiscal unification.

[7] The idea was brough up earlier before as well, see: Cattoir, 2004; Jacques, 2007; Menéndez, 2004

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It is vital to see, that the different directions of fiscal integration do have substantial meaning, and the political phrases used cannot spare us the work of investigating each point of decision separately. This paper aims to help in this very endeavor. Within the analysis of the present forms of EU intervention into tax policy making in the following chapter, I also discuss how the visible trends in the strengthening of the fiscal stability framework influence taxation and how it can be evaluated in the positive-regulatory dichotomy.

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Chapter 3 – EU involvement in national tax policies at present

Even if the distribution of capacities between levels of the EU is not always clear-cut, the fact that taxation, the prime example of the positive mode of governance, resides exclusively with the member states is rarely challenged. When describing the system of power sharing between different levels of the EU polity, the most prominent scholars in the field, such as Moravcsik (2002), Hix (1998), Hooghe and Marks (2001) all argue that while the EU has a strong mandate in the creation of the common market and the regulation thereof, it does not have powers over taxation and redistribution. According to Majone, acknowledging the EU's fiscal impotence is fundamental to understand the dynamics of EU policy making. That is the reason, namely, why it is forced to govern by non-fiscal, regulatory means (Majone, 1996: 55-56). All these point to the conclusion that the EU level is involved in member state policy making in largely technical and apolitical matters only, in cases when Pareto-improvements can be achieved, whereas the fields of positive governance with ideologically loaded questions and conflicting interests are left for the member states.

Yet, as discussed in Chapter 1 and as pointed out by many authors: the European Union's extended regulatory power is not limited to market regulation and the usual correction of market failures. As Ganghof and Genschel (2007), Genschel and Jachtenfuchs (2011), Uhl (2006) and others demonstrate, through secondary tax legislation of the Commission and the Council on the one hand, and through CJEU case law on the other, the European Union severely constrains the taxing power of member states, thus intervening in the domestic competence of taxation and redistribution.

This paper argues that after discussing the two well-known channels of EU intervention into member state tax policy making – namely, legislative and judicial intervention – a third one should be added, which is governance through soft law. Under soft law non-binding, quasi-legal

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instruments should be understood like recommendations, codes of conduct, guidelines, etc. Here, I demonstrate that these instruments have become increasingly prevalent in the onset of the crisis and together with legislative and judicial intervention, they largely shape tax policies in our present European multilevel polity.

This trend supports the argument of several authors, such as Uwe Puetter's, when they argue that the open method of coordination (another term approximating the soft law governance), which has a special emphasis in the post-Lisbon functioning of the European Union and a new upsurge in intergovernmental practices has been a characteristic element of economic policy governance in the onset of the crisis (Puetter, 2012, European Commission, 2013e).

Figure 2 visualizes the different dimensions of EU influence in member state tax policies in a simplified manner. I divide the instruments of tax policy governance (the left-hand side of the graph, under the left box in the second row, "Tax policy governance") into two strands; the first one is the harmonization of individual taxes, which is carried out by legislative or judicial means. The second one is the creation of EU guidelines shaping the entire tax structure of a country – to name a concrete example, the recommendation to shift taxes away from labor towards consumption, thus making the EU's tax systems less detrimental to growth. The main instrument for such action is the abovementioned soft law.

Although the subject matter of my present research only concerns the revenue side, it is important to point out that member states' fiscal autonomy is not only limited through EU involvement on the revenue side of the budget, but nowadays, what is even more prevalent is the strict regulation of the *outcome* of fiscal policy making – by means of the deficit ceiling. This is included in the right-hand side box in the second row ("Deficit regulation"), and can be associated with the fiscal stability union discussed above. The strengthened Stability and Growth Pact armored with the Excessive Deficit Procedure as a credible sanctioning mechanism has

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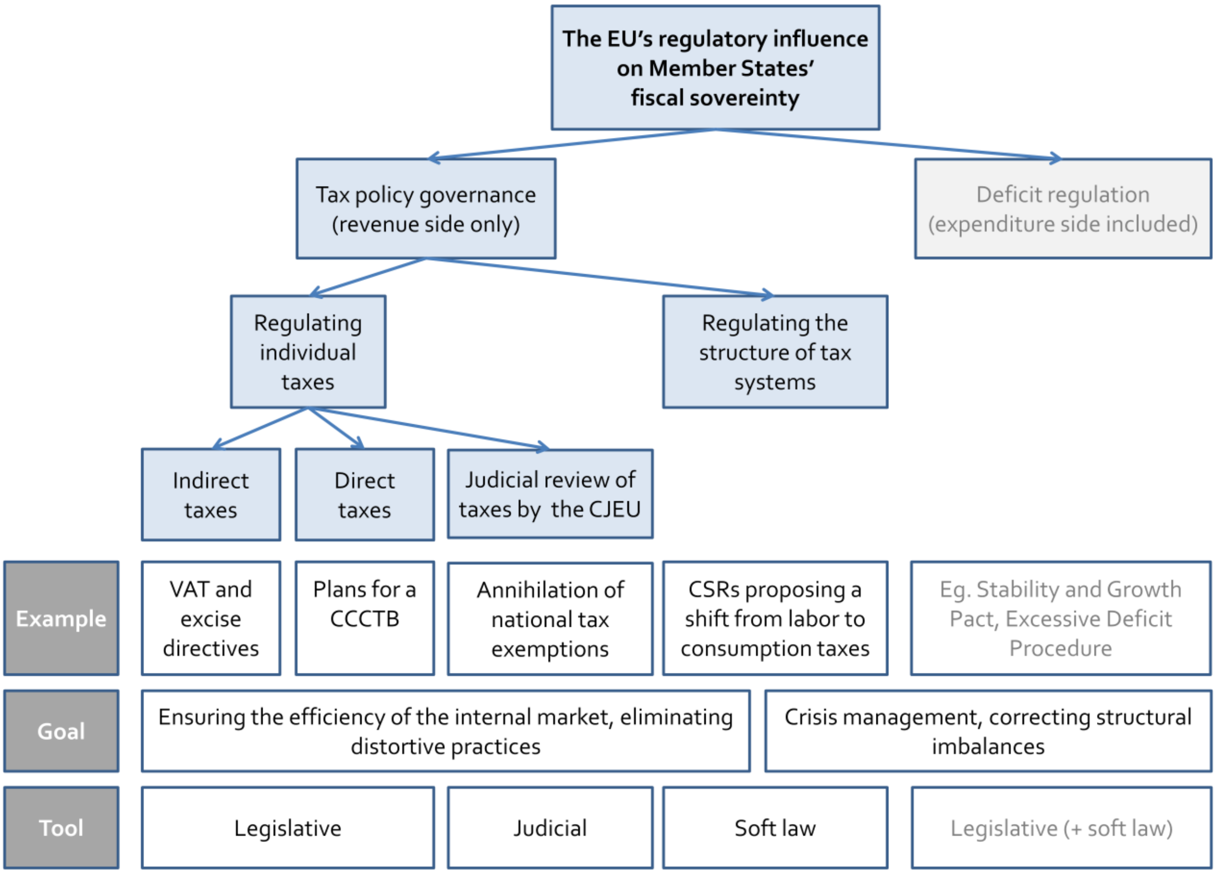
narrowed down member states' fiscal room for maneuver significantly, and that arguably gives the discussion over tax policy governance more relevance.

Figure 2

Modes of EU influence into member state tax policies through regulatory means



Source: created by author, based on Genschel and Jachtenfuchs (2011); Kemmerling (2011); McLure (2008)

All of the instruments within the tax policy governance strand will be discussed in detail in the following sections.

