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POLICY PAPER

Tax Policy Challenges in EU Countries: A Few Lessons from the 2012 Commission Tax Reform Report and the European Semester

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Abstract: The 2012 Commission Tax Reform Report and the 2013 European Semester point to a series of challenges affecting tax policy in EU Member States in the context of fiscal consolidation. These concern the potential need and scope for consolidating public finance on the revenue side and rationalising the tax system by shifting tax away from labour to least growth-detrimental bases, broadening tax bases, improving tax design and enhancing tax governance. Only a few countries are not affected by at least one of these issues, which call for an ambitious and resolute reform effort, also paying attention to the redistributive effects. This complements actions improving the global tax governance.

I THE POLICY CONTEXT

In the face of unsustainable public finances, tighter cooperation and better communication is essential for achieving better outcomes for Europe's economy. The European Semester was implemented as of 2011 to help meet such objectives. Launched every year with the publication of the Annual Growth Survey, it represents the annual cycle of integrated economic coordination across EU Member States. Its focus is on the six-month period

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from the beginning of each year, hence its name – the "semester". It allows for an annual assessment of each Member State's broad policy strategy. During the European Semester the Member States align their budgetary and economic policies with the objectives and rules agreed at the EU level. The European Semester brings two novelties. First, it synchronises the calendars of economic and fiscal policy reporting and evaluation at the EU level. Member States submit their national reform programmes (which include structural reform plans) and the stability and convergence programmes (fiscal plans) at the same time, in April each year. This way the EU Member States could better align their reform and budgetary goals and pursue their common EU-level objective more effectively. Fiscal, economic, financial and employment policies of Member States are now assessed in an integrated fashion and policy guidance is given in a coherent manner across policy areas. Second, the European Semester changes the coordination of national economic policies from *ex post* to *ex ante*. Under the Semester, Member States submit their budgetary and reform plans in the early stages of their national budgetary processes. The Council issues recommendations for member states' plans before their budgets are presented to national parliaments.

The European Semester regularly underlines the importance of the design and structure of the tax system to make it more effective, efficient and fairer. The Annual Growth Survey, launching each Semester, includes specific cross-country guidance on taxation every year. Moreover, many Member State received specific recommendations to improve their tax policy in the context of the Semester. In its fourth edition, the 2012 *Tax Reforms in EU Member States Report* (TRR), written by services of the European Commission,[1] contributed to this discussion and served as an analytical input to regular economic surveillance, including noticeably to the 2013 European Semester. The 2012 TRR also contributed to nourishing a dialogue between the European Commission and Member States on tax matters. It benefited considerably from discussions with the Member States at the Economic Policy Committee attached to the ECOFIN Council. Further dialogue with Member States appears mutually beneficial to dig deeper into country dimensions and to go beyond the identification challenges merely derived from quantitative indicators available for most EU countries.

In terms of detailed content, the 2012 TRR reviews recent tax reforms in Member States and indicates the scope for future reforms. Based on various information sources, it attempts to identify common trends of reforms across countries, while reporting reforms country-by-country. The report also

[1] This report, issued each year, was written jointly by two Directorates General of the European Commission, namely the Directorate General for Economic and Financial Affairs (DG ECFIN) and the Directorate General for Taxation and Customs Union (DG TAXUD).

analyses the tax policy challenges in EU Member States, in particular those having a potential impact on growth, employment and fiscal sustainability. It is also worth pointing out that housing taxation and tax governance – issues discussed during last year's workshop – were also covered in the 2012 TRR, showing the relevance of the annual tax workshop.

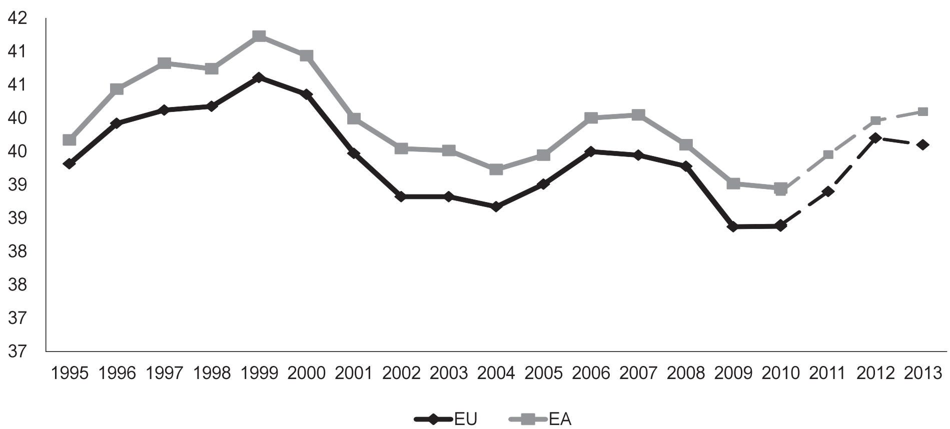
II MAIN TRENDS IN TAX REFORMS ADOPTED IN 2011–2012

The financial and economic crisis has resulted in a serious deterioration of public finances and major turbulence in sovereign debt markets. Thus, the fiscal policies in 2011 and 2012 were driven by the need to restore the sustainability of public finances. For most Member States, the need for more revenue to support consolidation effort was associated with other difficulties stemming from the requirement to support the economic recovery and restore sustained growth in the medium and long term.

