PUBLIC ADMINISTRATION & REGIONAL STUDIES
3 rd Year, No. 2 (6) – 2010
Galati University Press, ISSN 2065 -1759

TAXATION AND TAX HARMONIZATION AS A PROCESS IN THE EUROPEAN UNION[1]

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Abstract

The paper is focused on tax harmonization and development of taxation in the European Union. The first part defines and specifies the term tax harmonization, based on a literature review. Next, the degrees of tax harmonization are explained. The third part of the paper summarizes the European Union approach to tax harmonization. The fourth section presents current development and also the level and the structure of tax burden in the European Union.

Key words*: tax harmonization, degree of harmonization, tax burden, tax quota, implicit and nominal tax rate.*

JEL Classification: H20, H30.

Introduction

The concept of a common market involves the elimination of all obstacles to intra-community trade in order to merge the national markets into a single market bringing about conditions as close as possible to those of a genuine internal market. A debate about tax and fiscal cooperation and harmonization has existed in Europe since the foundation of the European Economic Community in 1957, and it has been intensified mainly because of the European Monetary Union (EMU). The EU proclaims that its functioning is connected to the single internal market, which is defined as an area without inner borders, and within this area, there are four kinds of freedom ensured, i.e. free movement of goods, persons, services and capital. That is why harmonization can be understood as the theoretical condition for achieving this goal. However, it is possible to identify varying levels of harmonization between the radical poles of absolute harmonization and non-harmonization. Fiscal policy remains a symbol of

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[1] This paper ensued thanks to the support of the grant GAČR 402/08/0067 'Financial Integration of the New EU Member States with Eurozone'.

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national sovereignty, so the idea of fiscal harmonization has been gradually narrowed to tax harmonization.

The aim of the paper is to define the tax harmonization and summarize the European Union approach to harmonization. The analysis will be focused on direct and indirect tax harmonization as well as on the current development, level and structure of tax burden in the European Union.

1. Definition and specification of tax harmonization

Although the term "tax harmonization" is frequently used, it is a problem to find comprehensive definition. Rounds (1992) defines harmonization as any situation where differences in taxation between the states (or provinces) are reduced either by cooperation among the states or by a federal government policy. Dosser (1973) restricts tax harmonization to tax coordination among nations in the process of integration in a customs union or economic union. However, this definition is no longer adequate to cover the full current use of the term. Prest (1979: 76) argues: "coordination is essentially a low-level meaning of harmonization because it could be interpreted as no more than some sort of consultation process about organising tax systems in a similar sort of way". Rounds (1992: 91-92) suggests that harmonization "refers to any situation where differences in taxation between the states (or provinces) are reduced either by co-operation among the states or by a federal government policy" but acknowledges that a completely uniform tax system may "not be optimal or practical." Peggy Musgrave (1967: 210) suggests a more open definition, based on ends rather than on precise institutional arrangements, "Fiscal harmonization may be viewed as the process of adjusting national fiscal systems to conform to a set of common economic aims".

Hitiris (1994) prefers a wider view of the term and describes two approaches to tax harmonization - the equalisations approach and the differentials or fiscal diversity approach. Essentially the equalisations approach is that each country ends up with the same tax system. The differential approach allows each country to use its tax system as a tool of policy in achieving major economic aims. This might be crudely summarised as saying that harmonization can mean that either different countries' tax systems remains the same or they become different, so some further exploration of the term is required.

In the report published by the International Bureau of Fiscal Documentation (IBFD), Lyons (1996: 153) defines tax harmonization as "the process of removing fiscal barriers and discrepancies between the tax systems of the various countries creating the European Union. The first part of the IBFD definition, removing fiscal barriers, refers to the promotion of a free trade area. It implies that imported goods and services within a free-trade area should not be subject to any fiscal discrimination in comparison to domestically produced goods and services. It is the aspect known as "removing...discrepancies between tax systems" more openly. Harmonization could be taken to mean bringing into harmony or agreement, reconciliation or standardisation in his point of view - Brown (1993: 1192).

