FROM TOTAL TO STRUCTURAL HARMONIZATION IN THE FIELD OF EUROPEAN DIRECT TAXATION

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Abstract:
Among economic policy questions remaining without a definitive response perhaps none are as contentious as the future of direct taxation within the European Union. In this paper I intend to express my opinion regarding the issue of Tax Harmonization versus Tax Competition which has been globally debated over the last decades and which is still considered extremely controversial at the European level. Studying the researches in the specified area corroborated with empirical evidence I summarized myself some key questions: Has indeed national tax systems a negative effect on EU market integration? Is indeed tax harmonization critical to the operation of the Single Market so that goods, services, people and capital can move freely around the EU? There are some questions appreciated as very important which I try to answer in this paper. Specifically, this paper encourages the Commission and member states to accept the beneficial role of tax competition in limiting the over-expansion of EU jurisdictions. Given that tax harmonization is an almost impossible goal for European Union, and on the other hand so many national different tax regulations pose problems for all companies doing business abroad, the solution would be consolidation of the tax rules.

Keywords: European Fiscal policy, Tax sovereignty, Tax competition, Tax harmonization

JEL Classification: F36, F42, G18

INTRODUCTION

The debate over taxation within the European Union (EU) is a heated one. The literature on the subject is fueled by one central question: Is regulated tax harmonization or is market driven tax competition the best solution to the awkward state of asymmetric tax rates that currently exists in the EU? Not surprisingly, the existing viewpoints run the gamut from entirely pro-harmonization to pure pro-competition stances. As a whole however, the literature simply reveals the ambiguity of the issue, as reflected by its increasingly complex attempts to convey the reality of the European situation.

Tax harmonization consists in coordinating the taxation systems of the European countries to avoid non-concerted and competing changes in national fiscal policies, which could have an adverse effect on the internal market. Full tax harmonization covering 27 countries is a difficult undertaking, since this area remains largely the prerogative of the Member States. However, a minimum degree of harmonization has been achieved, in the field of indirect taxation, e.g. VAT, excise and custom duties. In this paper I express my opinion regarding the issue of tax harmonization in the field of direct taxation.

Total tax harmonization is defined by the tax theory as the result of the structural harmonization and harmonization of the tax rates. The structural harmonization is defined by the tax theory as the result of the harmonization of the structure of taxes. Tax harmonization can also be understood as the process, the tools for reaching the selected aim and the result, harmonization of tax legislation itself together (Nerudova, 2008).

Based on a number of empirical studies from the literature, I have investigated several attitudes to direct tax competition and direct tax harmonization including the tax competition theories.

Perhaps the most important argument revealed by this paper is that fiscal policy is a discretionary instrument used by national authorities for influencing the macroeconomic indicators being the main reason for which the member states will not renounce its use. Harmonization efforts failed because the member state perceived them as the effort to restrict their fiscal sovereignty.

Specifically, this paper encourages the Commission and member states to accept the beneficial role of tax competition in limiting the over-expansion of European Union jurisdictions and not try to achieve the tax rates harmonization anymore but only the harmonization of the tax basis. The aim in this field must be only the structural harmonization.

The rest of the paper is divided in four sections. In the first section I will present a review of existing arguments pro tax harmonization. In the second section I will synthesize the successes and failures in the area of direct tax harmonization. In the third section I will present the main part of this paper, followed by arguments for fiscal competition. Based on my research I will present the solution I found for the controversial problem which is the aim of this paper. In the final section I will present some conclusions.

ARGUMENTS PRO TAX HARMONIZATION

The harmonization of taxation in the Community, an omnipresent issue within the European Commission, specifically provisioned in the European Community Treaty (TCE) is frequently brought in the attention of expert groups in the member states, in the context of the permanent enlargement of the community space, through the adherence of new states. If regarding indirect tax, the harmonization is the competence of the European Union, being imposed by the necessity of reducing disparities at the level of free circulation of goods and services, thus easing the functioning of the internal market, direct taxation is, in principle, the competence of the member states. Generally, states are reluctant regarding harmonization, but the European Community Court of Justice (CJCE) admits that the community law maker intervenes in the issue of direct taxation on the juridical base of Article 94 TCE, when there is a direct incidence on the functioning of the common market.

European Commission, with respect to the difference in the methods of national tax base construction, was focusing during the harmonization mainly on those types of the direct taxes, where at least the partial harmonization is considered to be the necessary condition for eliminating the obstacles to the smooth functioning of internal market. Especially corporate income tax is considered to be this type of tax. The integration of the financial markets made capital highly mobile factor, which can quickly move to the states with more advantageous tax regimes.