After drifting downward and reaching in 2009 the lowest levels since the beginning of the decade, tax revenue stabilised as a percentage of GDP in 2010 and reversed its trend in 2011. This is confirmed by a careful examination of the individual discretionary measures taken in the area of taxation in the last decade (Princen *et al.*, 2013).

This upward movement of the tax-to-GDP ratio is expected to continue at least until 2013 when it is expected to reach almost 40 per cent of GDP, despite adverse cyclical conditions causing some loss in tax revenue (see Figure 1).

Figure 1: *Development of the Overall Tax Burden*



Source: Commission *Report on Tax Reforms in EU Member States* (DG ECFIN and TAXUD, 2012).

This evolution has to be attributed to a large extent to the tax policy measures undertaken in 2011 and 2012. It shall also be noted that in international terms the European Union as a whole is still regarded as an area with high taxes, despite the considerable fluctuations in revenue since the onset of the financial and economic crisis.

In the period 2011-12, many Members States have increased taxes in order to speed up fiscal consolidation (see Table 1). Most of them have increased personal income taxes, mainly through hikes in statutory rates, or social security contributions, while aiming at increasing work incentives for specific groups. The changes in the corporate tax bases have been slightly more frequent than changes in corporate tax rates. About half of the Member States saw hikes in the VAT rates, both in the standard rate and the reduced ones. Excise duties increased in most Member States for environment and energy products and for alcohol and tobacco. Tax on immovable property was also increased in a few countries.

Table 1: *Overview of Tax Reforms in 2011 and 2012*

		Statutory Rates	*Base or Special Regimes*
Personal Income Tax	Increase	BE, DK, CY, FI, EL, ES, IE, IT, LU, NL, PT	AT, BE, CZ, DK, ES, FI, FR, EL, HU, IE, PL, PT, SK, UK
	Decrease	FI, HU, LV, NL	CZ, DK, EE, FI, DE, ES, HU, IE, LV, MT, NL, SE, UK
Corporate Income Tax	Increase	FR, PT	CZ, AT, BE, DK, ES, HU
	Decrease	UK, FI, EL, SI, NL	ES, HU, IT, LT, LU, UK
Social Security Contributions	Increase	AT, BG, CY, FR, EL, HU, LV, PL, PT, UK	IE, SK
	Decrease	DE, IE	CZ
Value Added Tax	Increase	PT, UK, CY, ES, IE, HU, LV, PL, SK, IT, FR, BG, EL, CZ	AT, BE, BG, CY, DK, EL, ES, FI, LV, NL, PL, PT
	Decrease		CY, EL, ES, IE, LT, PL
Excise Duties	Increase	AT, BE, BG, CY, CZ, DE, EL, ES, FI, FR, HU, IE, IT, LT, LU, LV, MT, NL, PL, RO, SE, SK, SI, UK	DK, EE, LV, PL
	Decrease	SI	
Taxation of Property	Increase	CY, EL, ES, IE, PT, UK	CY, IT, LT, LV
	Decrease	NL	

Source: Commission *Report on Tax Reforms in EU Member States* (2012).
Note: The reforms are not consolidated. Therefore a country could be recorded as having adopted both a tax increasing measure and a tax decreasing measure in the same area.

III IDENTIFYING THE MAIN TAX POLICY CHALLENGES IN CONSOLIDATION TIMES

The 2012 TRR also provides a first identification of the main tax policy challenges in EU Member States, using an indicator-based screening. The indicators considered vary for each type of tax challenges but are carefully chosen according to the prescription of the economic literature, their availability for most EU countries and their statistical reliability. For each relevant indicator, the statistical distribution thereof is exploited to identify the third worst EU performers under normality assumption. This benchmarking allows for signalling countries with potential tax issues. Each country is weighted by his share of the EU GDP. The latter offers a cross-country consistent methodology, which provides useful preliminary indications but deserves further country-specific investigation to avoid the one-size-fits-all fallacy. Moreover, the results of the report, old now by around one year, are updated in the 2013 issue of the report, published in autumn 2013.

The 2012 TRR looks into the need and scope for fiscal consolidation on the revenue side, but also into other dimensions particularly relevant in consolidation times, such as the broad rationalisation of the tax system and the redistributional aspects of taxation. It should be noted that the identification of challenges in the TRR is purely indicative for countries covered by an economic adjustment programme (Cyprus, Ireland, Greece and Portugal), since the challenges associated with their tax system are subject to a much more thorough and detailed scrutiny in the framework of the financial programme, which remains the authoritative reference in terms of policy recommendation.

3.1 *Need and Potential Scope for Consolidation on the Revenue Side*

As for the relevance of consolidation on the revenue side, the report screens Member States, according to the existence of a fiscal sustainability issue ("the need") and the availability of some "tax space" ("the scope"). This is shown in Table 2. A high value in one of the two commonly accepted indicators of fiscal sustainability (i.e. "debt compliance risk in the medium run", called also "S1", and "ageing-induced fiscal risks" in the long run, called also "S2") signals the need for a strong adjustment in the fiscal deficit. The latter will allow either for bringing the public debt level down to the Treaty threshold of 60 per cent of GDP by 2020 or for stabilising the debt level in the long term. This adjustment, if very large, may require using tax increases as a complement to expenditure controls.