James and Nobes (2002:17) argue about the extent of harmonization: "Complete harmonization might imply that each country had exactly the same tax system. This would mean that each country had the same taxes, for example, value added tax, imposed on the same tax base, that is the same goods and services were subject to tax in each country. It would also mean that the same tax structure, that is the same rates of tax, was applied in each country. However, harmonization might be considered to be something involving less standardisation - more in terms of tax systems operating in harmony in the sense of making up a consistent and orderly whole, without each part being identical". Following this fiscal federalism approach, the question becomes how far differences in taxes between countries may be consistent within an overall situation of tax harmonization.

Tax harmonization often deals with the ability of governments across jurisdictions in a union to coordinate or harmonize corporate tax rates so as to optimize local revenues, while simultaneously attracting capital to, and preventing outflows or cross-hauling of capital out of their jurisdiction (Bucovetsky, 1991; Frey and Eichenberger, 1996; Gordon & Wilson, 1986). As Wildasin (1999) says, this is especially important in unions where local jurisdictions have a great deal of discretion over corporate tax rate levels. Gordon (1983) declares that in a federal system of government each jurisdiction has independent choice as to what tax rate will be chosen, as well as what level of public goods will be provided.

This distinction however, does not apply only to federal systems but to multijurisdictional contexts in general. Kanbur and Keen (1993) recall the similarities between a federal system of government, in terms of tax harmonization, and political and/or economic unions, such as the EU, and even go so far as to include international tax issues. The reasons for these similarities are the underlying difficulties and benefits of this type of cooperation. The EU has faced many of the same problems as federal states throughout the course of its history, though contexts and constraints are different, similarities are nevertheless significant. For further discussion of tax definitions and classifications see James (2002), James and Nobes (2002) or Serna (2008).

2. Degrees of tax harmonization

There are several possible dimensions of tax harmonization including the taxes levied, the tax bases, the rates of tax and the ways in which taxes are administered. Figure 1 indicates a possible classification. Complete harmonization or standardisation of taxes is the one extreme shown at the right part of Figure 1. Each country has exactly the same tax system. It means each country imposes the same taxes, for example value added tax, levied on the same tax bases (goods, services) and at the same rates. No harmonization is the other extreme. The left part of Figure 1 implies different taxes in different countries. It also implies no double taxation agreements. Administration considerations might also be important – for example involving coordination between the tax authorities in different countries over matters such as tax evasion. No harmonization would also seem to imply no systematic administrative cooperation either.

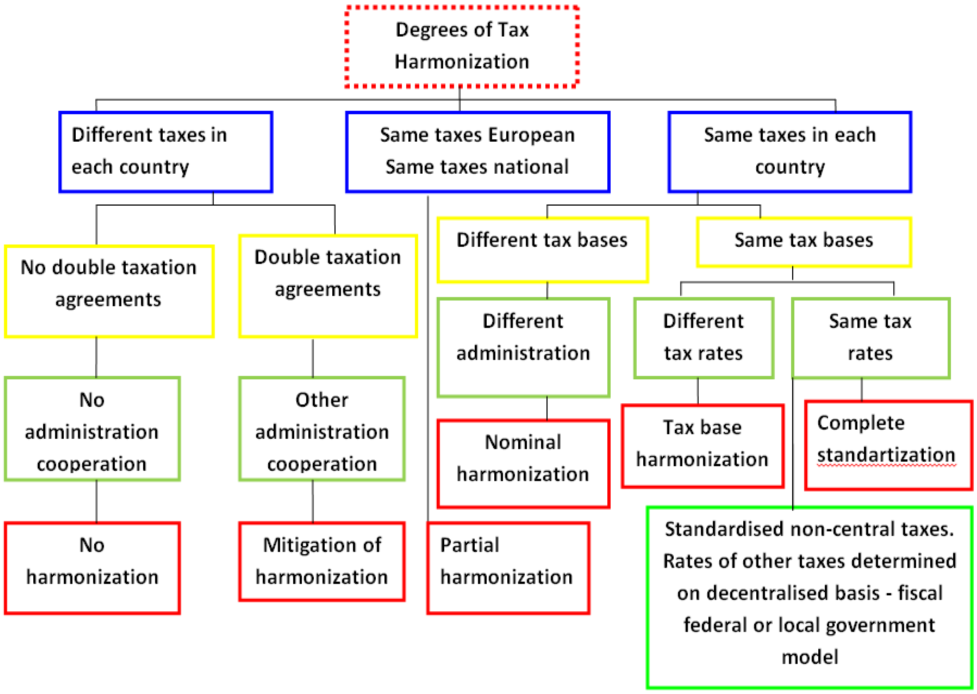

Figure 1: Degrees of tax harmonization
Source: based on James (2002: 19)

