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## **Some conclusions and recommendations of personal taxation harmonization taking account globalization process**

### **Некоторые выводы и рекомендации по гармонизации индивидуального налогообложения с учетом процессов глобализации**

#### **Summary**

The article proves that taxation of personal incomes is an extremely complex phenomenon which should be analyzed not only through the legal prism but also through social, cultural, economic and political and constitutional prisms. We cannot isolate the economic sphere from the tax sphere, as personal income taxes directly affect taxpayers, their purchasing power, they also determine labor costs for entrepreneurs and thus they significantly influence the GDP growth rate.

#### **Аннотация**

Статья доказывает, что налогообложение личных доходов является чрезвычайно сложным явлением, которое следует анализировать не только через правовую призму, но и через социальные, культурные, экономические, политические и конституционные призмы. Мы не можем изолировать экономическую сферу от налоговой сферы, поскольку личные налоги на прибыль напрямую влияют на налогоплательщиков, их покупательную способность, они также определяют затраты на рабочую силу для предпринимателей и, таким образом, они оказывают.

**Keywords:** income tax, harmonization, tax competition, tax technique

**Ключевые слова:** подоходный налог, гармонизация, налоговая конкуренция, налоговая техника

## Introduction

Referring to PIT it was emphasized that the tax should remain at discretion of member states. The only harmonization activities should concern removing barriers to four economic freedoms and providing uniformity of taxation. Similarities in the personal income tax in Community states concern the following areas<sup>1</sup>:

- The tax is related to total (global) income of a taxpayer,
- Scales are progressive with various numbers of ranges and minimum and maximum tax rate values,
- Most countries use tax-free amounts,
- Tax burdens are usually adjusted to inflation rate through the system of automatic or semi-automatic indexation of changes to tax thresholds,
- Personal income tax reflects the principle of taxpayer's payment capacity through its varied system of tax reliefs and exemptions;
- Different rules are used for taxation of family incomes, revenues from selling property and movable assets and capital incomes,
- There is a varied system of costs of obtaining revenues, related to the way in which revenue is gained,
- It does not differentiate tax burden due to sources of revenues from which it is obtained and its allocation,
- Income tax contains tax preferences related to the way the income is spent.

## Tax competition

Tax competition is a phenomenon directly related to globalization processes, especially to the growth of international mobility of employees and capital. Liberalization of labor and capital factors flow and decline of transaction costs account for the fact that individuals as well as capital seek attractive jurisdictions for their deposits, not only at home but also abroad. Theoretically, lowering tax rates does not have to result in lower budget revenue, as due to the flow of labor and capital factors, tax base will grow. However, if (theoretically) all EU countries decide to lower personal tax rates, the relative attractiveness of countries for PIT taxpayers (who may be treated as investors) will remain unchanged, while their budget revenues will decline. The tax income decline caused by lowering rates at unchanged tax base accounts for a situation when the country can allocate less money to

<sup>1</sup> Compare: J. Kesti, *European Tax Handbook 2013-2015*, IBFD International Bureau of Fiscal Documentation, Amsterdam 2013-2015; A. Krajewska, *Podatki, Unia Europejska, Polska, Kraje nadbałtyckie*, PWE, Warszawa 2004; A. Krajewska, *Podatki w Unii Europejskiej*, PWE, Warszawa 2012; J. Kulicki, *Opodatkowanie osób fizycznych, Podatek dochodowy w państwach UE. Analiza porównawcza z symulacją obciążeń fiskalnych w Polsce*. Biuro Studiów Ekspertyz Kancelarii Sejmu, Warszawa 2006.

accomplish their tasks of providing public goods<sup>2</sup>. The essence of tax competition often boils down to the belief that small tax burdens are the main factor determining the development of a given territory and its perception as an attractive place for final tax settlement<sup>3</sup>.