There could also be a potential scope for using tax increases if the tax-to-GDP ratio is relatively low, and if, at the same time, there is either some room for increasing the least distortionary taxes (consumption, recurrent housing and environmental taxes) or the absence of a "tax fatigue" (signalled by a large increase in the tax burden in the recent past). The main screening approach is explained in more detail and with some further improvement and proper updates in Wöhlbier *et al.* (2014). While some Member States had either a need or a potential scope for using tax to consolidate their public finance, only a few combined both conditions in 2012 (see Table 2). However, the result of Table 2, based on a fairly restrictive screening, is purely indicative and may have been made outdated by reforms undertaken after the production of the indicators used.

Table 2: *Consolidation on the Revenue Side: Screening Results*

Country	*Potential Need for Higher Tax Revenues to Help Consolidation*	*Overall Tax Space Available (Low Tax-to-GDP Ratio)*	*No Significant Increase in Tax-to-GDP Ratio in Recent Years*	*Scope for (Further) Increasing Least Distortionary Taxes*	*Conclusion: Need and Scope for Tax-based Consolidation*
BE	X		X	X	
DE			X	X	
EE		X	X	(X)	
ES	X	X	X	X	X
FR			X	X	
IT				X	
CY		X	X	(X)	
LU	X		X	X	
MT	X	X	X	X	X
NL	X		X		
AT			X	X	
SI	X	X	X	(X)	X
SK	X	X	X	X	X
FI			X		
BG		X	X	(X)	
CZ		X		X	
DK			X		
LV		X	X	X	
LT		X	X	X	
HU			X	(X)	
PL		X	X		
RO		X	X	X	
SE			X		
UK	X		X	(X)	

Source: Commission *Report on Tax Reforms in EU Member States* (2012).
Note: The screening results are not indicated for countries covered by an economic adjustment programme (Cyprus, Ireland, Greece and Portugal), as the latter remains the sole authoritative reference at EU level.

The consolidation effort needed in some Member States could be achieved through the following measures: (i) further tax hikes in the short term; (ii) cutting expenditures in the medium run – to reduce gradually the weight of taxes in some countries; (iii) broadening the tax bases (closing loopholes in direct and indirect taxation) rather than increasing tax rates.

3.2 *Rationalising the Tax Systems by Efficiency-Friendly Reforms*

Fiscal consolidation need is also an occasion to rationalise the tax systems by revenue-neutral reforms to enhance its efficiency and remove distortions harmful to growth. This would imply shifting taxation toward growth enhancing tax bases (away from labour toward consumption, property and environment), broadening tax bases and improving tax governance and the quality of tax administration. Table 3 provides an overview of Member States that may need to consider tax policy measures according to an indicator-based analysis.

3.2.1 Growth-Friendly Tax Structures

In many Member States, a high tax burden on labour, especially on those groups that face a particularly weak attachment to the labour market (i.e., low-skilled workers or second earners in couples), coexists with relatively low levels of those taxes considered less detrimental to growth, i.e., consumption taxes, recurrent property taxes and environmental taxes. Table 4 indicates Member States which may consider shifting tax away from labour.

The rationale for tax shifting lies in the ranking of taxes by the OECD in terms of growth-friendliness (Johansson *et al.*, 2008; Arnold *et al.*, 2011). These studies showed that the composition of tax revenues was significantly related to the level of income per capita in the long run, which was broadly confirmed by Acosta-Ormachea and Yoo (2012) over a larger country sample. Moreover, some consumption taxes, such as excise duties on tobacco, alcohol and polluting activities may contribute to pricing in negative externalities on health and environment and reducing the incentive for the consumption of goods hazardous to health and environment. These are part of the so-called “pegouvian taxes”, also popularly referred to as “sin taxes”.

However, a recent econometric study (Xing, 2012) has shown that the OECD ranking was not robust under different assumptions about the heterogeneity of the long-run and short-run coefficients across countries in the underlying econometric model. It should be borne in mind that the OECD ranking applies *ceteris paribus*: the specific design of the individual taxes also plays an important role in terms of economic efficiency, as noted by Keen (2013) in the case of the VAT structure or the base of corporate income tax. Some economists also argue that a possible complement for recurrent property

Table 3: *Overview of Tax-Related Challenges in EU Member States (Based on Quantitative Indicators)*

		Broadening Tax Bases					*Tax Governance Challenges*		*Special Topics*			
									Housing Taxation		*Environmental Taxation*	
	Contribution of Tax Increases to Consolidation	*Need and Room for Tax Shift*	*Need to Review Expenditure in PIT*	*Need to Review Expenditure in CIT*	*Debt Bias in Corporate Taxation*	*Increasing VAT Efficiency*	*Tax Compliance*	*Tax Adminis-tration*	*Structural Shift*	*Debt Bias*	*GHG Target*	*Design*
BE		X	(X)	X		(X)	X		X	X	X	X
DE		(X)			(X)							X
EE										X		
IE	–			X		(X)					X	
EL	–		X		X	X	X	X	X	X	X	X
ES	X		X	X	(X)	X	X		X	X		
FR		X	X	X	X	(X)			X			X
IT		X	X			X	X		X	X	(X)	X
CY	–						(X)		X		(X)	
LU				X	X		X		X	X	X	X
MT	X			X	X		X				X	
NL				X						X		
AT		(X)	X								(X)	
PT	–		X	X	X	(X)	X	X	X	X		X
SI	X			X			X				(X)	
SK	X					(X)	X	X			X	X
FI										X	(X)	

Table 3: *Overview of Tax-Related Challenges in EU Member States (Contd.) (Based on Quantitative Indicators)*