It is possible to identify varying levels of harmonization between the radical poles of absolute harmonization and non- harmonization. The first movement away from completely different fiscal systems might be the introduction of a degree of administrative cooperation between tax authorities regarding taxpayers with tax affairs falling within more than one tax jurisdiction. The next step might be the negotiation of formal double taxation treaties so that the same income is not taxed twice by two or more different tax jurisdictions. Therefore, this situation is described as the mitigation of harmonization.

A possible compromise could be partial harmonization, which entails the harmonization of some taxes and not others. In this way, for example, the European Community could establish some taxes to be applied uniformly in all the member states, allowing them to impose other taxes as they deem fit.

Nominal harmonization is a higher form of tax harmonization in that, although countries have the same taxes – as is the case in the European Community for corporation tax, value added tax and income tax, however, these taxes are not levied on the same tax base or by means of the same administrative methods in all the member states. For instance, the tax base might vary from country to country, and although each member state levies an income tax, the scope differs from such taxes in different countries. As regards indirect taxation, some goods and services are subject to tax in some countries, but they are not subject in other countries. Moreover, the method of administering a tax might be different. Each member state has a form of corporation tax, but they use different forms of interpretation between tax paid on corporate profits and that imposed on shareholders, e.g. the classical system or imputation system.

3. European Union approach to tax harmonization

Since the foundation of the European Economic Community in 1957, there is an ongoing debate over the necessity of an overall tax harmonization in Europe, which recently has been intensified mainly because of European Monetary Union. The EU proclaims that its functioning is connected to the single internal market, which is defined as an area without inner borders, and within this area, there are four kinds of freedom ensured, i.e. free movement of goods, persons, services and capital. Fiscal policy is a symbol of national sovereignty and responsibility for fiscal policy lies mainly with the member states, who may delegate some of it from central to regional or local level, depending on the constitutional or administrative structure of government. The efforts of fiscal harmonization have been centered around limited areas in the EU, where there are strong arguments in favor of the harmonization, being the case of indirect taxes that needed a high degree of harmonization for accomplishing the single market and especially for the elimination of the customs control. For the other fields, the solution is represented by the fiscal cooperation under the following forms:

- the coordination of the fiscal policies of the Member States, in order to make the fiscal systems of the member state compatible and to assure the

Commission that the rules from these fiscal systems comply with the Treaties;

- the information exchange and the cooperation between the fiscal administrations, instruments destined to ensure the coordination of the fiscal policies;
- cooperation within OECD, especially for fighting against the harmful fiscal competition, by imposing some minimal transparency standards and an exchange of fiscal information.

At the moment the EU includes twenty seven member states with twenty seven independent systems of taxation, whose configurations result from various economic, sociological, historical and other factors. Presented aims of the tax policy of the EU count support of harmonic development of economic activities, continuous and balanced development, increasing stability, growth of living standard and close collaboration of member states. The goal or effort of the EU is not to unify national systems of taxes and contributions, but to ensure their mutual comparability in accordance to accepted contracts established in the EU. The main areas for some degree of EU tax cooperation are such as:

- increased economic integration and mobility of factors of production may lead to a situation in which, on the one hand, Member States develop "harmful" strategies to attract or retain mobile tax bases and, on the other hand, taxation would increasingly be shifted to the immobile factor, labour;
- there are tax obstacles to the implementation of the single market and a common action is required to tackle those because action at national level could lead to an inefficient allocation of resources;
- there are tax externalities that can be better tackled at the EU level;
- the system and principles of the EU limits its role in stabilization and redistribution, so cooperation at the EU level may actually help Member States to preserve the resources needed to achieve these policies at the domestic level;
- because of common monetary policy, there may be a need for multilateral surveillance on the impact of taxes on economic output and stability[1].

[1] For details see EC (2000).