The author's own research proves that tax competition in the area of PIT (and social insurance contributions, years 2013-2015) does not contribute to the increased mobility of workers. The obtained Pearson's correlation coefficient at the level of  $r_{xy} = 0.20$  (respectively  $r_{xy} = 0.22$ ) indicates that there is no relation between the level of PIT (level of social insurance contributions) and increased workers mobility. The factors determining the increased migration of employees are flexibility of labor market, levels of remuneration and social and welfare infrastructure<sup>4</sup>. Therefore it should be clearly indicated that the harmonization of the effective PIT rates and social insurance rates is not necessary or essential for the functioning of common market and four migration freedoms. Since the general level of social and economic competitiveness and attractiveness obviously includes a tax element, it is difficult to deprive particular countries of their right to shape their own tax system adequate to their possibilities and needs. It should be expected that the potential progress of the tax harmonization process will limit this competition in a larger or smaller degree. Tax competition is manifested in reduction of tax rates and introduction of tax preferences in order to stimulate activity of national economic entities and attract foreign investment (PIT is of no importance in this respect). This means that the public authorities use tax policy instruments to enhance the attractiveness of their own area. It should be emphasized that after the introduction of the common currency in some EU countries, income tax has become one of the last "economic variables", depending only on local and central law-making bodies, which may be a measurable stimulus for stimulating taxpayers behavior. The author's own research shows that PIT is not a decisive factor in capital mobility, nor is it an instrument determining the attractiveness of a given country both for the workforce and investment<sup>5</sup>.

The best situation would be the one in which the marginal cost of providing the next unit of public goods and services equals the cost of PIT taxation. Such optimal level of taxation can be established in a closed economy, that is when regardless of the size of tax, human and capital factors do not flow in or out. For an open economy, benefits of providing public goods and services remain un-

<sup>2</sup> M. Desai, F. Foley, J. Hines, *Economic Effects of Regional Tax Havens*, NBER Working Paper No 10806/2004.

<sup>3</sup> R. McGee, *The Philosophy of Taxation and Public Finance*. Boston-Dordrecht-London, 2004, s. 105-107.

<sup>4</sup> Statutory research, Department of Economics of Enterprises and Local Development University of Economics and Innovation in Lublin, Lublin 2015.

<sup>5</sup> Statutory research, Department of Economics of Enterprises and Local Development University of Economics and Innovation in Lublin, Lublin 2014.

changed, whereas the costs of PIT taxation grow. This is so as each income tax growth leads to the flow of capital to countries with lower rates. On the other hand, income tax decreases will have much weaker than in a closed economy effects, since (theoretically) they will attract foreign capital to the country. Taxation of this increased human and capital base may partly offset the losses incurred by lowering the PIT rate. We may infer from the above that in an open economy the stimuli for lowering the PIT taxation are stronger than in a closed economy. Such reasoning may be conducted for each country separately, therefore we can assume that they will all be inclined to lower their PIT rates. However, if they all do lower their rates, the benefits of such conduct will disappear: human and financial capital will not flow into the country with lowered taxes if taxes are lowered in other countries as well. The general capital resource will not change, in principle (if capital resource grows, it will only be due to the ability of lower taxes to generate new investment). On the other hand, all countries will experience lower incomes, thus they will be able to allocate fewer resources for allocating public goods and services. This process of lowering tax rates which leads to excessive reduction of budget revenues is often known as the race to the bottom. Assuming that in a situation preceding the opening of economies, all countries had optimal PIT rates, as a result of the race to the bottom the possibility of providing public goods and services by them must deteriorate. It would seem that the optimal solution in this situation would be an agreement between countries that they will not compete with tax rates. Unfortunately, this solution is impossible to implement. This can be attributed to the fact that citizens of various countries differ in their preferences for goods that in their opinion should be provided by the state. Moreover, a state renouncing its sovereignty in fiscal policy would politically be very controversial and it is hard to imagine any government that would decide to take such steps. Moreover, to achieve the desired effect, tax coordination would have to take place in all countries remaining in economic relationships. If it is done only by a group of states, other countries will be undisturbed in their race, which will bring about the flow of capital to them and the deterioration of the economic situation of the group of countries with harmonized rates.

It seems that we should be cautious when assessing the phenomenon of tax competition in PIT. This is mainly because the only obvious and measurable indicator related to this phenomenon on an international scale are differences in PIT rates (and social insurance rates, integrated with PIT) between particular countries. It must be added that although data on differences in nominal rates are easy to obtain, their interpretation, as well as the evaluation of differences in effective rates, calls for taking into account a lot of extra information (such as applied incentives, tax reliefs or the structure of national economy) and are methodologically complicated. What is more, it is hard to determine the power of influence of differences in effective PIT rates which are the main symptom of “*tax competi-*

tion” on phenomena considered to be its effects. For example, we cannot clearly determine what percentage of the whole decline in corporate income tax revenue is caused by the changes to the effective rate of such tax in another country. It is impossible to isolate some phenomena in fiscal sphere out of all economic conditions. Moreover, the power of influence of the tax competition phenomenon on a given country depends on the specific characteristics of that country as well as on the characteristics of the “tax competitor” (for example Poland versus Slovakia versus Czech Republic). Finally, even if PIT is radically lowered in one country, but the risk of conducting economic activity remains very high, the likelihood of attracting potential taxpayers from abroad is low.