		Broadening Tax Bases					*Tax Governance Challenges*		*Special Topics*			
									Housing Taxation		*Environmental Taxation*	
	Contribution of Tax Increases to Consolidation	*Need and Room for Tax Shift*	*Need to Review Expenditure in PIT*	*Need to Review Expenditure in CIT*	*Debt Bias in Corporate Taxation*	*Increasing VAT Efficiency*	*Tax Compliance*	*Tax Adminis-tration*	*Structural Shift*	*Debt Bias*	*GHG Target*	*Design*
BG							X	X				
CZ		X		X		(X)	X	X		X		
DK										X	(X)	
LV		X		X		X						
LT				X		(X)	X				X	X
HU		(X)				(X)	X					
PL			(X)			(X)	X	X				
RO		X		X		X	X	X				
SE					(X)					X		
UK			X	X		X						

Source: Commission *Report on Tax Reforms in EU Member States* (2012).
Note: The screening results remain purely indicative for countries covered by an economic adjustment programme (Cyprus, Ireland, Greece and Portugal), as the latter remains the sole authoritative reference at EU level. The first two columns are derived from the last column of Table 2 and 4 respectively.

taxes could be to raise inheritance taxes (alongside parental gift) which are very low in some countries (Piketty and Saez, 2012; IMF, 2013), although evidence on the distortion of such taxes is mixed (Boadway, Chamberlain, and Emmerson, 2010).

Model simulations seem to broadly confirm the OECD findings. A simulation of a permanent fiscal consolidation based on the *QUEST* model suggests the importance of the choice of the tax instrument (Roeger and In't Veld, 2010).[2] Coenen *et al.* (2012) compares the impact of seven discretionary fiscal stimulus shocks in seven structural DSGE models, all used heavily by policymaking institutions. The long-term negative GDP effect across type of taxation broadly mirrors the ranking of taxes by distortionary effects in the public finance literature: direct taxation appears more distortionary than indirect taxation across the models considered. The negative output effect in the long run arises from a negative wealth effect, which is exacerbated by the distortion induced by taxation.

3.2.2 Broadening Tax Bases, Improving Taxation Design and Tax Governance

Many Member States could broaden their tax bases. Some need to review/reduce tax expenditure in direct taxation. Many Member States still face a low VAT collection caused by the numerous reduced rates and exemptions, which should undergo a serious economic review.

Other relevant challenges relate to the specific design of individual taxes, such as the debt bias in corporate and housing taxation and the revision in housing and environmental taxation.

Lastly, a number of Member States face the challenge of improving tax governance, by either reducing a large shadow economy and fighting against high levels of VAT fraud and evasion. Some have a particular potential to increase the efficiency of the tax administration, by cutting high administrative costs per net revenue collected or reducing the high administrative burden of tax systems for mid-sized companies.

[2] An increase in corporate profit tax has, with relatively high adjustment costs on capital, a relatively small short-term impact but GDP losses build up over the following years as investment is depressed and the capital stock declines. It causes the largest long-run GDP loss of all tax based consolidations. In contrast, a consolidation through labour taxes yields a strong initial GDP loss (although in the long run labour taxes can be curtailed owing to the fiscal space that becomes available as a result of the reduction in government debt, and GDP eventually turns positive). Taxes on consumption (VAT and other consumption taxes) and taxes on housing property have smaller short-term impacts. GDP falls slightly below baseline but gradually recovers and becomes positive after three to four years. Therefore, a revenue-neutral shift from labour taxes to consumption taxes is found to have positive effects on employment and GDP using the model *QUEST* (European Commission, 2013).

Table 4: *Tax Structure: Screening Results*

	High Tax Burden on Labour		*Potential to Shift*			*Conclusion: Need and Room for Tax Shift*
Country	*Overall*	*Specific Groups*	*Low Consumption Taxes*	*Low Recurrent Taxes on Housing*	*Low Tax Burden on the Environment*	
BE	X	X	(X)		X	X
DE	(X)	(X)	(X)	X		(X)
EE				X		
IE			X			
EL			X	X	X	
ES			X		X	
FR	X	X	X		X	X
IT	X	X	X			X
CY			(X)			
LU			X			
MT			(X)	X		
NL		(X)				
AT	(X)	(X)		X	X	(X)
PT			X			
SI				X		
SK			X	X	X	
FI	(X)					
BG				X		
CZ	X		(X)	X	X	X
DK						
LV		X	(X)		X	X
LT			X	X	X	
HU	X	X		X		(X)
PL						
RO		X	(X)		X	X
SE	(X)	(X)				
UK			(X)			

Source: Commission *Report on Tax Reforms in EU Member States* (2012).
Notes: The screening results remain purely indicative for countries covered by an economic adjustment programme (Cyprus, Ireland, Greece and Portugal), as the latter remains the sole authoritative reference at EU level.

(X) depicts borderline cases. Member States are considered to have a room to shift if consumption tax indicators are very low (below one standard deviation under the average), if they are low (below average) combined with a very low burden on at least one of the two other potential bases for tax shifts (consumption, housing, environment), or if the burden on at least one of the other bases is very low with the burden on the other one being low.