Nowadays there are boundaries for individual types of taxes determined in the EU as follows:

- personal incomes taxes remain in the authority of national governments;
- corporate taxes should help free movement of capital and should not cause harmful competition between individual states;
- social and pension systems should eliminate discrimination of residents of individual states and should not be an obstacle to free settling and investing in any member state of the European Union;
- indirect taxes—directly affecting functioning of the single market—attract a lot of attention and efforts to be harmonized.

Although harmonization has progressed significantly in the area of indirect taxes, substantial differences still exist in commodity tax rates, and they cause some distortion. "One of the reasons for its temporary discernment is the worry in some member countries that reduction of indirect taxes would have serious implications for the provision of public goods, and thus welfare, in those countries." (Lahiri and Raimondos, 1998: 266). But Baimbridge and Whyman (2004) argue that the literature emphasizes the potential welfare gains from indirect tax harmonization (Keen, 1989; Keen and Lahiri, 1993; Kanbur and Keen, 1993; Lopez-Garcia, 1996; Delipalla, 1997; Lockwood, 1997; Lahiri and Raimondos, 1998; Lopez-Garcia, 1998). The progress that has been achieved thus far is the establishment of minimum rates of indirect taxes. The system of indirect taxation is based on the Value Added Tax (VAT) and the destination principle in the EU, and the goods are taxed on the basis of where they are consumed. The minimum standard VAT rate is currently 15 %, and the minimum reduced VAT rate is 5 %. However, exemptions can be applied to this rule for a number of commodities (e.g. basic goods and newspapers) in some member states (see details in Szarowská, 2008).

On the other hand, differences in direct taxation have higher importance as they cause more severe economic distortions. The prospects for more coordination in corporate taxation were revived in 2001 when the European Commission issued a communication on company taxation in a single market. The report from the European Commission contained a study on the level, the dispersion and the determinants of corporate effective tax rates in the EU15, and a Communication with concrete policy proposals based on the identification of a series of tax obstacles to the completion of the single market, first the cross-border loss relief and transfer pricing, the presence of excessive tax administrative costs, double-taxation problems and other tax-related difficulties for companies doing business on an European-wide basis. To analyze the effect of the 2000 German tax reform, the study used marginal and average effective corporate tax rates for domestic and cross border investment in 1999 and 2001. It found a large dispersion of these rates in Europe as the average effective tax rate varied for example from 10.5 % in Ireland to 34.9 % in Germany. The report did not study the impact of this dispersion on investment patterns in Europe, nor did it assess the welfare effects. However, it provided statistical simulations of policy changes on the dispersion of the effective rates. Its main conclusion was that effective tax rates were mainly influenced by statutory rates and that harmonizing the latter would significantly reduce dispersion.

In terms of policy recommendation, the European Commission issued a two-track approach to tackle the tax obstacles to cross-border economic activity in the Internal Market. First, some so-called targeted solutions aimed at refreshing some pieces of EU legislation to deal with specific situations not foreseen by the legislator or to widen their scope of action. This is, for example, the case of the 1990 Parent-subsidiary directive and the 1990 merger directive for which the new European Company Statute had to be integrated into the legislative texts. In addition, the holding threshold from which the parent-subsidiary directive applies was lowered from 25 % to 10 %, and the new merger directive now covers the conversion of permanent establishments into subsidiaries. Second, the European Commission discussed four so-called comprehensive solutions for harmonizing corporate tax bases in Europe:

1. Home State taxation

It involves all or groups of member states agreeing to accept that certain enterprises with operations in a number of member states should compute their taxable base according to the tax code of a single member state – the „home State"- instead of according to all the different tax codes of the respective member states where they have operations. For companies operating in several member states, this would represent a significant simplification compared with the current situation.

2. Common consolidated corporate tax base (CCCTB)

It involves all member states, or possibly initially only a group, agreeing on a set of common rules for establishing the taxable base of certain enterprises with operations in a number of member states. The agreed upon set of common European rules should take agreed International Accounting Standards / International Financial Reporting Standards (IAS/IFRS) as a starting point. Each group of companies would have only one tax base (CCCTB) to calculate, tax rate would be set by the individual member states.