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3.1 Tax harmonization through legislative and judicial means

3.1.1 Regulating indirect taxes

The EU has an extended mandate in the regulation of indirect taxes[8], which is also made explicit in the Lisbon Treaty (Treaty on the Function of the European Union or TFEU). The specific legal basis granting the EU power to intervene in member state indirect tax policies is Article 113 TFEU, which provides that

> The Council shall (…) adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition. (Art 113 TFEU).

The major source of legislation of indirect taxation are the VAT Directive (2006/112/EC) and the Directive concerning the general arrangements for products subject to excise duty (2008/118/EC) – the latter encompassing alcoholic beverages, tobacco products and energy products. In case of VAT, rates are harmonized by a compulsory minimum rate of 15%, while allowing for maximum two reduced rates of at least 5%. Temporary derogations are also possible (European Commission, 2013b). In the area of excise duties, the most important provisions concern the harmonized structure of product categories, and the production, storage and movement between member states of these products. There is a standard minimum rate with respect to each type of product (European Commission, 2013c).

Perhaps the most convincing evidence for the accelerated pace of regulatory governance of indirect tax policy is the comprehensive research done by Genschel and Jachtenfuchs (2011), which I will mostly rely on in the following two sub-sections describing the present state of EU tax policy governance.

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[8] meaning taxes like a sales tax or value-added tax levied usually on consumption and not directly on the factors of production (labor and capital)

The authors collect all tax-related legislation of the Commission and the Council, as well as case law of the European Court of Justice between 1957 and 2007, and thoroughly describe the scope and depth of EU intervention into member state tax policy making, while focusing on the trends that can be seen in the respective time span. One of their conclusions is that the EU level has tighter control over tax policy making than the federal level has in the United States, although the US Federal Government, unlike Brussels, has a strong mandate in fiscal matters. They find an increased number of secondary tax law acts (there were 183 in the 39-year period between 1958 and 1997, and 199 between 1998 and 2007), a widening of the scope of regulations (also protruding into the field of direct taxes), an increase in the variety of the legal instruments used and a tendency towards delegation of tax cases from the Council to the Commission (Ibid.: 298-300)

The main legal instrument for the comprehensive regulation of indirect taxation is secondary law made by the Council and the Commission – mostly directives, occasionally regulations. Decisions, which are mostly used for granting derogations from harmonization provisions, have also grown largely in number. Directives are seen as suitable for harmonization, since they are binding only, with respect to the result to be achieved, while member states are left with a discretionary room concerning the means to achieve these objectives (Ibid.: 299). The "mild trend" towards delegation to the Commission is a particularly interesting development, if we bear in mind the strongly articulated preferences of member states in retaining their tax autonomy (Ibid.: 300). The lack of a strong opposition to these delegations seems to suggest that a regulatory-type of intervention is usually not accompanied by politically salient or ideologically loaded debates in the national political arenas – not even when it has an indirect, but visible impact on a core governmental function.

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3.1.2 Regulating direct taxes

As discussed earlier, the treaties leave the European Union with very limited powers in the field of direct taxation – which remains a national affair. Since the European Union has no explicit powers in the field of revenue collection and redistribution, this also seems self-explanatory. However, the EU does have a very strong mandate in the creation and maintenance of the single market, and this also have serious implications to tax policies and tax systems of members states. As the EU official sources put it:

> member states' tax systems and tax treaties must in any event respect the fundamental Treaty principles on the free movement of workers, services and capital and the freedom of establishment (Articles 45, 49, 56 and 63 TFEU) and the principle of non-discrimination (European Commission, 2013c)

One has to remember that goods, services, workers and capital (the free movement of which needs to be assured) also constitute the major tax bases of member states (Genschel and Jachtenfuchs, 2011: 297). Derived from its mandate safeguarding the fundamental freedoms, secondary law-making of the Commission and Council also emerged in the area of direct taxation – first in corporate taxation, through the 90/434/EEC and 90/435/EEC Council Directives on the taxation concerning companies of different member states, then also in personal income taxation through the 2003/48/EC savings directive (Ibid.: 299). Genschel and Jachtenfuchs find 14 tax acts in the 1998 – 2007 period, which dealt with corporate or personal income tax, compared to the 2 in the previous 40 years period (Ibid.: 298).

Even though the explicit mandate conferring competence to the EU in the direct tax policy field is missing, harmonization of direct tax laws can be derived from a more general Treaty provision, Article 115 TFEU, which provides Council (unanimously, after consulting the European Parliament and the Economic and Social Committee) "to issue directives for the approximation of such laws, regulations or administrative provisions of the member states as directly affect the establishment or functioning of the internal market". (Art 115 TFEU) This

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suggests already that there is room for the EU to expand its influence in the field of direct taxes as well. The clearest evidence for such a tendency is the proposal for a Common Consolidated Corporate Tax Base, which will be thoroughly discussed later.

Over and above the expanding impact through Commission and Council legislation, a significant influence is exercised through the tax jurisprudence of the CJEU. Since all national tax policies need to be compatible with the above cited principles of free movement and non-discrimination, member states tax policy acts are subject to judicial review if they are thought to conflict with the *acquis communitaire* (community law).

Genschel and Jachtenfuchs look at CJEU case law in the 1957 – 2007 time period in the same manner as in case of the secondary law-making of the Council and Commission, and the trends they see are also quite similar to those listed above: a general increase in the tax-related cases, a significant increase in the share of procedures concerning direct taxation (mostly abolishing protective arrangements in member state tax codes), and preliminary rulings (legal procedures which can be initiated by private taxpayers) outnumber infringement procedures (those initiated by the Commission). As they point out, the latter finding is worth considering, since private taxpayer-initiated tax litigation have a tax reduction bias – an intuitive thing, since tax-payers are expected to challenge a law only if they expect a tax reduction (Ibid.: 303).

Other researchers, such as Graetz and Warren (2007) or Ring (2008), reached the same conclusion as Genschel and Jachtenfuchs: that the CFEU does not only regulate tax policy, but participate in the policy making process in a more active way. Even though most of the rulings concern secondary tax law, there are a growing number of cases also, which concern primary treaty law – in other words, the Court "creates judge-made European tax law" (Ibid.: 302). These can be fields, when the Council is unable or unwilling to legislate – most notably, because of the unanimity rule. As discussed in Chapter 1, Fritz Scharpf criticized EU involvement in member state policy making exactly for the bias stemming from the process of negative integration. It was

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also Scharpf, who coined the concept of the "joint decision trap" for the description of the dynamics of EU governance (Scharpf, 1999). This refers to an institutional paralysis of EU decision making, and the inability to advance in matters of pressing importance because of a small number of member states having conflicting interests blocking the process. Consequently, negative integration and the joint decision trap together give a suboptimal result, since negative integration can abolish parts of national tax legislations, while the Council is unable to agree on a new policy solution (Genschel and Jachtenfuchs, 2011: 302).

The unanimity rule is still persisting in taxation-related matters. The Commission needs to bear the unanimous support of all the member states in the Council and the European Council and consult with the European Parliament to proceed in tax-related provisions. It is a long-standing debate whether Qualified Majority Voting should be introduced to certain tax-related fields as well. All such proposals were struck down by member states, who fear that giving up a chunk of decision making power (in this case: veto power) in the field of taxation brings about unwanted tax rate harmonization and a loss of competitive edge. However, the joint decision trap in this particular case and the extension of EU governance in tax policy by negative integration seem to point to the direction that the extension of Qualified Majority Voting would help the policy development process to carry on in a more conscious and controlled way. (European Commission, 2013d)

3.1.3 Limits of EU involvement

The 1992 Maastricht Treaty (Treaty on the European Union, TEU) provides the most important guidelines for the vertical division of capacities between the different levels of the EU polity, which are the principles of subsidiarity and proportionality. These principles also set a limit to the exercise of competence in the area of tax harmonization.