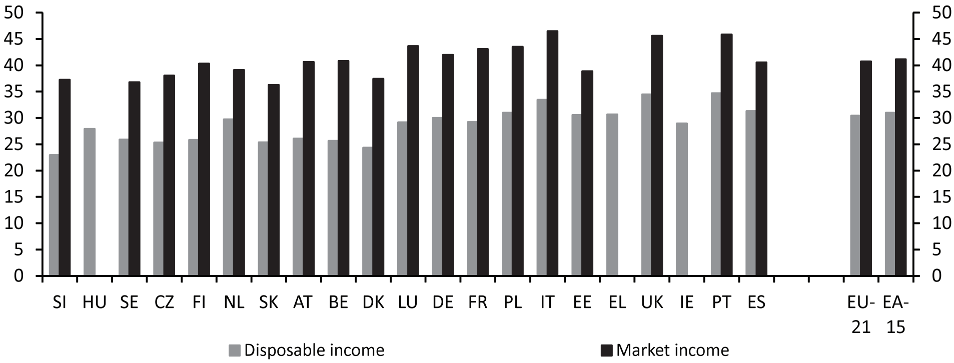
The policy to improve tax governance at national level is complemented by a broad effort to improve global tax governance. One prominent issue in this respect is to coordinate corporate taxation across Europe and, more ambitiously, across the world, with a view to fighting against tax avoidance and tax evasion. The Commission has launched a number of initiatives to fight tax fraud and tax evasion EU-wide, including tackling the issue of aggressive tax planning in the area of company taxation. Aggressive tax planning consists in taking advantage of tax systems' loopholes or of mismatches between two or more tax systems with a view to reducing tax liability. It can lead to double non-taxation, by which, for instance, income is neither taxed in the country of source nor the country of residence, or the same loss is deducted twice, both in the country of source and residence. This aggressive tax planning reduces the ability of a sovereign state to collect taxes. More worryingly, it forces governments to raise taxes predominantly on the least mobile tax bases, which are subject to less erosion, such as labour income and profits of individual entrepreneurs or SMEs. This reduces the capacity to shift tax away from bases most detrimental to growth and employment. It also pushes Member States to engage in tax competition, which could be seen as an unproductive "race to the bottom", leading to distortion to the Single Market, costly rent-seeking activities for firms and global revenue losses for the whole area.[3]

3.3 *Paying Attention to Redistributive Considerations*

Last but not least, the need to distribute the burden of tax increases (required by fiscal consolidation) fairly across the society is another issue to be borne in mind when designing tax policy. The tax system has indeed a strong impact on the income distribution, as suggested by Figure 2. Redistribution can take place through several channels, namely: (i) progressive tax scale for labour income (but also through income replacing transfers, benefits and public consumption expenditures); (ii) tax expenditures (which run the risk of making the system regressive); (iii) labour disincentives to work, embedded in the tax system (hitting the low skilled particularly); (iv) low tax compliance, favoured by inefficient tax governance, tends to increase the tax pressure of

[3] The revenue loss due to tax avoidance is difficult to estimate. See, e.g., Fuest *et al.* (2013), for a critical review of available estimates and empirical research of the significance of corporate tax avoidance. The authors mentioned some stylised numbers from public debates. For instance, Richard Murphy claimed in his report "The Missing Billions" that GBP 12 billion of corporate income tax are lost each year due to tax avoidance by the 700 largest companies in the UK. The German Institute for Economic Research (DIW Berlin) puts forward an estimated revenue loss associated with profit shifting of EUR 90 billion in Germany. However, Fuest *et al.*, highlighted serious methodological flaws underlying the presented estimates, such as comparing taxable profits or actual tax payments with inadequate benchmarks, which hamper their reliability.

Figure 2: *Impact of the Tax System on Income Concentration Concentration of Market Income and Disposable Income Measured by the Gini-Coefficient*



Sources: Commission *Report on Tax Reforms in EU Member States* (2012); OECD.
Note: EU-21 refers to EU members of OECD and EA-15 to euro area members of OECD. The OECD data refer to the working-age population. Data refer to a year between 2006 and 2009. Income data are adjusted for household size. Averages used are arithmetic.

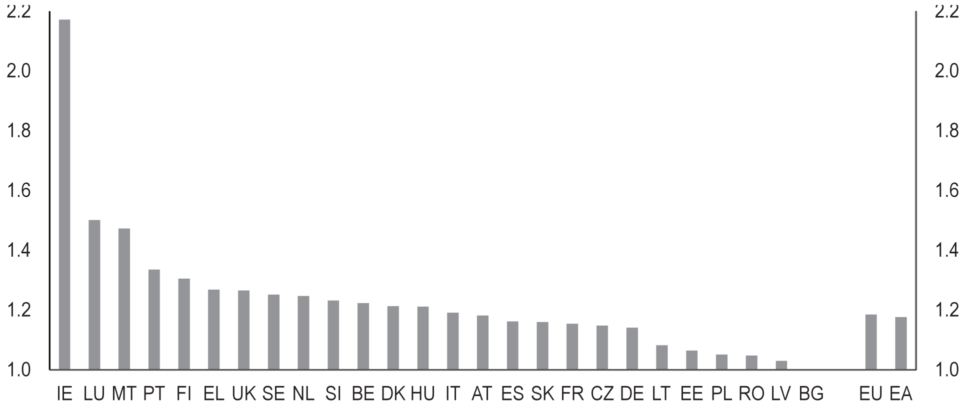
those actually complying with the tax rules, in order to compensate the revenue loss caused the non-compliant.[4]

Redistribution through the tax-benefit system is the prerogative of Member States, which have different perceptions of social equity and different collective preferences for balancing efficiency versus equality. The redistributive features of tax systems, such as the progressivity of labour taxation, vary strongly across countries (see Figure 3). Therefore, it is difficult and unwise to come up with prescriptive policy recommendations in this complex and sensitive area. The identification of clear policy challenges in this field rests at national level.