3. European Union company income tax

This system would also require the drafting of a new, single corporate tax code to apply across the EU. In its purest form, it would be administered by a new single authority, with a single EU tax rate. Revenues would be used to fund the EU institutions and activities with any excess allocated between member states according to an agreed upon formula. However, it could also be administered by individual member states in much the same way as value added tax, and each member state could apply its own tax rate to its allocated share of the tax base. From a political perspective, EU company income tax represents a fundamental change in that member states are required to relinquish an element of their fiscal sovereignty and establish a federal EU tax.

4. A single compulsory harmonized tax base

This system would require a single corporate tax code to be applied across the EU, to all enterprises, by all member states, replacing the existing domestic tax codes. The setting of the tax rate would remain in the jurisdiction of single member states. The existing tax codes would cease to exist and member state administrations would all operate the harmonized code without the need for a new centralized administration. The consolidated tax base of each EU enterprise would therefore have to be allocated between member states according to the terms of an agreed upon mechanism.[1]

[1] For details see EC (2001) or Blechová (2007: 7-15)

It has been noted in various studies that the benefits of harmonization and results are not unambiguous. For example, Jacobs et al. (2005) examine overall effective tax burden in 13 countries. Their analysis is based on a comparison of differences in taxation with and without a system of Common Consolidated Corporate Tax Base[1] . The adoption of IAS/IFRS has an impact on the deduction of expenses from the tax base (e.g. depreciation, valuation of inventories, provisions for liabilities). A transition to tax accounting on the basis of IAS/IFRS within the EU has only minor effects on the effective corporate tax burden. A major finding of the study reveals that the effective corporate tax burdens in all countries (except Ireland), tend to increase slightly since the tax bases tend to become broader. Moreover, some member states fear that harmonization of the tax base would be done in such a way that the agreement would lead to small tax bases, forcing these countries to raise their rates as to keep revenues constant. It shall be insisted that the best option is a broad tax base for efficiency reasons. The European Commission has no plan to harmonize the rates or to impose a minimum statutory corporate tax rate. The comprehensive solutions seek to tackle particular tax obstacles to cross border activities, to reduce the compliance cost of dealing with different tax systems now, and to improve the competitiveness of European companies while preserving the public finance of the member states.

[1]System CCCTB is based on International Accounting Standards / International Financial Reporting Standards (IAS/IFRS) which are obliged for all companies listed on EU stock exchanges from 2005.

4. Development of tax burden in the European Union

The next table presents tax rates in the EU and we can see significant differences in tax burden between Member States.

Table 1: Tax rates in the European Union in percentage (2010)

	Personal income tax			**Value Added Tax**		
Country	Number of rates	The highest rate	**Corporate income tax**	Super reduced rate	Reduced rate	Standard rate
Austria	4	50	25	-	10	20
Belgium	5	50	33	-	6; 12	21
Bulgaria	1	10	10	-	7	20
Cyprus	4	30	10	-	5;8	15
Czech Rep.	1	15	19	-	10	20
Denmark	4	59	25	-	-	25
Estonia	1	21	21	-	9	20
Finland	3	43.6 *	26	-	9;13	22
France	5	40	33.3	2.1	5.5	19.6
Germany	5	45	15	-	7	19
Greece	4	40	25	4.5	9	19
Hungary	2	36	19	-	5; 18	25
Ireland	2	41	12.5	4.8	13.5	21
Italy	5	43	27.5	4	10	20
Latvia	1	23	15	-	10	21
Lithuania	1	15	20	-	5; 9	21
Luxembourg	17	38	21	3	6; 12	15
Malta	8	35	35	-	5	18
Netherlands	4	52	25.5	-	6	19
Poland	2	32	19	3	7	22
Portugal	7	42	25	-	5; 12	20
Romania	1	16	16	-	9	19
Slovakia	1	19	19	-	10	19
Slovenia	3	41	20	-	8.5	20
Spain	4	43	30	4	7	16
Sweden	3	56.5 **	26.3	-	6; 12	25
UK	3	40	28	-	5	17.5

*The maximum personal tax rate (25 %) plus the average municipality rate (18.6 %).
**The maximum personal tax rate (25 %) plus the average municipality rate (31.5%)
Source: data from Taxes in Europe [online database] [cit 2010-08-15]

According to the fact that taxes bring the highest incomes into the public budgets, member states of the European Union may be divided into three groups. The following table shows that in sixteen countries, the main source of public revenues is indirect taxes, i.e. taxation of consumption. In six countries the highest revenues come from direct taxes (mainly personal and corporate incomes taxes) and in five countries the basic source of public budgets are payments for social welfare.