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The principle of subsidiarity, under Article 5(3) of the TEU, provides that in those policy fields,

> which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the member states, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level,

whereas the principle of proportionality (Article 5(4) TEU) provides that "the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties".

In order to abide by these principles, draft legislations have to include a qualitative and quantitative assessment of the expected financial impacts on member states, as well as the implications on national legal provisions in case of a directive. After that, the so-called "yellow card procedure" makes it possible for member states to withdraw the draft (KPMG, 2012: 15).

The subsidiarity and proportionality principles are often perceived as safeguards for member states to retain their autonomy in policy areas where they do not want to endure a loss of sovereignty. However, critics of the subsidiarity principle argue that it is an "empty concept", which can be used to defend both sides (Sinn, 1993). The findings of this research imply that the division of competences within the European multilevel polity are shaped in a dynamic process, where there is no clear functional blueprint to decide what powers belong to the separate jurisdictions. Therefore, I share the view that the subsidiarity test cannot give a clear-cut answer whether to centralize or decentralize, it is a functional tool to inform decision-makers about the costs and benefits of an otherwise inherently political decision.

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3.2 Developments in the onset of the crisis: influence through soft law

In Chapter 2, I already gave a brief account of the manifold strengthening of the fiscal surveillance framework of the EU – through the creation of the European Semester on the one hand, and the strengthening of the Stability and Growth Pact on the other. Because of its direct relevance in our subject matter, the following few sections will deal with the former. I analyze the first complete cycle of the European Semester (December 2010 – July 2011) from the point of view of its effect on EU involvement in member state tax policy making.

The launching of the European Semester can be appraised as a milestone in the EU's regulatory involvement in member state tax policy making. The issue of further Europeanization in the field of tax policies rarely came up in the academic or public discourse over furthering fiscal integration. The Annual Growth Survey for the year 2011, however, explicitly raises the issue of taxation:

> Although sensitive, work should be taken forward on taxation. This has an important economic potential to stimulate growth and job creation, reduce administrative burden and remove obstacles in the Single Market. Tax treatment disadvantaging cross-border trade or investment should be eliminated. In particular the Commission will propose in 2011 measures to modernise the VAT system, to introduce a common consolidated corporate tax base, and to develop a coordinated European approach to taxation of the financial sector. Progress on taxation also implies reducing taxes on labour to the minimum necessary and adapting the European framework for energy taxation in line with the EU energy and climate objectives. (European Commission, 2010: 9)

The paragraph cited from the AGS says it quite clearly: even though tax autonomy is a touchy subject for member states, central objectives of stimulating output and employment necessitate further coordination in tax policies – and not only through negative integration (abolishing cross- border trade and investment barriers), but also through positive action.

Using the conceptual framework applied here, the Semester is a model example of intervention through soft law as it incorporates recommendations, policy guidance, enables cross-border learning and exchange of best practices. In contrast to the means of intervention discussed above – regulations, directives and decisions on the one hand, CJEU case law on the other – these soft-law tools are not legally binding[9], there are no sanctions attached to them, peer pressure and market pressure are the only channels they are expected to influence national

[9] for a detailed discussion of soft-law governance, see McLure, 2007, Treib et al., 2007

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economic policies. The involvement is regulatory in nature, which is underscored by the use of words in the official documents: they talk about *pragmatic* tax coordination. This phrase suggests that these measures are legitimized by economic efficiency.

CSRs focus on the dual mandate of the European Semester, and aim at fiscal consolidation and growth-enhancing measures. The revenue side is obviously of vital importance to achieve these goals, and in line with that the materials make it explicit that tax policy reforms of member states are also included in the list of desirable changes. The major principles behind the policy proposals are the reduction of taxes on labor, and fiscal consolidation (i.e. tax increases) through less distortive taxes, like the recurrent property taxes, consumption taxes and carbon taxes. It also states that broadening tax bases are preferable to increasing the tax rates. (European Commission, 2011b: 14)

It is also quite telling that the AGS urges furtherance of all those tax harmonization issues that are currently on the agenda: VAT-reform, CCCTB and FTT, even though these are not included in the European Semester process. This reflects a very important tendency – namely the aspiration of the Commission to create a link between its otherwise separate channels of fiscal policy governance.

3.3 Legislative, judicial and soft law intervention – a hybrid model

What is emerging from the above discussed three channels of regulatory intervention into member state tax policy making is a hybrid model of regulatory governance and positive governance.

In Figure 3, I visualize the regulatory and positive dimensions of EU involvement in member states' economic governance, with examples relevant for taxation, in a stylized graph. Here, fiscal surveillance schemes and tax legislations come up, as measures with fundamentally positive or interventionist content, but carried out by regulatory means (that is why it is placed in

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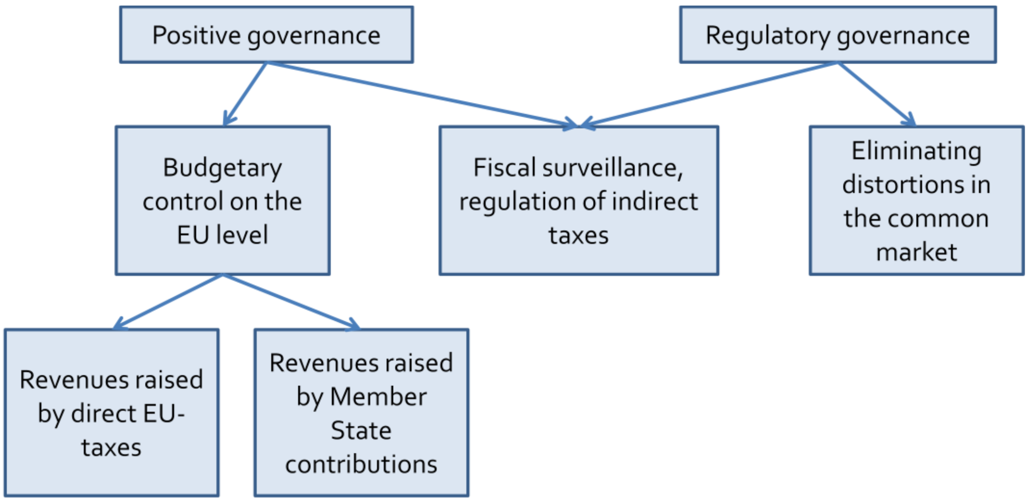
the middle). The alternative of the EU central authority *instructing* budgetary policies of member states is when part of the budgetary control itself is delegated to the level of the central authority. This would mean that the revenues themselves are collected in the center.

Figure 3

A stylized graph of tax policy governance in the positive-regulatory framework



Source: created by author, based on Majone (1997 and 2009)

The conclusion we can draw from the recent developments outlined above is that tax policies will continue to be governed through the legislative and judicial channels, complemented by soft law tools of the strengthened fiscal surveillance network. The principle serving as a legal basis for EU influence in member state tax policies has been the EU's mandate to create the common market based on free movement and nondiscrimination. Arguably, the most significant change brought about by the ongoing financial crisis was that the goals of fiscal stability and competitiveness emerged, and were established as justifying the EU-levels intervention.

