

Statement of Sarah Godar (EU Tax Observatory) in the public hearing on “Potential Distortions of the Single Market due to Personal Income Tax: challenges for SMEs and risks of harmful tax competition”

Thank you very much for the invitation to discuss the risks of harmful personal income tax competition in the EU.

Since 1995, the number of preferential personal income tax regimes targeting foreign individuals has increased from 5 to 29 in the EU. These regimes offer tax exemptions or reductions to newly incoming tax residents while preserving the general income tax schedule applied to domestic taxpayers. In our report “[New forms of tax competition – an empirical investigation](#)” my co-authors and I have analyzed those regimes in detail. We distinguish three types of regimes:

- **Foreign source or worldwide income regimes:** They offer preferential taxation of worldwide income or of foreign income while applying standard taxation to income earned domestically.
- **Regimes which apply to income earned while performing a specific economic activity in the host country:** These regimes offer tax reductions on the income earned domestically. Most of them target high-skilled or high-income workers or specific professions such as scientists, artists or athletes.
- **Regimes targeting pensioners:** They offer lower taxation of foreign source pension income. One objective is to attract consumers with higher purchasing power than the average population.

To identify the most aggressive regimes, we rank them according to the duration of the preferential treatment which ranges between 2 and 15 years and the magnitude of the tax benefit. In addition, we consider regimes that require an economic activity in the new tax domicile as less harmful because they might have an industrial policy purpose beyond attracting tax revenue from other countries. Furthermore, we consider a regime more harmful if it is designed exclusively for high-income earners. According to this assessment the six most harmful regimes are the Italian and the Greek foreign source or worldwide income regimes for high-net-worth individuals introduced in 2017 and 2019, followed by the high-income and pension regimes in Cyprus, and pension regimes in Greece and Portugal.

The collected data suggest that most preferential regimes attract an increasing number of beneficiaries over time and that at least 200,000 individuals across the EU currently benefit from preferential tax regimes.

Why is this trend problematic?

1. Personal income tax competition potentially undermines tax revenue collection in the EU as a whole.

In our report, we estimate that the EU loses EUR 4.5 billion per year due to the preferential regimes offered to incoming foreigners. This sum is equivalent to the annual budget of the entire Erasmus programme. It is a lower bound estimate because we lack data for Cyprus, Greece, Luxembourg, and Malta. We assess the overall fiscal cost of the regimes as follows: We compute the additional revenue that could be generated in the host countries if they all removed the preferential regimes at the same time without considering further behavioural adjustments. We thus obtain a rough idea of the potentially forgone tax revenue at the EU level regardless of how it would be distributed among member states.

2. There is a grey zone between industrial policy and beggar-thy-neighbor

Not all regimes are equally aggressive. Some seem to serve industrial policy goals, e.g. attract foreign researchers, populate structurally weak regions or provide implicit wage subsidies to multinational enterprises. Unfortunately, we know very little about how the costs and benefits are distributed across countries. A recent study by Timm et al. (2022) analyses the Dutch preferential regime for high-income employees. The results suggest that 25% of the beneficiaries came because of the tax incentive, while the other 75% would have come regardless of it. Despite those windfall effects, the authors derive an overall positive revenue effect for the Netherlands. This would imply revenue losses for other countries. If governments find they lose out to other member states, this can lead to political tensions. For example, with regard to the Portuguese and Greek pension regimes, the Swedish Parliament seems to have concluded that they contradict Swedish interests and has terminated its double taxation agreements with both countries in 2021 (Sveriges Riksdag 2021).

3. Preferential regimes raise equity concerns

Regardless of how the fiscal costs of personal income tax competition are distributed between countries, they raise equity concerns with regard to the interpersonal income distribution. The majority of the regimes have explicit or implicit income thresholds above which they apply or are only available to academics. They thus tend to undermine the progressivity of EU income tax systems.

4. Personal income tax competition is likely to intensify in the future

The estimated fiscal costs of EUR 4.5 billion might look moderate at first sight. However, the overall fiscal costs are likely to increase in the future due to the generally increasing mobility in the EU (Muñoz 2019) and the spread of remote work in (high-skilled) white collar jobs due to the anti-covid restrictions. For example, de la Feria and Maffini (2021)

estimate that 3-15% of all UK taxpayers could, in principle, work remotely and might thus become internationally mobile in the medium term. In addition, more governments might be tempted to offer preferential personal tax regimes as a complement to corporate tax incentives (Fischer et al. 2022).

What can be done to address the described trends?

The EU should monitor the rise of preferential personal income schemes carefully, improve data availability and impact assessments. The mandate of the Code of Conduct group might be extended to personal income taxation as suggested in the European Parliament's resolution on reforming the EU policy on harmful tax practices. In the absence of a coordinated approach (which would be preferable), member states might consider unilaterally taxing their expatriates during transitional periods and under certain conditions, e.g. above high income thresholds. This may reduce the attractiveness of preferential personal income tax regimes.

Finally, I would like to highlight that the most aggressive regimes have been implemented after the financial crisis of 2008/9 and by countries that were hit hard by the subsequent public debt crisis. The imposed austerity measures and the pressure to generate additional tax revenues might have played a role in fueling the rise of aggressive tax regimes. This is not a justification but I wonder whether more fiscal solidarity in the EU might have prevented this and whether it might also play a role in reducing beggar-thy-neighbor tax policies in the future.

References

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