Table 2 Division of EU countries according to the main tax resource in 2008

Main Source of Tax Revenues		
Indirect Taxes	Direct Taxes	Social Contributions
Bulgaria, Estonia, Ireland, Italy, Cyprus, Lithuania, Latvia, Hungary, Malta, Poland, Portugal, Austria, Romania, Greece, Slovenia, Spain	Belgium, Denmark, Finland, Luxembourg, Sweden, United Kingdom	Czech Republic, France, Germany, Netherlands, Slovakia

Source: The author's compilation according to Eurostat data

Member states have very different structures according to the type of tax. Direct taxes only account for around 22 % of total revenues in Bulgaria, Romania and Slovakia while they represent more than 62 % in Denmark. The share of indirect taxes varies from 30 % in the Czech Republic, Spain and Finland to 56 % in Bulgaria. Social contributions only bring 2 % of total revenues in Denmark, but 45 % in the Czech Republic[1].

Total average revenues accounted for 38% of indirect taxes, 32 % of direct taxes and 30 % of social contributions in 2008. It also confirms a standard, generally used economic rule which prefers indirect taxes[2] to direct ones. As Široký (2009) points out, high income taxes may discourage employees from earning more, and force companies to take their profits into countries with the lowest tax rates. Therefore, many economists claim

[1] For details see Taxation trends in the European Union (2010)
[2] Indirect taxes are value added tax, excise tax, duty and other indirect taxes.

that the best taxes for the economy are those from consumption. Their level may threaten groups with low incomes but this may be compensated for special social benefits. Moreover, they are transparent[1].

The next figures are focused on development and changes in structure of taxation (measured by total tax quota[2] and implicit tax rates[3]) in member states.

Figure 2 delineates the change in the overall tax burden into (positive or negative) changes of its three major components. The red line shows the change in the overall tax to GDP for all the countries. The figure highlights that some member states only shifted taxation from one type of taxes to another in the period under consideration. The Czech Republic is an example of zero total changes in tax burden as it shifted the burden of taxation from taxes to social contributions - France did the opposite. Slovenia, Latvia, and the Netherlands also changed a tax mix and shifted the burden of taxation from social contributions to taxes. Examples of significant changes in the tax mix are Bulgaria and Romania, which shifted the burden of taxation from social contributions to indirect taxes. However, this is not visible in the figure due to the lack of data for 1995. We can find the highest difference in tax burden in Slovakia (decrease more than 11 %) and Cyprus (increase more than 12 %) during the period 1995 - 2008. Significant structural changes in fiscal policy are the main reasons for the development.

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[1] Direct taxes are imposed on a concrete subject that may not transfer this tax on somebody else, e.g. income tax. Indirect taxes are also imposed on a concrete subject, but may be transferred on another one.

[2]Total tax quota is a macroeconomic indicator that is calculated as proportion of tax and duty revenue and to GDP in current prices. It eliminates shortcomings of information about statutory taxation in international comparison as statutory taxes does not say much about real tax burden with regard to different construction of taxes in individual countries. Level of tax rate is only one of the variables. Resulting values substantially affect differently constructed tax bases, from which the tax is calculated, as well as systems of exceptions and deductible items that vary in every country.

[3] Implicit tax rates consider not only statutory tax rates but also other aspects of a tax system that determines volume of effectively paid tax.