3.4 Proposals about a common European tax

Although never getting enough political support to be considered a serious alternative – the fiscal union that has taxing and/or spending power of its own (like federal governments do) would be one option for moving forward with tax policy integration by positive modes of

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governance. There are many pro and con arguments on this truly controversial topic, some of which are worth mentioning to get a whole picture.

The case for the central authority having control over its own budget is that it would allow a broader fiscal autonomy for the EU level. Through this, it could pursue its macroeconomic stabilization function and be a more effective and credible authority to achieve fiscal discipline and stability within the whole of the Union, as it has vested interests in it member states might sometimes have temporarily differing interests and some might want to ease the fiscal brakes (a moral hazard problem).

Undoubtedly, taxation has traditionally been one of the most salient issues on the political agenda because of the direct affectedness of all, and it always has to be an inherent part of public discourse. This implies the argument already discussed previously, in the section dealing with the democratic deficits of the governance of taxation in the EU. The lack of a European demos and an EU-level public sphere, or the underdeveloped EU-level party system all account for the fact that truly salient issues like the creation of a centralized scheme of redistribution seem to be hopelessly far-fetched. For the direct EU tax to have democratic legitimacy, the strengthening of the public trust and legitimacy of the directly elected European Parliament is an essential precondition, as there is a complete lack of a visible, transparent institutional framework through which taxes could be decided upon (DeBardeleben and Hurelmann, 2007).

From the point of view of democratic legitimacy, the core argument for the EU to have taxing power is that if a polity has public expenditures as the EU does, revenues these expenditures are financed from should be raised through a system that is both visible and understandable for the citizens (Menéndez, 2004). Although the European Union has extended regulatory powers to intervene in the tax systems and tax rates of its member states, Brussels has no authority to directly tax individual and corporate citizens, which would be a more transparent and visible way to intervene in their public expenditures.

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As for the lack of a European demos and a democratic public sphere, the delegation of an issue of such salience before a constituency can actually cause the maturing of the political community, the stimulation of public debates and the evolution of a public sphere. This would fit the so-called Monnet-method of integration, which I very briefly referred to in Chapter 1 (see, for instance, Dinan, 2005).[10]

As discussed already in Section 1.3, member states of the EU are quite heterogeneous in terms of size, culture, history and a number of other factors. This also implies serious differences in citizen preferences for tax systems, tax levels and the size of the taxing state: Irish and Swedish preferences for a social security system could most likely not be integrated into one system, which in turn brings up the problem of subsidiarity. Moreover, member states' levels of tax evasion and fraud or efficiency of public goods provision also differ, which means they have a differing marginal benefit from an extra unit of tax revenue (Wellisch, 2000). That is why policy convergence in this field did not succeed in the pace it did in several others.

Brussels has no taxing and spending capacities of its own, which has been brought up as an argument for the euro zone not being an Optimum Currency Area (as described by Robert A. Mundell 1961., Ronald McKinnon 1963. and many others), which lies in the heart of the present euro crisis. Together with the high degree of heterogeneity of constituent states, a lack of real economic convergence, insufficient flexibility in prices and wages and low labor mobility, the lack of fiscal transfers is listed among the prime factors responsible for the unsustainability of the single currency. As all member state contributions to the central budget account for a sheer 1% of the Community members' GDP, the EU is generally seen as inadequate to respond to asymmetric shocks with countercyclical fiscal stimuli, which would be of central importance in

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[10] However, assuming that spill-overs from the monetary union will create incentives to carry on and federalize the fiscal side of economic governance as well is not supported by the prolonging crisis experienced in today's Europe.

case of a currency union, where tools of monetary policy, like nominal devaluation in times of recession, are federalized.

According to some authors, a bigger pool of own resources would be advisable to help convergence within the Union and being able to tackle recessions (See, for instance: Le Cacheux. 2007). These features could enable vital adjustment mechanisms, which help regions to adjust to asymmetric shocks. These adjustment mechanisms could be facilitated by the enlargement of the EU budget. This is an especially significant issue in times of recessions like the present crisis of the euro zone

The arguments for a European Union tax are sometimes also derived from the fundamental goals and values of the Union and of Community law, like the promotion of economic growth and socio-economic cohesion. These views suggest that beyond the negative duties of the European Union to respect the independence and sovereignty of the member states, there are also positive obligations to provide internal and external security and prosperity, thus strengthened powers for the central administration can be justified and Brussels can execute the fundamental objectives set forth in the Treaties, the prerequisite for that is raising revenues through taxes. To fulfill the abovementioned objectives, these expenditures should be financed through a transparent system of raising revenues (Menéndez, 2004).

All in all, even though the debates over granting the EU the power to tax and spend are an important process from the viewpoint of the long-term future of the Union, the next chapter will show that even in case of politically less salient regulatory-type functions, delegating tax-related powers to the European Union level are made an exceptionally difficult endeavor by strongly differing, divergent interest structures of member states.

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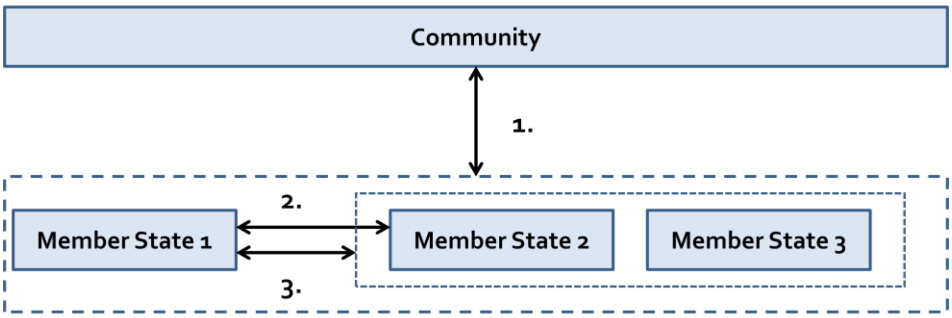
Chapter 4 – Actor-centered analysis

Figure 4 shows the relationships where underlying conflicts of interest may arise between the EU-level and certain member states or groups of member states (1.), between individual member states (2.) or between coalitions of member states (3.). As individual member states' decisions whether to delegate certain tax-related functions to the Community level are largely shaped by these conflicts, the following chapter aims to map out the possible interests along these relations, which in turn determine the costs and benefits member states attach to delegation.

Figure 4

Relationships where conflicts of interests can emerge



Source: created by author

It is important to note that the costs and benefits attached to these decisions can be assessed along many dimensions, from which I look at the basic political and economic ones. The sources I rely on when tracing back the interests are publicly announced member state positions and some background information I got from my interviewees – all Brussels-based EU-officials who wished to remain anonymous. The approach I use is a simplified rationalist perspective, which is standard in Political Economy analyses (see, for instance, Drazen, 2004).

I decided to look at the EU-level (represented by the European Commission) and the member state governments as decision makers, since, as discussed earlier, tax-related matters are decided upon with joint unanimous decision making in the Council and the European Council,

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the European Parliament having a consultative, and not a decisive role. This is a voluntary simplification, whereby intra-state interest conflicts, for instance between parties of different political affiliations or interest groups are only touched upon briefly, and not analyzed in depth. It supports the trend already discussed before, pointing to a strengthened role of intergovernmental decision making fora in post-crisis economic policy governance, instead of the Community method (Puetter, 2012).

4.1 EU-level versus member state-level

The main conflict of interest between the EU level and the member state(s) is obviously the loss of sovereignty stemming from the delegation of power. One has to bear in mind here that tax policy is a traditional exclusive sovereignty of member states, so the surrender of it constitutes a major political cost for member states.