Flexibility and freedom enjoyed by public authorities of every member state of the European Union these days in determining income tax rates guarantee the creation of favorable climate for economic activity and sound competition between countries, which may bring long-term benefits to all participants of this market game, provided they take advantage of opportunities available to them. A competitive game to attract investors is not a zero-sum game in which someone has to lose for another person to gain, especially in the long run. Sound tax competition between countries, apart from gradual decrease of tax rates, should force sanative activities in the public finance sphere and make countries with lower burden more attractive to investors. We should obviously remember that it is not only the level of PIT, but also lower labor costs (pension system), infrastructure, quality of workforce and administration, transparency of law, including tax and business law, that determine the investment attractiveness of a particular region or country and competitiveness of enterprises operating there.

## Harmonization of employment

The issue of taxing incomes from employment abroad is a complex one, since we need to analyze not only Polish regulations, but also international ones (including relevant agreements on avoiding double taxation concluded between Poland and particular countries) and regulations in a country where work is performed. It is necessary, *inter alia*, to determine whether such incomes must be settled in Poland at all. If the answer is positive, then the question arises of how to avoid double taxation, if, for example, these incomes were also taxed in the country where a person performed their job. This is of vital important both in case of people who individually start working for foreign employers and for employees delegated by employers to work abroad. An essential issue is to determine in which country an employee is obliged to pay social and health insurance contributions. This is regulated by the so-called coordination provisions issued by relevant bodies of the European Union. They also include regulations governing some specific groups, for example employees delegated to work abroad or running their own business acti-

vity also on the territory of another country. Another issue concerns regulations governing benefits which can be obtained when working in various EU countries, for example the amount of future retirement pension. Additionally, it is essential to know where and how this retirement pension will be taxed. It may happen that a particular person (taxpayer) will have more than one place of residence (that is both in Poland and in a country where he or she works – on the basis of internal regulations of these countries). In this case, in order to determine which country is the final country of residence for tax purposes, certain criteria are applied, based on a relevant agreement on avoiding double taxation, concluded between Poland and that country. As a result of such analysis, a taxpayer should be able to determine in which country their final place of residence is. It is advisable that this should be confirmed with a tax residence certificate issued in that country. This does not mean, however, that the taxpayer will pay taxes only in one country. If this person is a tax resident of a given country, but performs work in another, he may be subject to taxation both in the country where he works (as the country of source) and in the country of tax residence. In order to avoid double taxation, an appropriate method adopted in a relevant agreement on avoiding double taxation must be applied.

It is worth remembering that it is possible to deduct from obtained income (or – respectively – tax) mandatory social and health insurance contributions paid in another country of the European Union, European Economic Area or Switzerland. In order to take advantage of this entitlement, one must meet certain requirements. The deduction does not concern contributions whose calculation base is income exempted from tax on the basis of agreement to avoid double taxation (that is when we apply the method of exclusion with progression to particular revenue). Moreover, contributions cannot be deducted from income (tax) in a country where the work is done. It is also necessary to have legal base arising from an agreement on avoiding double taxation or other international agreements ratified by Poland in order to provide the tax authority with some information from the tax authority of a state in which the taxpayer paid contributions. EU countries have widely varied PIT structures and retirement pension contributions systems, which makes it practically impossible to fully harmonize these public tributes. Nevertheless, it is possible to attempt at coordinating the principles of calculating and settling, without harmonizing the rates, tax credits, or tax deductions and reliefs.

The rulings of the ECJ exert significant influence on the PIT in EU countries as well as on the areas of potential harmonization. These rulings translate into automatic (forced by the rulings) coordination of tax legislature and provisions regulating social insurance. ECJ rulings greatly affect domestic tax law and, by the necessity of implementing rulings into domestic tax law, they contribute to standardization (harmonization) of tax provisions, especially in the area of human flow and PIT settlement as well as SSC in member states. As a result of ESC ru-

lings, regulations are becoming similar and uniform, which is an element directly preceding potential future harmonization (of selected elements in PIT structure).