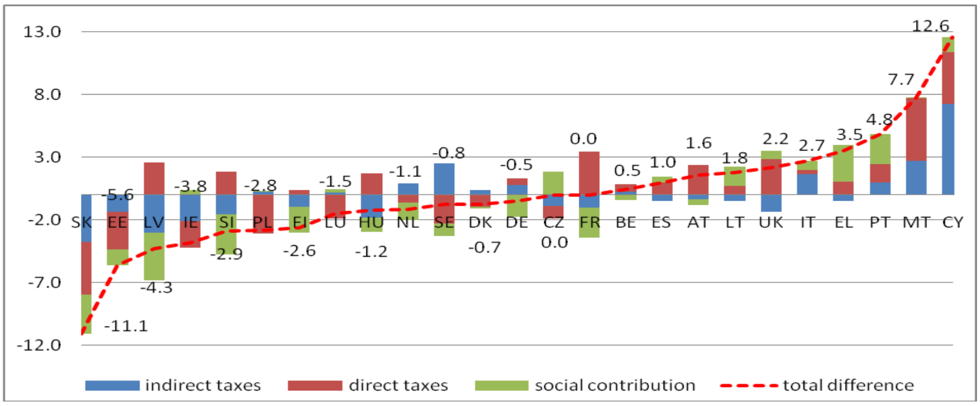


Figure 2 Total tax quotas in % GDP - difference 1995 - 2008
Source: The author's compilation based on Eurostat data

Member states with lower share of direct taxes in tax mix often seek to harmonize corporate income taxes. These states have higher levels of corporate tax burden compared to other states, and to the rest of the world1. The European Commission (2010) points out that the increase of capital mobility has raised concerns that excessive levels of taxation could influence capital and especially move profits to low tax jurisdictions. At the same time, there are hopes to attract foreign capital investments by offering an attractive tax treatment. Taxes on capital and corporate income may have distorted effects on the market, particularly in highly integrated areas like the EU Internal Market. These distortions may also impact personal income taxes because taxes on capital reduce capital accumulation and therefore negatively impact productivity levels, which in turn depress wages. Next, the fact that capital is generally more mobile than labour has generated the apprehension that the burden of taxation would be shifted from the former to the latter. Equity considerations also feature prominently in the debate on the taxation of capital held by individuals,

[1] The European Union is a high tax area. In 2008, the overall tax ratio (i.e. the sum of taxes and social security contributions) amounted to 39.3 % in the GDP-weighted average in the 27 Member States (EU-27), and it is more than one third above the levels recorded in the United States and Japan. The tax level is in the EU high not only compared to those two countries but also compared to other economies in general- among the major non-European OECD members, only New Zealand has a tax ratio that exceeds 34.5 % of GDP.

given that capital is more lightly taxed than labour income, and is often taxed at flat rates, which calls for an effective taxation of capital income to avoid eliminating the meaning of the income tax progressivity. The relative mobility of capital has stimulated the apprehension about tax competition and a subsequent race-to-the-bottom in capital tax rates.

Since 1995, corporate income tax rates in Europe have been cut forcefully, from a 35.3 % average in 1995 to 23.2 % now. This trend has not been interrupted by the financial crisis. On the contrary, a few member states introduced cuts in 2010 (the Czech Republic, Greece, Lithuania, Hungary, Slovenia) and none increased them. Although the downward trend has been quite general, corporate tax rates still vary substantially within the Union. The adjusted statutory tax rate on corporate income varies between a minimum of 10 % (in Bulgaria and Cyprus) to a maximum of 35 % in Malta, although the gap between the minimum and the maximum has shrunk since 1995. Figure 3 presents differences between nominal and implicit corporate tax rates1.