However, any Member State facing substantial efficiency challenges in the tax-benefit system (e.g., large share of tax expenditures) and at the same time achieving a poor outcome in terms of mitigating income inequalities may have scope for improving efficiency without compromising redistribution policies or increasing redistribution without harming efficiency.

[4] Recently, some academics have suggested going farther by introducing a well-designed tax on total wealth in EU countries, beside income taxation. According to them, it could maximise the redistributive effect of taxation given the high dispersion of wealth, its concentration at the very top of the distribution and the much higher wealth-income ratios in Europe compared with the US (Piketty, 2013). However, such a proposal faces serious implementation issues at national level, given the mobility of capital throughout the world, and equally strong political economy obstacles.

Figure 3: *Indication of the Progressivity of Labour Taxation Ratio of Tax Wedge 167 Per Cent/67 Per Cent of the Average Worker (Single, No Children), 2010*



Sources: Eurostat and OECD.

Moreover, the need to take the sustainability of public finances into account in the design of tax policy corresponds to what intergenerational equity generally demands, in particular avoiding passing a considerable (and unsustainable) debt burden on to the next generation. Such a burden may imply more taxes, less growth-friendly public expenditure and less social protection, with a possibly adverse impact on growth and welfare for the next generation.

IV RESULTS OF THE EUROPEAN SEMESTER 2013

4.1 *The Policy Outcome: the Country-Specific Recommendations*

The European Semester is concluded in the month of June by the endorsement by the European Council of the country-specific recommendations (CSRs), which has been proposed by the European Commission one month before. This endorsement may be accompanied by some changes compared with the initial proposal. The proposed CSRs follows a careful examination by the Commission of the economic strategy of each Member State, as stated in its national reform programmes (economic, growth and employment policies) and its stability/convergence programmes (fiscal policy).

On 29 May 2013, the Commission presented its proposal for CSRs in the framework of the 2013 European Semester. 23 Member States received at least one CSR, covering all countries but Cyprus, Ireland, Greece, Croatia and

Portugal. Cyprus, Ireland, Greece and Portugal are subject to a macroeconomic adjustment programme, which has its own process (Memorandum of Understanding and regular reviews). To avoid duplication and confusion, there are no additional recommendations in the form of CSRs for these four countries. Croatia was not yet a member of the EU when the 2013 European Semester started. The Member States will now translate these recommendations into their forthcoming decisions on budgets, structural reforms and employment and social policies, while promoting full national ownership and preserving social dialogue. The Council and the European Commission will closely monitor the implementation.

Based on the Commission proposals and with fairly limited changes, the Council on 9 July 2013 issued the final recommendations for non-programme Member States. In all of them (bar Denmark and Finland), the CSRs encompassed issues related to taxation, which are reported in Table 5. The omnipresence of these issues is telling about the importance of tax policy in the current policy debate.

Table 5: *CSRs in the Area of Taxation Adopted by the EU Council in June 2013*

Tax Policy Dimensions (non-mutually exclusive)	*Member States*
Contribution of tax to fiscal consolidation	LT, SI, UK
Shifting labour taxes toward more growth-friendly bases	BE, CZ, FR, IT, LV, HU, AT
Reducing the tax burden on labour with no reference to a tax shift	NL, DE, SK
Reviewing tax expenditures in direct taxation	BE, ES, IT, SE
Broadening VAT base.	BE, DE, ES, FR, IT, LU, SE, UK
Addressing corporate debt bias	ES, FR, MT, LU, SE.
Housing taxation	CZ, DE, IT, LV, LT, NL, AT, SK, SE, UK
Environmental taxation	BE, CZ, EE, ES, FR, IT, LV, LT, LU, HU, AT, RO
Enhancing tax governance.	BE, BG, CZ, ES, IT, LV, LT, HU, MT, PL, SI, SK, RO

Source: EU Council (2013). Classification by the author.
Note: Some individual tax CSRs could fall under two or more tax policy dimensions, such as CSRs recommending to shift taxation from labour environmental taxation and housing taxation, recorded in the table three times, under “shifting labour taxes” toward more growth-friendly bases, “housing taxation” and “environmental taxation”.

Compared with last year's CSRs, the tax CSRs adopted in 2013 appear more specific and concrete. They generally go beyond the statement of policy objectives, suggesting possible policy options and the possible use of some policy instruments. They generally strictly follow the horizontal principles set in the *Annual Growth Survey*, which are released at the end of the year preceding each European Semester (in end November 2012 for the 2013 European Semester). The principles generally apply to tax policies that are decided at national level and are relevant to influence the macro-economic performances (growth, employment, fiscal sustainability and macroeconomic balance). The CSRs encompasses the following dimensions: consolidation through tax measures, tax shifts and reducing labour taxation, reduction in tax expenditure, broadening of VAT base, reducing debt bias in corporate taxation, environmental taxation, housing taxation and tax governance.