The conflict itself is quite clear – the European Commission, representing the interests of the Union as a whole, has very strong interests towards delegation, while the member states represent their own particular agenda. From a plausible rationalist perspective, all political actors (in this case the Commission and national governments) seek to extend their powers, and they can do so at the expense of the other.

As the analysis set forth in the previous chapters suggests, the Commission is a decisive player here, since they are the ones pushing the agenda of tax harmonization through legislative means (by proposing directives and decisions), also by judicial means (by initiating most tax-related proceedings at the CJEU), through soft law (by adopting CSRs) and quite importantly, through communication and policy learning (by conducting in-depth research to be able to give policy advice). The Directorate-General for Taxation and Customs Union has a well-equipped research unit with regular publications on the desirable directions of tax reforms in member states (see, European Commission 2011b and 2012).

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As discussed in Chapter 3, the Commission typically moves forward in influencing tax policies in the channel of regulatory governance and legitimizes such actions with the technocratic rationale. Their argument for tax harmonization is based on the efficient, distortion-free functioning of the Common Market, and they seek to advance tighter tax coordination reasoned by the Community-wide interest of fighting macro-imbalances and enhancing competitiveness of the Union as a whole.

Some member states are quite cautious about the delegation of even regulatory functions to the Commission. Many sources refer to the Commission's operation as a creeping extension of powers by gradually taking up seemingly harmless functions, and then using it as a point of reference to push for more powers. These fears come up when Irish and British government representatives argue in the issue of a Common Consolidated Corporate Tax Base, which they see as a precursor of harmonized tax rates (Euractiv, 2011).

Since member states may generally be distrustful towards giving up parts of their fiscal sovereignty fearing that a lot more would follow, it is a possible scenario that even if there are economic gains to be realized, fears about losses from further harmonization might restrain a member state from delegating the function.

The most reluctant delegators have been those countries with the weakest public support for the EU. Having electorates with traditionally low support for the EU may result in a long-standing reluctance of a member state to advance in tax policy integration. The central example for this is the United Kingdom, which usually shows up among the countries whose average pro-EU scores are the lowest (Standard Eurobarometer 77, 2012: 52). The British have for a long time been vehement opponents of any moves in the field of taxation – there is an overarching consensus in this between the different political sides. In 1998, Chancellor Gordon Brown and Prime Minister Tony Blair defended UK tax sovereignty in the debate over abolishing unanimity voting in taxation matters:

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> Everybody knows that tax proposals require unanimity, and a change to that requires a treaty change ... and that is simply not going to happen (Brown in: BBC News, 1998).

Diane Ring quotes a British government spokesperson from 2003:

> We have been very clear – nothing on tax. Tax is the province of the national states. (…) Anything to do with tax is about sovereignty, and the Treasury must have control over how and what is collected. (Ring, 2008: 41)

Prime Minister David Cameron's government indicated its strong insistence to retain national tax autonomy in the decision to opt out of the Euro Plus Pact (European Commission, 2011b, see sub-section 2.2.3).

In the UK case, moves towards tighter coordination of tax policies or delegating related powers to the EU level clearly constitute a political cost for the government, while being a militant opposing force to these proposals could be rewarding politically.[11] However, from the structural analysis performed above, the inference we can clearly draw is that EU involvement in member state tax policies is proceeding by utilizing regulatory-type policy instruments (even in cases when the effect of the intervention protrudes into positive state duties). These regulatory modes of governance are more technical in nature and have little political salience, thus also reduce political costs for governments.

Yet there are country cases where the size of the tax state is part of the core political agenda, so giving up on these issues would certainly constitute direct political costs for national decision makers. Interestingly, these cases are at both ends of the spectrum: those countries with competitive tax regimes (such as Ireland) are just as reluctant to give up a bit on tax autonomy as those with high tax regimes (Sweden being the prime example). Figure 5 shows the approximate size of the taxing state. With the EU-average at 35.7% and the euro area average at 36.7%, there

[11] A matching concept to specify this political cost could be *domestic audience cost*, borrowed from International Relations. See Tomz, 2007

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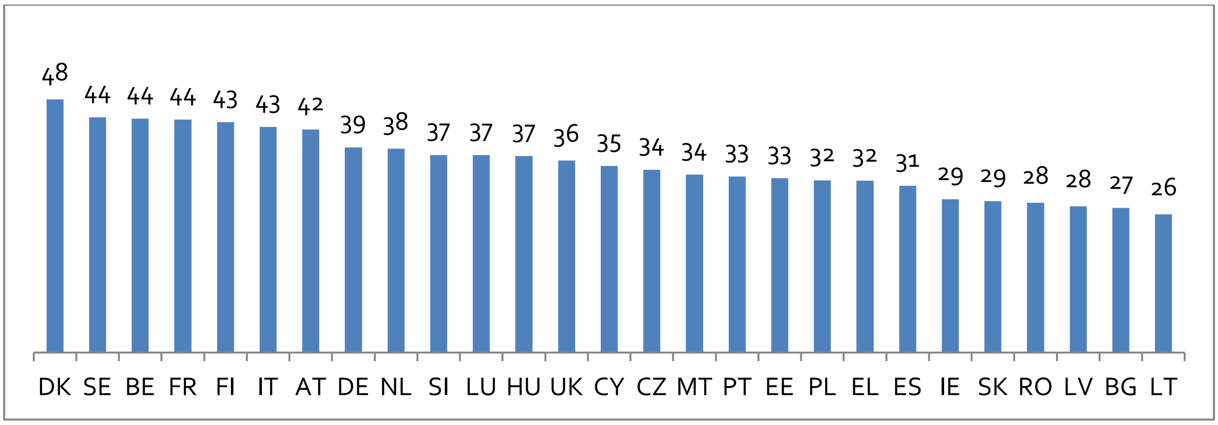
is visible variation between member states, indicating varying preferences for the size of the state and the amount of revenues needed.

Figure 5

Total Taxes (including Social Security Contributions) as % of GDP, 2011[12]



Source: DG for Taxation and Customs Union and Eurostat, 2012

Similarly to the UK, Sweden also opted out from the Euro Plus Pact, and the decision was motivated by fears that policy convergence will result in Sweden failing to finance its generous welfare state and general reluctance of any intrusion into the quite unique Swedish state model, which is based on a collective bargaining system (see The Economist, 2011). The UK and Sweden are neither in the euro zone nor under a legal obligation to join in. This means they do not share the direct possible benefits of tax harmonization and tighter cooperation, which could arise from the strengthening of the euro area. Therefore, their cost-benefit analyses clearly place them among the opponents of tax harmonization or tighter tax policy coordination.

The other two opt-outers were the the Czech Republic and Hungary, whose Prime Ministers (Petr Nečas and Viktor Orbán) both stressed their countries' reluctance to tax harmonization, which they see as a logical next step after the tax policy coordination prescribed in the document. Hungary's reason was also to retain its competitive tax system (Euractiv, 2011).

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[12] I used the latest available data from the 2013 edition of the DG TAXUD-Eurostat publication

The costs and benefits can also be substantively shaped by the party- and ideological affiliations of subsequent national governments. Governments consisting of political forces less supportive of the EU naturally face different incentives than those who are backed by an electorate in favor of deepening integration.[13]

4.2 Conflicts between member states and coalitions

4.2.1 Tax competition or "tax dumping"?

Probably the most apparent cleavage-forming interest is among member states which have highly competitive (lower than average) tax rates to attract foreign direct investment – Ireland and the new member states fall into this category, for instance (DG for Taxation and Customs Union and Eurostat, 2012). These countries fear losing competitive edge by tax harmonization and are suspicious towards tax base harmonization as well, as they associate both with convergence to the higher average tax rates. Figure 6 shows the statutory corporate income tax rates throughout the EU. Since corporate income is a relatively mobile tax base, fierce competition and conflicting interests are expected to emerge here.