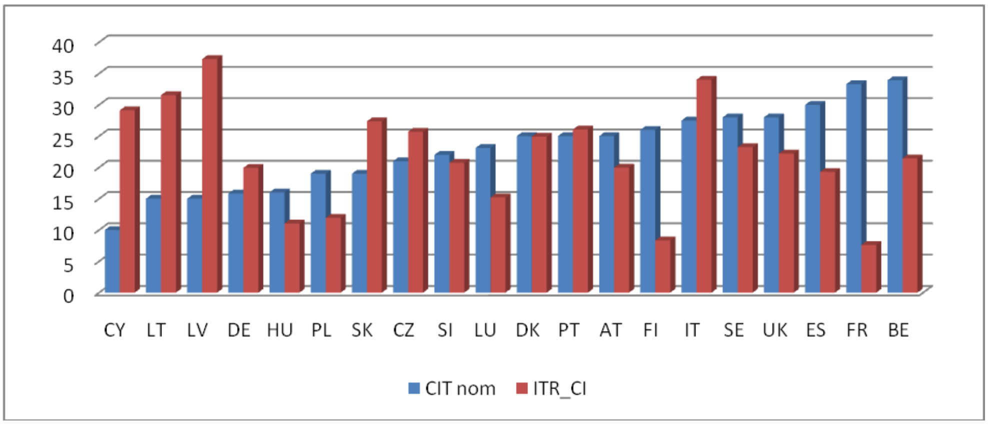


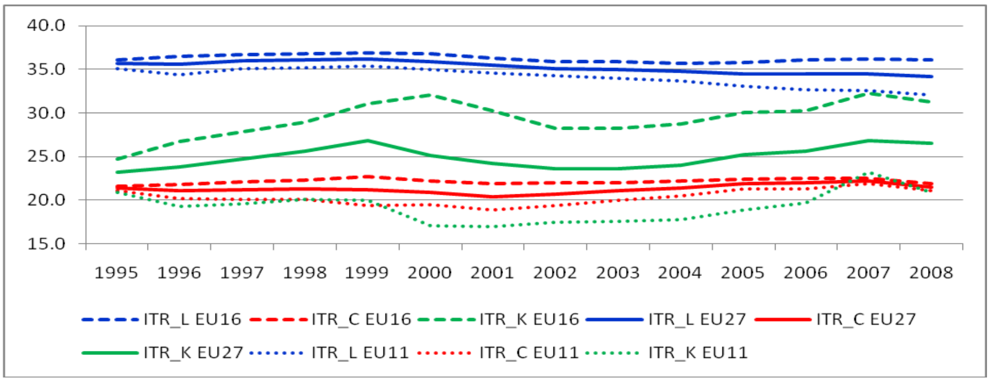
Figure 3 Nominal and implicit corporate income tax rates (2008)
Source: The author's compilation based on Eurostat data

[1] For comparison of tax burden, the easiest way is to use statutory tax rates but the result may be rather inaccurate. More convenient way is comparing implicit tax rates that consider not only size of statutory tax rates but also other aspects of tax systems determining the total amount of effectively paid taxes.

Figure 4 highlights trends in development of the three main implicit tax rates: on labour (ITR_L), on consumption (ITR_C) and capital (ITR_K) in the period 1995 - 2008. Implicit tax rates on labour remain well above those for capital and consumption. The decline in labour taxation stopped in 2005 and we can see now a stabilised development. Effective taxation of capital was on the increase until 2007, this was the case despite considerable cuts in the top corporate tax rates, most likely indicating a base broadening. Consumption taxation has been trending upwards slowly since 2001, before falling slightly in 2008. Figure 4 also confirms significant differences between tax burdens in and out of the Eurozone.

Conclusions

The concept of a common market is based on an idea of elimination of all obstacles to intra community trade in order to merge the national markets into the single market. That is why harmonization can be understood as the theoretical condition for achieving this goal. However, it is possible to identify varying levels of harmonization between the radical poles of absolute harmonization and non-harmonization. The efforts of harmonization have been centered around limited areas in the EU, where there are strong arguments in favour of the harmonization, being of the case of indirect taxes. The progress that has been achieved thus far is the establishment of minimum rates of indirect taxes in the EU.



Note: EU11 (Bulgaria, Czech Republic, Denmark, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Sweden, United Kingdom).

EU16 - Eurozone (Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia).

Figure 5 Development of implicit tax rates in % (1995 – 2008)
Source: The author's own compilation based on data from Eurostat.

The system of indirect taxation is based on the VAT and the destination principle, in which the goods are taxed on the basis of where they are consumed. The minimum standard VAT rate is currently 15 %, the minimum reduced VAT rate is 5 %. However, exemptions can be applied to this rule for a number of commodities in some member states. Differences in direct tax rates have greater importance as they cause more severe economic distortions. Functioning of the single market is disturbed by many problems related to business activities realized across the borders of individual member states in the EU. The reason is a substantial dissimilarity of tax systems used in member states, and a related dissimilarity of effective tax burden of business units in individual member states. However, we can see progress in the field of double taxation, administrative cooperation or cross border activities. Theoretically, it is possible to better harmonize direct taxes, but it is difficult to realize in practice because the member states do not want to give up on their fiscal sovereignty. Tax competition and differences in tax burden are noticeable between member states in spite of an effort to harmonize them. **Moreover,** harmonization of taxes is usually associated with rising tax burden and it could reduce the EU competitiveness against the rest of the world. The EU is already an area with a high tax burden.

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