The compliance with these horizontal principles is evaluated through a thorough assessment. As for tax policy, it uses the assessment framework set out in the TRR, based on cross-country consistent indicators, but in a flexible and non-mechanical fashion. The analysis is of course supplemented by precise country-specific evidence. The process benefits from a tight dialogue between the Commission and the Member States (e.g. missions, bilateral meetings). The CSRs are also subject to a systematic consistency checks across countries, to ensure the equal treatment of Member States.

Significant deviations from the horizontal assessment framework sketched in the TRR could occur when drawing up the tax CSRs. They are warranted by a series of valid reasons. First and in addition to special country specific circumstances (not systematically taken into account in the horizontal assessment framework), spill-over effects of tax systems on other Member States and the European dimension of tax policy reforms deserve to be considered in earnest in the CSRs. Second, the horizontal assessment framework may not take due account of very recent measures adopted or implemented in Member States, since they may not be captured (yet) by the quantitative indicators used there, which are often backward-looking. These recent measures should justify revisiting or modifying the CSRs, because they could represent a significant action taken by Member States to address a challenge already mentioned in previous CSRs. The existence of bigger challenges in other sensitive policy areas than taxation may also justify not including or scaling down tax CSRs, in order to focus the reform effort on the right priorities. Political opportunities and other political economy considerations may be factored in CSRs and cause some further legitimate deviations from the results of the TRR assessment framework.

4.2 *On Which Areas Did Tax CSRs Focus in 2013?*

Table 5 indicates the main tax dimensions concerned by the CSRs adopted by the EU Council in 2013. A country count by tax dimension provides insight on the relevance of a specific type of tax challenge throughout the EU (although programme countries and Croatia are not included). Thirteen countries, that is, more than a half of the EU Member States covered by the European Semester, have received a CSR to improve tax governance. Most of them regard the need to enhance tax compliance and fighting against evasion and fraud. Fewer also concern the efficiency of tax administration.

Twelve countries have been advised to step up their environmental taxation. In half of the cases, this is recommended as part of a tax shift. In the other half, CSRs recommend raising green taxes so as to meet climatic or environmental objectives.

Ten countries have been urged to reduce their tax burden on labour to favour job creation. Six of them were specifically encouraged to reduce labour taxation on specific labour groups (low income earners, low skilled or second earners), to boost employment creation and reduce the risk of undeclared work. In seven out of the ten countries, the CSRs recommend explicitly to shift taxation away from labour to less detrimental taxations, such as consumption, property or environmental taxes. In most cases, the recommendations to reduce labour taxation and/or to shift tax were already mentioned in the previous European semester and were carried over this year because of the absence of sufficient implementation of the 2012 CSRs.

Ten countries also received a CSR on housing taxation. Some CSRs refer to the scope for increasing real property taxation either to meet consolidation challenge or to allow for a growth-friendly tax shift away from labour. Some others suggest reforming and modernising the functioning of the housing tax, through a reassessment of the tax base, often involving a revision of outdated cadastral values. Finally, the other relates to the need for reducing the debt bias in real property taxation with a view to lowering household indebtedness, through for instance the reduction of mortgage interest deductibility.

Eight countries received a CSR advocating to broadening their tax bases. This generally concerns reducing the scope for or increasing VAT reduced rate, which is combined in some countries (BE, ES, IT and SE) with the recommendation to review the numerous tax expenditures in personal and corporate income taxation as well.

Furthermore, five countries were invited to reducing the debt bias in corporate taxation. While reforms on that are under way in many countries, they do not seem to be sufficient in several Member States. Lastly, three countries (LT, SI, UK) were invited to consider using taxation to support their fiscal consolidation effort.

4.3 *Are There Cross-Country Spillovers Between National Tax Policies?*

The CSRs mainly focus on the need of reforms in EU Member States with a view to improving their economic performance. However, tax reforms in one country may generate a number of spillovers on other EU countries. These interactions should be borne in mind, when assessing the risks involved in reforming the tax system of many countries simultaneously. There are three main types of tax spillovers.

The first type of spillover is related to tax competition: marked difference in the average effective rate of corporate income taxation and the existence of favourable tax regimes for specific sectors or types of firms may affect the location of firms and investments and influence profit shifting behaviours.[5] This has led to a tendency to lower the statutory rates of corporate income tax and to maintain generous amortisation rules and other favourable tax expenditures for corporate incomes. This has been seen as a "race to the bottom", that is, a non-cooperative game with a suboptimal outcome for the whole EU, in terms of revenue loss and weakened capacity by governments to shape their tax system. Tax could be avoided by shifting corporate incomes to subsidiaries located in lower tax countries (i.e., profit shifting) and could be evaded by the use of tax havens and creative accounting. In order to limit this type of harmful spillover, some form of tax cooperation was put in place. The Commission launched the *Code of Conduct on Business Taxation* in 1997, under the aegis of Commissioner Monti. While it represents an important political agreement to remove harmful tax regimes and refrain from introducing new ones, achieving tangible results appeared often challenging in practice. In December 2012, the Commission published its Action Plan to strengthen the fight against tax fraud and tax evasion. While it concerns fraud and evasion related to both direct and indirect taxes, some of the actions are specifically related to corporate tax.[6] Finally, the Commission shares the view that international tax rules must be updated, strengthened and complied with

[5] There are three main effects through which tax competition may operate (Devereux *et al*., 2008). First, multinational firms make discrete decisions regarding the location of their foreign subsidiaries, and these hinge up on the impact of taxation on the after-tax total profit available in each potential location, as measured by the effective average tax rate. Second, regarding the decision on how much to invest (conditional on location), the firm will consider the effective tax burden on capital income generated by a new investment, that is, the effective marginal tax rate, which takes into account the statutory tax rate and the base effects (such as the existence of a capital allowance, amortisation rules or other tax expenditures). Third, conditional upon where real activity takes place, multinational firms can shift profits from one country to another in order to lower the overall tax liabilities. They can do so through lending by subsidiaries in low tax countries to subsidiaries in high tax countries or by setting appropriate transfer prices on intermediate goods exchanged within the multinational firm. The incentive for profit-shifting depends on the difference in the statutory tax rate between countries.