According to ECJ rulings, it is forbidden to discriminate citizens of one member state in another member state<sup>6</sup>. Tax discrimination takes place when different people in comparable situation are treated differently by tax regulations. Different tax treatment of residents and non-residents does not have to mean discrimination. The situation of individuals who have limited tax obligations in a given member state is not comparable to the situation of individuals with unlimited tax obligation. A taxpayer's personal situation is usually taken into account when taxing income in a country of their residence. However, if a non-resident obtains in the source country "most of their income" or "the whole or nearly the whole income", whereas he or she does not obtain in the country of residence sufficient income to take advantage of tax reliefs used there (for example – joint taxation with a spouse), then the source country should treat such a person as its resident and grant them relevant tax reliefs<sup>7</sup>. The situation of both categories of taxpayers is comparable concerning tax rates, therefore it is not allowed to use a higher personal income tax rate for an individual with limited tax obligation<sup>8</sup>. Within research work, we analyzed the tax rulings of the ECJ vital for the freedom of human flow<sup>9</sup>. The ECJ rulings have led to numerous amendments (standardization) or even repealing of internal tax regulations. The analysis of the ECJ rulings allows us to formulate a number of conclusions related to harmonization, essential for the standardization of the PIT structure in the EU countries and indicating areas of further harmonization:

1. The community law bans all forms of tax discrimination not only related to nationality, but also bans hidden forms of discrimination which lead to the same result by using various differentiating criteria. The application of a permanent place of residence with reference to the return of PIT down-payments usually results in worse treatment of citizens of another member state.
2. Failure to grant tax relief to taxpayers who paid social insurance contributions for foreign insurers is compensated by exempting benefits paid out in the future from tax. If a state was to allow deduction of social insurance contributions, it should also be able to tax the sums paid out by citizens. Obliging the insurer to collect tax or adopting solutions in bilateral agreements are no less restrictive means. In the Bachmann case, the argument concerning the coherence of a tax system concerned the same taxpayer and the tax of the

<sup>6</sup> Compare cases: Schumacker (C-279/93); Saint Gobain (C-307/97); Wielockx (C-80/94) and Asscher (C-107/94).

<sup>7</sup> See more: case Schumacker (C-107/93); Sermide (C-106/83).

<sup>8</sup> See more: Asscher (C-107/94).

<sup>9</sup> Rulings of ECJ: Biehl (C-175/88); Bachmann (C-204/90); Werner (C-112/91); Schumacker (C-279/93); Wielockx (C-80/94); Gilly (C-336/96); Gschwing (C-391/97); Gerritse (C-234/01); Wallentin (C-169/03); Ruffler (C-544/07) and Asscher (C-107/94).

- same kind, whereas there was a close relationship between deducting insurance contributions and taxation of future benefits.
3. In a situation when a non-resident obtains in the country of their employment most or all of their income, while not obtaining sufficient income in the country of residence to take advantage of tax reliefs (such as joint taxation with a spouse), then the country of employment should treat such a person as its resident and grant them relevant tax reliefs.
  4. Non-resident who obtains the whole or nearly the whole income in a country where they perform their job is in the same situation as the resident of this state who performs the same job.
  5. Member states are competent to determine the reasons for taxation in order to avoid double taxation via international agreements.
  6. Granting tax reliefs in PIT in the source country (tax credit, joint taxation) depends on where a taxpayer obtains most of their taxable incomes.
  7. Taxation of people who work or receive retirement or disability pension, but live or have dependant relatives in another member state has always been a source of problems. Generally speaking, bilateral agreements allowed to avoid double taxation, but did not solve such issues as application of different forms of tax reliefs available in the country of residence with reference to the income obtained in the country of employment.
  8. There is a rule according to which a given member state, when collecting income tax and social insurance contributions, cannot treat EU citizens not residing in this country but, taking advantage of free movement, working in its territory, in a less beneficial way than its own citizens.
  9. Generally, we can say that integration in the area of direct taxation of individuals has taken place more as a result of the European Court of Justice rulings than normal legislative procedure.

## Ways of harmonization of personal income taxation principles

Analysis of community tax legislation (rulings and cases of the ECJ) allows us to formulate a thesis that harmonization of personal income taxation principles is impossible to historical, political, social and technical reasons. The Court rulings cannot influence harmonization of personal income taxation principles, as these concern only taxation of savings income and exchange of tax information, while the progressing and visible “quiet harmonization” is a result of competition among national tax systems, not ECJ rulings. Generally, individuals may appear as parties in the court proceedings only before their home courts. Generally, difficulties in harmonizing personal income tax cover the following issues:



- Political factors – income tax payers are a very numerous group of voters. Politicians are unwilling to resign from using the PIT tax technique in implementing regulatory and stimulating function of taxation, as it is a valuable instrument in their relations with voters.
- Harmonization of personal income tax has never been a vital factor for creating the common market. It is a neutral form of taxation for internal trade and does not disturb competition conditions in the common market.
- Personal income tax is imposed mainly on income from work and retirement benefits, while the level of fiscal burden does not translate into increased migration in Europe.
- In EU countries, social security systems are financed from various sources. These are both contributions made by taxpayers and direct financing from state budget (premiums are then included in general taxes – as in Denmark).
- EU countries have various systems of rewarding work and shaping the population income level. There are various systems of costs of obtaining revenue, methodology of shaping progression, etc.
- Personal income tax plays both fiscal and non-fiscal role in EU state tax systems, which makes it impossible to create a homogenous system of personal income taxation, especially if we take into account the necessity of unanimity of the Council in passing any directives in this respect.
- This thesis is supported by the work of an outstanding specialist in OECD fiscal policy, *Ken Messere*. He distinguishes five groups of countries in the European union, differing in tax solutions adopted in their tax policy (excluding new member states). The classification allows us to identify characteristic elements of EU tax systems. We have:

**The first group** consists of Northern European countries: Belgium, Denmark, Finland, the Netherlands and Sweden. The personal income tax share is high, often integrated with social insurance contributions. Personal income tax is either passed in full or almost in full to local budgets.

**The second group** covers Southern European countries: Greece, Spain, Portugal and Italy. “Southern” tax mentality accounts for large share of ‘grey zone’ (especially in Greece – the highest share of grey zone in the EU), therefore PIT effectiveness is relatively low. The common feature of these countries is high share of indirect taxes and social insurance contributions in budget revenues. Those countries do not make efforts aimed at extending (exploiting) their tax base.

**The third group** is composed of two Central European countries: Austria and Germany. They have a similar, three-level division of tax entitlements, typical for federal states. However, PIT principles are different. A unique feature of German personal income tax is the use of a mathematical formula (instead of ranges) in

tax progression and introduction of additional tax burden (solidarity tax) in 1991 and 1995 for developing eastern lands, in the amount of additional 5.5%.

Western European countries, namely Ireland and Great Britain, constitute **the fourth group**. They are characterized by a relatively large share of income tax in GDP and relatively low share of social insurance contributions. Apart from this, a major source of income revenues is revenue from property tax and VAT. Taxation of personal incomes is deprived of social reliefs (relative neutrality). This function is performed by various social allowances.

## Conclusions

Personal income constructions widely differ in the European Union countries. It is even difficult to compare such key elements in the personal income tax construction as the number and level of tax rates and related level and span of tax thresholds. In particular countries the issue of general exclusion of incomes at specific level from taxation is approached differently, some have zero tax rate, others different amounts of tax credit. An additional difficulty in comparisons is presented by the application of tax rates of various amount depending on the source of income. The problems with comparing the personal income tax structure are also related to various systems of transfers to different public finance sectors – incomes from this tax may finance not only central budget but also budgets of self-government budgets or social insurance funds. Currently, most EU countries use progressive PIT rates, depending on the level of incomes, though 7 countries – Bulgaria, Czech Republic, Estonia, Lithuania, Latvia, Romania, Slovakia – have a flat tax. From the taxpayer's point of view, what really matters is the size of the minimum and maximum tax rates and the number of the so-called tax thresholds. However, on the basis of these data it is impossible to draw final conclusions concerning the size of personal income burden in particular member states, as of vital importance here is the method of determining tax base and all deductions from income or from tax amount. Below I will present changes in time concerning basic parameters characterizing taxation of personal incomes in the European Union countries. As we already mentioned, the need to harmonize of personal income taxation was discerned much earlier, and recently this has been manifested in the Lisbon Strategy, in which the common tax policy of the European Union was treated as a necessary requirement to be met in order to improve the competitive ability of the whole economic system but this concerns especially tax policy towards companies (no PIT principles). The need to develop a common position on corporate taxation was manifested in the so-called Tax Package, whose element is the Code of Conduct for Business Taxation. The importance of this code, adopted in 1997, consists in obligation of member states to observe principles of fair com-

petition and to resign from solutions causing harmful tax competition. In a case of PIT, the most important arguments against harmonization are listed below:

1. **firstly**, further loss of sovereignty in local (national) financial policy, which constrains the possibilities of influencing economic and especially social processes by the government. Harmonizing the principles of calculating the tax base and adopting uniform rates (rate) means passing tax prerogatives to a transnational institution – in this case the European Union. In this situation each country must conduct its own cost/benefit analysis.
2. **secondly**, various social models which determine various financial needs of the state
3. **thirdly**, historical conditions, that is factors which shaped national tax systems;
4. **fourthly**, inequality in competition between companies operating exclusively in the internal market and those which operate in many countries of the Community.

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