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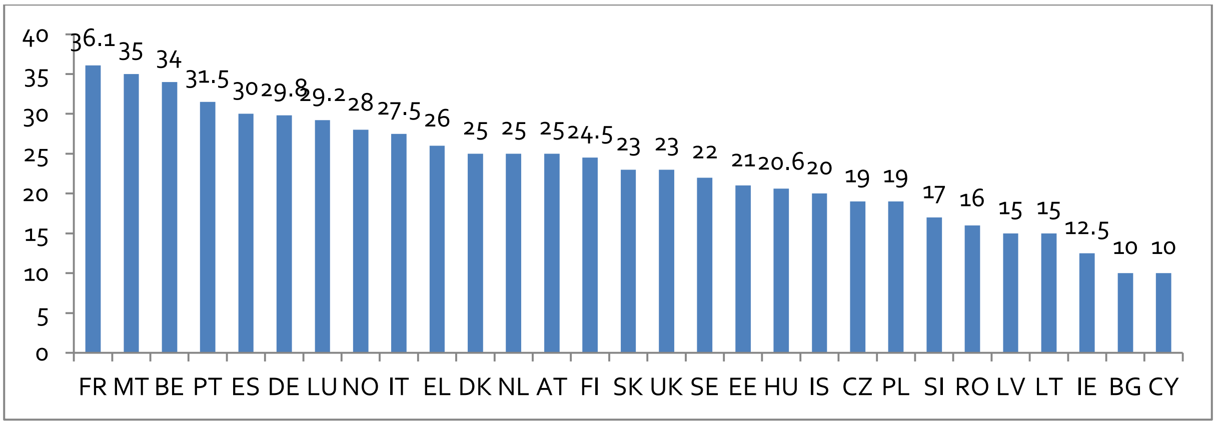
[13] From this point of view, the changing party-affiliation of the French government from President Sarkozy (who was one of the main proponent of furthering tax harmonization and tax policy coordination) to President Hollande (who seems more reluctant in this field) would be an interesting case to look at, but due to a lack of retrospect, it is not discussed in this thesis. Also, due to pressing reasons for simplicity, inter-country interest conflicts will not be discussed.

Figure 6

Adjusted top statutory tax rates[14] on corporate income, 2013



Source: DG for Taxation and Customs Union and Eurostat, 2013

The bars in Figure 5 trace out the ground of the long-standing and deep conflict between two "coalitions" – member states of high and low corporate tax regimes. The debate has been quite acrimonious, with accusations about "unfair tax competition" and "tax dumping" of Ireland and the new member states regularly brought up by France and Germany (see Ring, 2008).

Slovakia was one of the new member states in 2004 which, right after the accession, opted for a very low flat tax regime with a rate of 19% in 2004 to increase competitiveness and successfully attract FDI. Former German Chancellor Gerhard Schröder dubbed this "tax dumping" and adamantly campaigned against it, especially because it became a pattern which more new member states started to follow and which thus raised fears in old member states. The Baltic countries also opted for very attractive tax regimes and realized fast growth in the mid-2000s. This was the ground on which the Franco-German coalition for tax harmonization was grounded (see Radio Praha, 2004; Credit Suisse, 2006).

The recent debates between former French President Nicolas Sarkozy and Irish Taoiseach Enda Kenny showed that the conflict is still ongoing. President Sarkozy also unearthed the

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[14] Note that a better measure for inter-country comparison could be the average effective tax rate, which I unfortunately only found for a limited set of member states

formerly used terms and accused Ireland of "social and fiscal dumping" and "disloyal competition" (The Economist, 2011a, 2011b). The situation was complicated by the fact that Ireland asked for EU financial support to consolidate its crisis-torn economy. The French reaction to this was as follows:

> We're not asking Ireland to put up their corporate taxes to the European average, but to make some effort. (…) you can't ask others to contribute for you, when you won't make an effort on your tax receipts. (Sarkozy in: Bloomberg, 2011)

An argument suggested by this is that member states like Ireland can afford low tax regimes because they receive or received significant amounts of cohesion funds to finance public goods like infrastructure projects. This is also a sign for the sharpening conflict between core and periphery member states in tax policy issues.

Countries defending their low tax regimes have arguments on their sides as well. When confronted with the accusation of tax dumping, Estonian Prime Minister Andrus Ansip pointed out that tax competition is not a zero-sum game in the European Union:

> In 2003, more than EUR 350 billion of investment left the EU – for the US, South Korea, China or India. Only EUR 6 billion of investment flowed from the old EU members into the economies of the ten EU candidates of that time. I am fully convinced that the Eastern expansion is the most successful project in the history of the EU. And both sides will benefit from it. (Ansip in: Credit Suisse, 2006)

The economic argument for these small countries cutting taxes being a profitable decision is that revenue losses are small compared to the gains from the inflows of foreign tax base (Kanbur and Keen, 2001 in: Genschel and Kemmerling, 2009). Moreover, these countries on the low end of tax regimes (New member states on Europe's periphery especially) are also confronted with the problem of high levels of tax evasion. This highlights the economic argument that the marginal benefit of plus one unit of tax levied might become very low at a point (Wellisch, 2000). In case of these countries, as long as the problem of tax dodging is not eliminated, low-tax regimes may be an economically reasonable solution.

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The clear conclusion we can draw from the debates above is that there are deep cleavages between member states and groups of member states, which make any furtherance of a common harmonized taxation scheme a very unrealistic goal in the present setting of unanimous voting.

4.2.2 Coalitions between member states

According to my Brussels-based sources, coalitions are very hard to come by in the field of EU tax policy making. They are most of the time ad hoc alliances between member states along the lines of some common interests. Countries like Bulgaria and Hungary, for instance, who both are agricultural states (having a large share of revenues coming from agricultural production) lobby together in cases involving VAT regulations of agricultural products, to name an example. Another example is the case of energy taxation. As discussed above, a shift from labor taxation towards taxes aimed at discouraging production practices that are environmentally polluting is highly backed by the European institutions. Here, the technocratic rationale is even backed by the EU's traditional role as an adamant promoter of environmentalism. Recent proposals for the creation of an energy tax, which would be levied based on the levels of CO_2-emissions are heavily opposed by some Central Eastern European member states, who (in contrast to their Western European counterparts) still use polluting practices in their production.

Even if there are some agreements that are met between member states in some tax cases, conflicts of interest are expected to arise between them over the exact content of each proposals. Each and every article can be understood differently and when it comes down to the exact numbers and details, interests start to diverge, even in cases, where the political will to move forward is not questionable, as it was the case, arguably, with the Financial Transaction Tax started in enhanced cooperation between 11 member states.

The European Parliament, in December 2012, and more recently the ECOFIN in January 2013, voted in favor of the plan of a common Financial Transactions Tax (FTT) of 11 member

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states – Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain – under enhanced cooperation, after a proposal for a common EU-wide tax on the financial sector was vetoed by countries such as the UK or Luxemburg, who have well-developed financial centers and thus fear to lose out on a tax like that. There are many technical details, however, which make the final agreement even among this narrower group of member states, who originally agreed on the desirable policy direction really difficult to be achieved (see: Cazeneuve in: EurActiv.com, 2012b, The Economist, 2012, KPMG, 2013).

