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Tax Harmonisation and Legal Diversity in the European Union: Balancing Fiscal Sovereignty and Market Integration

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Abstract
European Union (EU) is grounded on the two principles, both being integration of the market and sovereignty of member states, a combination that is the most evident in the field of taxation. The following paper examines the conflict that is becoming real to the dream of the EU to have a single-market without hustle and the fiscal sovereignty of separate states which is being passionately defended. The problem here is that, despite the fact that the EU law is creating free movement across the borders, it does not harmonies the direct taxation, only the order of competitive fiscal federalism. This asymmetry in the law permits tax competition, because member's states have the ability to promote mobile capital and company by adopting different taxation policies, which could lead to an outcome of the race-to-bottom scenario demise to the base of national revenues and market deception essentially. The capacity to raise, administer and allocate resources is what is referred to as fiscal sovereignty as one of the crucial attributes of national government and of democratic responsibility. However, the single market is crippled by uncoordinated systems of taxation internalizing inefficiencies and favoring aggressive tax avoidance schemes that would shatter a level playing field. The EU on its part has responded with a conglomeration of action to level competition in taxation that is disastrous without necessarily going into the process of harmonization as the political will mostly lacks.

1. Introduction

EU is perhaps a unique experiment in modern relationships, with its foundations of paradox in the desire to create an economically highly integrated union, at the same time preservation and recognition of national sovereignty of the member states that make up the EU. This tension, however, is more vivid and politically sensitive in no other area of life than in taxation. When the Single Market is created to permit the unrestricted flow of goods, services, capital, and people, it is intelligible that a level playing field would be desired, meaning that the taxation policy would be considerably coordinated. However, the authority to levy taxes is one of the final and most prized possessions of national sovereignty, which is inseparably connected to the social contract of a particular nation, democratic responsibility, and ability to finance its welfare state.

The dilemma that this dichotomy causes is the opposition of market integration and fiscal sovereignty, which the current paper discusses. The legal structure of the EU has helped to violently tear down the obstacles to the economic activity across borders but it has consciously avoided taking direct taxation under its wing and allowed the member states to largely remain in control of the same. With this kind of an asymmetric integration, there has been the creation of such an environment of continuous tax competition whereby jurisdictions are using their tax regimes to tap into mobile investment and corporate profits. Although healthy competition is observed to be a checking force on government expansion, this competition is frequently connected to a race to the bottom that weakens the tax bases of nations, skews fair competition under the Single Market, and transfers the tax burden to less mobile forms of capital, such as labour and consumption.

The basic meaning of fiscal sovereignty is the right of any one level of government to make independent decisions on its revenues, management of its resources and its spending. Member states guard this power jealously. However, market integration requires such national policy variations to be abolished in the instances that they serve as a barrier to smooth trade across borders. As a result of this attempt to balance these mutually exclusive forces, the landscape of the EU tax policy has become highly intricate and fragmented neither a linear process towards tax harmonization-process of harmonizing tax systems, but a multifaceted and often circuitous process of dealing with diversity.

2. The Principle of National Fiscal Sovereignty in the EU Legal Order

The first legal protection of such sovereignty is the rule of unanimity that is provided in the Treaty on the Functioning of the European Union (TFEU). Article 115 TFEU, in the case of most laws dealing with harmonization of direct taxation, i.e., corporate tax or income tax, needs a unanimous consent in the Council of the European Union. This in effect gives a veto to all member states and substantive harmonization becomes extremely hard to achieve. The political argument to support this high legislative bar is simple; taxation is the blood of the state. It defines the dimensions and character of state services, system of welfare and whether the government can enforce its economic and social policies. These acutely divergent social models, as well as their national structures of social public finance, are aspects wherein member states are unprepared to relinquish control over these key policy tools to a supranational institution where national interests might be out-voted. This power should be retained, so that a question of taxation can be open to a national process, and to a national responsibility.