[6] Besides, the Commission released two Recommendations to promote a common EU stance against so-called "tax havens" and recommended action against aggressive tax planning.

globally. This applies for instance to the digital economy, where tax rules have failed to keep pace with the changing environment. To this end, the OECD published an Action Plan on *Base Erosion and Profit Shifting* (BEPS). It aims to address several deficiencies in the existing international tax rules and standards, which are exploited by multinationals worldwide to *erode* the tax base in high tax countries and to *shift* the tax base to reduce their overall tax bill. The BEPS project has received wide, global support from G20, G8, European Council and various other international fora.

The second type of spillover is related to the macroeconomic interactions. For instance, the impact of a tax reforms on growth is likely to positively affect other EU countries, via the trade link: better growth performance in a country will stimulate imports, which represents additional exports from the standpoint of trade partners. In contrast, a tax shift away from labour will, at least in the short term, boost the national competiveness and the trade balance, at the expense of trade partners. Such a tax shift, which could be motivated by the long-term reduction of supply-side distortions, also leads to a "fiscal devaluation", which reduced the (labour) cost of national producers vis-à-vis importers. In addition to its positive impact on GDP in the long run, shifting the tax burden from labour to consumption might also be beneficial, mainly in the short term, for those countries that are still suffering from losses in price competitiveness built up over the past decade. Indeed, while VAT is applied in the same way to foreign and domestic producers, a decrease in labour costs stemming from the tax shift would mainly benefit domestic producers, with their production costs being (temporarily) lowered vis-à-vis foreign competitors. However, such a fiscal devaluation corresponds to a "beggar-thy-neighbour" policy and its positive impact on competitiveness fades away when all countries are applying it. Moreover, its positive impact on the national trade balance disappears in the long run (see de Mooij and Keen, 2013, and European Commission, 2013). Lastly, beside the positive spillover of growth and the negative spillovers on competitiveness, a reduction in consumptions taxes (VAT, excise duties) may generate cross-border shopping and thank tourism (i.e., fuel-tanking trips in border regions) at the detriment of the countries with relatively high taxes. Overall, while the positive "growth spillover" – especially in the medium to long term – renders synchronised reforms across several countries more efficient than a unilateral reform, the negative "competiveness spillover" tends to reduce the effectiveness of synchronised tax policies, especially in the short term. Thus, the eventual effect of synchronised reforms remains unclear from a macroeconomic view point, particularly in the short run.

The third type of spillovers is related to the political economy. Tax reforms generating a significant rise in revenue or demonstrating a positive effect on growth and jobs may be seen as a good practice for other EU countries. The exchange of national policy experiences may encourage some Member States to replicate or broadly follow successful policies. For instance, policies reducing taxation on low-skilled labour to improve the incentives to work are generally considered as good practices and have spread over to many EU countries. The European Semester has clearly supported that by stressing the relevance of this labour-friendly tax policy in the different issues of the *Annual Growth Survey* and via the numerous Country Specific Recommendations addressed to EU Member States to this end (i.e., ten of them in the 2013 round). The positive political economy spillover is likely to be magnified with synchronised reforms since the moral suasion and the political appeal of best practices increase if the latter are seen in a group of countries.

V CONCLUDING REMARKS

The European Semester, launched in 2011, has led to an annual process to scrutinise tax policies and spur the reforms thereof at national level with a view to improving their contribution to economic efficiency, employment and fiscal sustainability. This annual process can only be evaluated thoroughly over several years. First, it strives for promoting, among others, long-standing tax reforms, which are likely to bear all their fruits in the medium to long run. Second, many tax challenges appear sizeable and demand substantial reforms to address them, while substantial reforms were often carried out by steps rather than through a radical overhaul. Third, many tax challenges seem to persist over time. The 2013 issue of the Commission's *Tax Reform Report*, released in October 2013, updates the results of the 2012 issue and represents an analytical input to the preparation of the next European Semester (European Commission, 2013). The recent issue of the report confirms that many of the challenges indicated in the 2012 Commission's *Tax Reform Report* are persistent and still valid for the year to come despite many measures undertaken by Member States in 2012 and early 2013. The latter have shown varying levels of ambition: while many of them went in the right direction, they sometimes proved insufficient, at least in the short term, to fully respond to the initial challenges. This persistence of tax challenges points to the need to tackle the implementation gap, which is common in the field of structural reforms. Of course, the long-term impact of past reforms, alongside the effect of the recent measures adopted in response to the country-specific recommendations issued by the 2013 European Semesters, are still to be evaluated in the framework of the next European Semester.

The European Semester remains complementary to wider actions to improve tax coordination and global tax governance at EU level but also at international level. These are meant to reduce harmful tax competition, aggressive tax planning and other distortions leading to base erosion and hampering the functioning of the Single Market.

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