4.2.3 Conflicts in the CCCTB case

The aim of a proposed Common Consolidated Corporate Tax Base (CCCTB) is to create an EU-wide harmonized system of assessing tax bases, so that companies operating in two or more member states do not have to cope with potentially 27 different tax systems, but have one set of rules they can use when calculating their income tax base. The consolidation part of CCCTB is meant to allow companies to consolidate all their profits and losses in a "one-stop-shop" system, and then, profits are to be divided among individual companies or subsidiaries using a single apportionment formula.

Based on the arguments of the Commission, there would be serious efficiency gains derived from the harmonized system, it would enhance the cross-border movement of economic activity, and raising the ability and willingness of companies to expand abroad would also improve competitiveness of these companies (KPMG, 2012 and European Commission, 2013f).

Official EU-sources never fail to emphasize in CCCTB-related discussions that in spite of the common tax base, member states would obtain their full sovereignty in setting tax rates, so CCCTB would not curb member state tax sovereignty. However, member states are quite skeptical about letting the Commission any room in this field, since they fear that by delegating

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the power to set tax bases, they let the Commission expand its influence on all other fields as well.

CCCTB was first set forth in an official Commission working group in 2004, and since then, many different versions of the proposal have emerged, which also have different expected implications on member state tax revenues, output and employment. There is a plethora of research papers produced by tax analysts, who get to very different results when assessing the potential costs and benefits of the reform proposal. Just like in case of the FTT – when the individual proposals come down to the technical details – interests very strongly diverge, and therefore it is also very difficult to proceed with these proposals. My sources called the creation of a CCCTB "absolutely hopeless", exactly because of these diverging interests and because of the many small details of national tax systems, which can hardly be accommodated within such a harmonized system. There are rumors about the Commission wanting to carry on with the CCCTB in enhanced cooperation as well, and create a smaller group of member states who would adopt it.

4.3 A summary of the actor-based analysis

The findings of this chapter clearly point to the fact that because of the irreconcilable conflicts of interests between member states, unanimous multilateral decisions are not expected in the next period of time.[15]

The decision of member state governments upon further integration in the field of taxation is driven by many specific motives. Delegation has certain costs and benefits for all members compared to the status quo. The cost side is that they have to give up a chunk of their national sovereignty, and relax the principle that control over tax policy resides with the member states. There are also specific costs on the side of member states who are not expected to be decisive

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[15] Although different in its context, it is interesting to link Dóra Győrffy's research on the effects of political polarization on policy reforms to these developments

over the exact *content* or direction of the policies – namely those, who are economically or politically dominant to shape reforms like that (supposedly the core, and not the periphery). On the benefit side, there might be the expected stabilizing effect of further integration on the fiscal side of economic governance for all players (this is especially relevant in case of euro zone members), pro-EU integration governments and there are beneficiaries of the actual content of the policy as well.[16]

A powerful force pushing for a reform like that could probably be a group of member states, who are expecting to be in the decisive coalition after the decision over the content of the policy. But since unanimity does not seem to be an available option in a polarized state of affairs like the present one, those member states in favor of the reform need to move towards the so-called "enhanced cooperation" model, thus losing out on efficiency of the integration process and create a threat of a multi-speed Europe.

These concluding remarks about the improbability of furthering tax policy integration by any other means but soft law economic coordination will be put into a broader context in the concluding chapter up next, where I summarize the main results of my research and offer areas for further research.

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[16] For these relationships expressed in a simple formalized model, see the Appendix.

Chapter 5 – Conclusions

The aim of my thesis was to assess how the EU-level exerts its influence over member state tax policies in the multilevel governance structure of the European Union. Taxation is the ultimate limit of EU intervention into member state policymaking, as it is one of the core functions of the modern nation state and therefore, an exclusive member state competence. Based on its mandate to create the Single Market, however, the EU is entitled to intervene into tax policies – and by regulatory means, it does so as well. The first finding I made in Chapter 1, relying on a thorough review of the existing literature is that in contrast to the popular belief, tax policy making is jointly determined by the multiple levels of the EU polity.

My first research question addressed how recent developments shaped EU involvement in the field of tax policy making. Since the outbreak of the continent-wide economic crisis, several different proposals emerged aiming to strengthen the fiscal side of economic governance – and these different scenarios also involved the very sensitive field of tax policy coordination as well. What my findings suggest is that the advancement towards a fiscal union is not progressing through institutional reforms explicitly passing on parts of member state tax sovereignty (for instance by granting the EU powers to tax), since both political and economic arguments for member state tax autonomy are still strongly prevalent.

The strengthened tax policy coordination is realized through the extension of the EU's regulatory involvement, which significantly grew in the onset of the crisis – most notably through the manifold strengthening of the fiscal surveillance scheme, which also includes growing control over the revenue side of member state budgets. This finding supports my first initital hypothesis: that the euro crisis accelerated EU involvement in member state tax policies, and this involvement is extending through the adoption of functions of regulatory nature. The adoption

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of the European Semester and the Euro Plus Pact both explicitly address the need for coordinated tax policies and maps out preferred directions for member state tax reforms.

However, EU involvement proceeding through secondary legislation (such as the long ongoing process of creating a Common Consolidated Corporate Tax Base) initiated by the European Commission seems to become increasingly difficult because of the deep cleavages and distrust among member states, which is a development I did not anticipate. Supranational schemes of tax policy governance seem to be substituted with intergovernmental fora, and as Uwe Puetter suggests, the Council and the European Council emerged as the main players involved in economic policy governance. The easing of the deadlock of unanimous decisions is attempted by the enhanced cooperation mechanism, which allows a smaller group of member states to carry on with tighter integration. This, however, might have serious implications in terms of the cohesion of the Union.

There are many criticisms surrounding the EU's "muddling through"-strategy (see, for example: Atkins, 2012), namely advancing integration by incremental steps, leaving the underlying structural problems untouched. Moving forward in the field of taxation fits this strategy, and can also be criticized for proceeding through technical, politically less salient and therefore also intransparent ways, while also failing to achieve a real paradigm shift in the tackling of problems stemming from serious imbalances in the monetary union, and in the EU as a whole. Taxation also sheds light on the problems related to the low levels of democratic legitimacy, citizen participation and transparency. The restricted capability of EU-level decision making bodies to decide on issues involving ideological and redistributional conflicts is a strong argument to prevent any further integration in the field of taxation, let alone the creation of an EU-tax. As the EU already exerts power in the field of taxation, these channels of citizen participation should be fostered, so that EU involvement would be backed by strong democratic legitimacy, and not just technocratic legitimacy. One important implication of my findings is that these structural

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problems need to be addressed; otherwise the level of unification already achieved may be endangered and the conflicts between member states may become even more acute.

The actor-centered analysis, which aimed to trace back member state motives behind further EU involvement in tax policy matters – thereby constituting the other part of the contribution I made in my research – a supported the above outlined results. My second hypothesis was vindicated by the finding that there are traceable conflicts of interest that can be mapped out between member states and the EU-level, as well as between individual member states or groups of member states. Even in case of more technical matters, there are strongly diverging positions, which makes any progress quite difficult. There are also very visible fears of member states that extended regulatory influence will trigger further harmonization.

The most vocal supporters of further integration in the observed period were the core countries of the EU/euro area, most notably Germany and France, who might expect that their preferences will prevail in decisions over the exact content of the policy in question. The most vocal opponents of tightening cooperation are on the one hand, those governments whose countries have competitive tax systems (meaning low average tax rates) – like new member states or Ireland; on the other hand, those where retaining national sovereignty is of core significance on the national political agenda – most notably, Great Britain. The European Commission, which has an obvious interest in extending its influence in more and more policy fields, does so through less conflict-loaded channels, as country-specific policy advice or transnational learning, which it tries connect to other fields of competence as well.