Nonetheless, this fiscal independence is not absolute. National sovereignty is challenged and limited by other tenets of EU law that prevail and take precedence over the principle of national sovereignty. Two primary legal forces limit member states fiscal autonomy:

1. **The Four Freedoms and Negative Integration:** The European Court of Justice (ECJ) has been critical in influencing national tax policy limits by the concept of negative integration. The Court continuously rules against national tax laws that discriminate or facilitate biases to people or firms in other member countries or generate unfair limitations on the four main freedoms: the free movement of goods, services, capital, and people. The ECJ is not a direct harmonization of tax rates or bases, although jurisprudence compels member states to alter their tax codes to eliminate discriminatory aspects of these codes, which often brings about a sort of judicial harmonization. This process will make sure that although the member states are allowed to design their tax structures, this should not be done in a manner that divides the Single Market.
2. **State Aid Rules:** Another more recent and controversial tool applied to police national tax policies is EU State aid law. The actions of the government that confer a selective advantage on particular undertakings, thus, distorting competition, are usually forbidden under Article 107 TFEU. This rule has increasingly been used by the European Commission in an attempt to counteract tax practices that it considers harmful, especially in specific tax rulings, bestowed on multinational corporations that are in effect reduced to pay less tax than other companies.

These constraints demonstrate that fiscal sovereignty in the EU exists in a constant state of negotiation. While member states retain the formal power to legislate on direct taxation, this power is bounded by the supranational legal order, which prioritizes the integrity and functioning of the Single Market.

3. The Inevitability of Tax Competition in an Integrated Market

The Single Market increases the mobility of these factors of production by eliminating obstacles to the free movement of capital, labour and businesses. At the same time, keeping the tax policy largely non-harmonized, the EU provides a margin of diversity to national legal systems that enables their nation to compete over such mobile resources. Such an intensification of interdependencies between nations, what Fritz W. Scharpf has developed to refer to as an "asymmetric integration," is a phenomenon that creates strong interdependencies between countries in which the taxation policy of one country directly affects the economic performance of its neighbors.

The rationale behind tax competition is straightforward. With so high capital mobility, governments have a reason to provide more compelling tax regimes to foreign direct investment-friendly, such as reduced corporate tax rates, special treatment of certain forms of income, or a special tax decision, in order to entice foreign direct investment and keep domestic firms at home.

On one hand, there is the school of thought that is based on the public choice theory, which states that tax competition is good. In this perception, it serves as a checking mechanism on governments so that it does not become a fat and bloated "Leviathan" that tax and spend excessively. Competition may result in increased efficiency in government spending and an improved business-friendly economic policy by compelling governments to compete over a mobile tax base. This view also implies that efforts of harmonization are likely to build a high-tax cartel of governments at the cost of economic energy.

Conversely, the general feeling in the EU and the international policy circles is that tax competition that is unchecked is mostly detrimental. The primary concerns associated with this "race to the bottom" include:

- **Erosion of Tax Bases:** Multinational companies engage in Base Erosion and Profit Shifting (BEPS) through the aggressive tax planning made possible by differences between national tax systems. This enables firms to declare them to have earned a profit in jurisdictions with low tax rates, even though those profits might have been earned in other areas, and so reducing the tax receipt of high-tax nations.
- **Distortion of the Single Market:** Tax competition compromises the concept of a level playing field. Big, multinational companies that are able to use cross border tax loopholes have an unfair advantage over small, local companies that cannot.
- **Shift in the Tax Burden:** With competition, governments are forced to find other ways of sourcing revenue since corporate tax revenues continue to shrink. This is likely to bring a structural shift in the burden of taxes on the highly mobile capital and less mobile factors such as labour (income and social security taxes) and consumption (Value Added Tax). **Loss of Policy Autonomy:** This irony also implies that extreme competition in taxes can prove detrimental in the long-run to the type of sovereignty it tries to show. The freedom of countries to maneuver taxation to national social and economic needs is constrained by the operations of its neighbors as countries get embroiled in an arm race.

The difficulty of the Union has thus been to devise meanings of restraining the destructive elements of this competition without having recourse to the politically unappetizing alternative of perfect harmonization.

4. The EU's Toolbox for Tax Coordination and Harmonization

With the political impossibility of complete harmonization through the unanimity rule the EU has invented a deep and pragmatic toolbox of tactics to deal with tax competition and its adverse externalities. Such a method is not one, consistent strategy but a set of legal, political, and administrative tools that reach various degrees of force and efficacy. It is possible to divide these instruments into negative integration, soft law coordinating and targeted positive legislation.