Moving towards some form of a fiscal union, especially in case of the euro area member states does appear to be a pivotal question of the future of the EU. However, it is of vital importance to proceed on this way through transparent ways, not fearing, but encouraging ideologically loaded debates. How different ideas about a fiscal union materialize or do not

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materialize in the near future will definitely change future trends of tax policy integration as well. Therefore, the area will offer many more research questions left unanswered.

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Appendix

A.1 Tax-related proposals in the 2011 Country Specific Recommendations

Euro Area	„Pursue further tax reforms which give priority to growth- friendly sources of taxation while preserving overall tax revenues, in particular by lowering taxes on labour to make work pay"
Austria	„reduce, in a budgetary neutral way, the effective tax and social security burden on labour, especially for low- and medium-income earners"
Belgium	„Improve participation in the labour market by reducing the high tax and social security burden for the low-paid in a budgetary neutral way (…). Take steps to shift the tax burden from labour to consumption and to make the tax system more environmentally friendly."
Bulgaria	-
Czech Republic	„exploit the available space for increases in indirect tax revenue to shift taxes away from labour, improve tax compliance, and reduce tax evasion"
Denmark	„reviewing the functioning of the mortgage and property tax systems"
Estonia	„Take steps to support labour demand and to reduce the risk of poverty, by reducing the tax and social security burden in a budgetary neutral way"
Finland	-
France	„Increase the efficiency of the tax system, including for example through a move away from labour towards environmental and consumption taxes, and

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	implementation of the planned reduction in the number and cost of tax and social security exemptions (including 'niches fiscales')."
Germany	„Closely monitor the effects of recent reform measures to reduce tax disincentives for second earners and take further measures in case disincentives remain"
Greece	-
Hungary	„Enhance participation in the labour market by alleviating the impact of the tax reform on low earners in a budget-neutral manner."
Ireland	-
Italy	-
Latvia	-
Lithuania	„Reinforce tax compliance" „take steps to shift taxation towards energy use"
Luxembourg	-
Malta	-
Netherlands	-
Poland	-
Portugal	-
Romania	-

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Slovakia	„safeguard growth-enhancing expenditure, and use available room to increase revenue through environmental and property taxes and by increasing the efficiency of VAT collection" „Take steps to increase employment and to support labour demand for the low-skilled unemployed by reducing the tax wedge for low-paid workers"
Slovenia	[„'student work' constitutes a sizeable, largely unregulated, tax-advantageous, parallel labour market"]
Spain	„Explore the scope for improving the efficiency of the tax system, for example through a move away from labour towards consumption and environmental taxes while ensuring fiscal consolidation plans."
Sweden	-
UK	-

(Source: European Commission, 2011c)

A.2 Modelling the problem

The following simple model by Roger D. Congleton (2008) might help to understand the dynamics behind a Member State government's decision to delegate a function to a central level or stay in the status quo position (meaning continue executing the function independently). The case is that local government 'j' can voluntarily decide whether or not to participate in a new centralized program that will determine public policy 'i' for all members (in our case, 'local government' is a Member State government and 'all members' are all Member States).

$$P_{ji}\,(B^{M}{}_{ji} - C^{M}{}_{ji}) + (1 - P_{ji})\,(B^{N}{}_{ji} - C^{N}{}_{ji}) > N_{ji}$$

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Figure A.1 (Congleton, 2006:137)

Pji is the probability of Member State government 'j' getting into a decisive (majority) coalition to decide on issue 'i' when entering the centralized program. $B^{M}{}_{ji}$ is the anticipated benefit, $C^{M}{}_{ji}$ is the anticipated cost the Member State government attaches to the situation above. Accordingly, (1— P_{ji}) signals the probability of Member State government 'j' being in a minority coalition, thus missing out on the opportunity to be decisive over issue 'i'. $B^{N}{}_{ji}$ is the anticipated benefit, $C^{N}{}_{ji}$ is the anticipated cost attached to it. N $_{ji}$ is the benefit in case of independent production, which is the status quo situation, when Member State government 'j' does not participate ($N_{ji} \geq 0$).

What the model shows us is that a Member State government will only decide to voluntarily join the centralized scheme at the end of a cost-benefit calculus, if the expected value derived from the costs and benefits of both outcomes (majority and minority positions) will exceed the fixed benefit it has in the status quo. If only one of the both outcomes (the majority position) would make a Member State better off than it is in the status quo, what the Member State has to consider in the process of the political decision making is whether the level of risk ending up in the minority coalition (i.e. not decisive about the actual content of the economic policy) is reasonable.

Let us take the example of a Member State of the European Union voluntarily deciding, whether to join an agreement about a common European tax, which raises revenues for the central EU budget. As we see above, the decision of Member State governments upon further integration in the field of taxation – either through regulatory or positive means – is driven by many specific motives.

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The decision has certain costs and benefits for all members compared to the status quo. In this simplified case, we suppose that these cost and benefit motives can be "EU-tax specific", based on general attitudes towards the EU and further integration in the field of taxation, and "content-specific", based on orientations towards the actual economic policy content of the change, and its expected costs and benefits thereof.

The cost side is that they have to give up a chunk of their national sovereignty, and relax the principle that the power to raise taxes resides exclusively with the Member States. There are also content-specific costs on the side of Member States not participating in the decisive coalition. On the benefit side, there might be the expected stabilizing effect of further integration on the fiscal side of economic governance for all players (this is especially relevant in case of euro zone members), pro-EU integration governments and there are beneficiaries of the actual content of the policy as well. A powerful force pushing for a reform like that could probably be a group of Member States, who are expected to be decisive over the content of the policies – namely those, who are economically or politically dominant to shape reforms like that.

But as voting over taxation in the Council is subject to the unanimity rule, those countries experiencing more costs than benefits can block the reform.

However, if we consider a dynamic version of the model, (Figure A.2),

$$P_{jit}\,(B^{M}{}_{jit} - C^{M}{}_{jit}) + (1 — P_{jit})\,(B^{N}{}_{jit} - C^{N}{}_{jit}) > N_{jt}$$

Figure A.2 (Ibid.)

the deadlock of the voluntary convenant might also change. I previously stated that the utility in the status quo position can also significantly alter the outcomes. We can have, for instance, a status quo position which leaves the Member State in the minority group better off than in case of an agreement (Figure A.3). That would probably mean no cooperation.

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$$(1 - P_{ji1})\,(B^{N}_{ji1} - C^{N}_{ji1}) < N_{j1}$$

Figure A.3 (Ibid.)

But then, due to an external shock, a crisis or an existential threat (The main example for this is that emerging federal states typically decided to centralize the governmental function of military services in case of an immediate external threat, which marked the origin of federal agreements in the United States or Switzerland, among others. [Ward and Ward, 2009]) the status quo can deteriorate to a level which changes the considerations of the Member State in question (Figure A.4).

$$(1 - P_{ji2})\,(B^{N}_{ji2} - C^{N}_{ji2}) > N_{j2}$$

Figure A.4 (Ibid.)

Pressures from the global financial markets, the possible disintegration of the Monetary Union, bankruptcy or the societal consequences attached to these outcomes may have the radical altering power of this kind. It is also possible that the probabilities of getting into the decisive coalition increase, as the beneficiary Member States are also facing serious threats and are more likely to be willing to compromise.

But those Member States in favor of the reform have another option as well – namely pursuing a cooperative scheme without the opponents, in form of “enhanced cooperation”. This is discussed in the next section.

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