A. Negative Integration: The Judiciary as a Harmonizing Force

The European Court of Justice, as has been argued above, has been an influential, albeit indirect, instrument of tax harmonization. The ECJ has struck down a broad spectrum of discriminatory fiscal measures by policing the compatibility of national taxation regulations with the fundamental freedoms of the EU. It has, by way of example, struck down regulations that levied elevated taxes on dividends paid to foreign shareholders than local ones or that withheld tax deductions to international business expenses. Although it seems that this judicial intervention does not constitute a standardized EU tax code, it insets a similar set of principles that all tax systems should adhere to, namely, the principle of non-discrimination and non-restriction and in this way cybernetic ally facilitates convergence and eliminates some of the most glaring barriers the Single Market has to offer.

B. Soft Law and Policy Coordination

Where legally binding legislation is unachievable, the EU has often turned to "soft law" instruments based on political agreement and peer pressure. The most prominent example in the tax field is the **Code of Conduct for Business Taxation**, established in 1997. The Code is a political commitment by member states to refrain from and roll back tax measures deemed "harmful." A measure is considered harmful if it provides for a significantly lower level of effective taxation than that which generally applies in the state and is targeted at non-residents or transactions with non-residents.

C. Positive Harmonization: Legislative Successes and Failures

Despite the unanimity constraint, the EU has succeeded in achieving positive harmonization in some areas. The outstanding success story is the **Value Added Tax (VAT)**. A common VAT system, with harmonized rules on the tax base and a minimum standard rate, was deemed essential for the functioning of the Single Market by eliminating the tax-related border controls that distorted trade. This demonstrates that where a clear and direct link to the functioning of the single market exists, member states have been willing to pool sovereignty.

In the realm of direct taxation, however, progress has been far more limited. The most ambitious project, the **Common Consolidated Corporate Tax Base (CCCTB)**, serves as a case study in the difficulties of harmonisation. The CCCTB proposed a single set of rules for companies to calculate their taxable profits across the EU, which would then be apportioned to member states based on a formula.

5. Conclusion

The consultation between tax policy, fiscal sovereignty, and market integration approach in the European Union is not a fixed state of affairs but a process of negotiation and compromise.It has given rise to decades of arguments and an ongoing quest to find a solution to a practical compromise. This has led to a real world and rough policy amalgamation whereby the legal scrutiny of ECJ, the persuasiveness of soft-law coordination and legislative interventions where a political consensus can be brokered are combined. This strategy recognizes that member states will not hand over their basic right to tax but their use of that right should not be permitted to kill off the single market or also enable an enabling race to the bottom.

In recent developments, especially, the accord of global corporate tax minimum, there is an indication of an attainable turning point. The positive outcome of the implementation of Minimum Tax Directive of the EU proves that radical external shocks and a national change of the world opinion can be used to overcome the long-lasting internal stalemate

that occurred in the EU leading it to the next stage of structural harmonization. As the full convergence of the rates and base of direct taxes and bases seems impossible politically, the age of unhindered tax competition seems to be declining. This practical, multi-speed approach is probably going to be continued in the future. This conflict between sovereignty and integration is here to stay since it is embedded in the very basis of the EU project. The Union will always find itself in this dilemma not by selectively upholding either principle, but by re-adjusting the balance between the two.

The consultation between tax policy, fiscal sovereignty, and market integration approach in the European Union is not a fixed state of affairs but a process of negotiation and compromise. The process of EU has not been a smooth ride to a system of a harmonised federal tax. This challenge is based on the essence of asymmetric integration of the EU which has released the powers of tax competition by liberalizing markets without centralising the fiscal power to control the markets. This has led to a real world and rough policy amalgamation whereby the legal scrutiny of ECJ, the persuasiveness of soft-law coordination and legislative interventions where a political consensus can be brokered are combined. This strategy recognizes that member states will not hand over their basic right to tax but their use of that right should not be permitted to kill off the single market or also enable an enabling race to the bottom.

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