In the area of taxation policy, the Community is pursuing a number of objectives:

1. In the field of direct taxation, where the existing legal framework mostly takes the form of bilateral agreements between Member States, the primary objective of Community action has been to close the loopholes which permit tax evasion; and to prevent double taxation.
2. The objective of more recent moves towards a general taxation policy has been to prevent the harmful effects of tax competition, notably the migration of national tax bases as firms move between Member States in search of the most favorable tax regime. Though such competition can have the beneficial effect of limiting government's ability to "tax and spend", it can also distort tax structures. In recent years the proportion of total taxation accounted for by taxes on relatively mobile factors like capital (interest, dividends, corporate tax) has fallen, while that on less mobile factors, notably labor – for example social charges - has risen.
3. The Maastricht Treaty provisions on Economic and Monetary Union introduced a new dimension to general taxation policy by severely limiting government's ability to finance public expenditure out of borrowing. Under the Stability and Growth Pact, UE Member States must not at any time run budget deficits at a level above 3% of GDP. The general aim of the Pact is for Member States budgets to be roughly in balance over the economic cycle. Higher public spending can therefore be financed only out of higher revenues.

The Commission in its Communication "Tax Policy in the European Union - Priorities for the years ahead" of 23 May 2001 stated its belief that taxes on personal income may be left to Member States even when the European Union achieves a higher level of integration than at present. (European Commission, 2001) At the same time the Commission acknowledged that coordination at European Union level is in some cases necessary to safeguard the application of the Treaty freedoms and to eliminate tax obstacles to cross-border activities. The Commission also referred to the need to coordinate personal income taxes to prevent double taxation or unintentional non-taxation in cross-border situations, or to tackle cross-border tax evasion.

The European Court of Justice has consistently held that, in the absence of harmonization, taxes on personal income fall within the competence of the Member States but they must respect the fundamental Treaty principles on the free movement of workers, services and capital and the freedom of establishment. In particular, there must not be any direct or indirect discrimination on the basis of nationality, nor may there be any unjustified restrictions to the four freedoms.

In the frame of practical harmonization the European Commission decided for the structural harmonization at first and then successively for the harmonization of the tax rates.

SUCCESSES AND FAILURES IN THE AREA OF DIRECT TAX HARMONIZATION

The fundamental directive in the field of direct taxes is Council Directive 77/799/EEC of 19th December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation for the reasons of controlling the multinational companies' activities. In 1997 the validity of this directive was extended and includes the indirect taxes too, especially value added tax.

In connection with the establishment of the internal market two very important directives were adopted in 1990 concerning the corporate taxation. Both of these directives are in force since 1993. The first Council directive no. 90/434/EEC from 23rd July 1990 is known as The Merger Directive**.** It regulates deferment of the tax liability resulting from capital yield during merger, business divisions, transfer of assets and cross-border shares exchange within the European Union. The aim of the directive is to avoid taxation of the profit, which can arise during the merger from the difference between value of the transfer of assets and liabilities and their accounting carrying value. The Merger Directive was amended by the directive no. 2005/19/EC, which was adopted particularly in connection with the establishment of the statute of the European company. This directive extends existing competence of The Merger Directive to European company and European cooperative society as well. Directive particularly enables transfer of the seats and reorganization of the European company and European cooperative society within the European Union without any tax obstacles; ensures that transformation of the branch to the subsidiary will not have any tax consequences and includes a new type of transaction – so called split off.

The second directive no. 90/435/EEC from 23rd July1990 known as The Parent-Subsidiary Directive regulates the system of the taxation of the group of companies, which operate on the national level and companies, which operate within the European Union. The aims of the directive are to ensure that member state of the parent company either does not tax the incomes of the subsidiary with the seat in other member state or if these incomes are taxed, it enables parent company to deduct the income tax paid by subsidiary in other member state from the tax base; to exempt the distribution of the net profit of the subsidiary from the withholding tax.

In 2003 was adopted the directive no. 2003/123/EC, which amends the original Parent-Subsidiary Directive and extends the competence of directive to distribution of profits obtained from the permanent establishment located in one member state from the subsidiary, which is resident in other member state; distribution of profit of the company to permanent establishments, which are located in other member state than companies and subsidiaries; new types of the companies – to the European company and European cooperative society.

The Arbitration Convention no. 90/436/EEC is valid in the European Union since 1995 for the period of five years and its aim is to eliminate double taxation which could arise in the case of different interpretation of principle of the transfer pricing in different countries. Until now the validity of the convention has been always extended by other five years. Nowadays it is valid until 2015.

The Savings Directive no. 2003/48/EEC was adopted to enable the taxation of the incomes in the form of interests payments resulting from the member state to persons, who are trying through their residency to decrease or eliminate taxation. The Directive has entered into force since 1st July 2005. The member states are obliged to provide other member states with information about interests, which were paid off to the individual savers.

The uniform system of the interest payments and royalties taxation between associated companies is set in Interest and Royalties Directive no. 2003/49/EC, which has entered into force since 1st January 2004. Directive eliminates withholding tax in case of interests and royalties cross-border payments.

In the field of direct business taxation the main measure was to introduce a Common Consolidated Corporate Tax Base for European business, a strategy the Commission has been working towards since 2001. A second series of measures is aimed at removing cross-border tax barriers faced by EU businesses. The third measure is aimed at creating a new car taxation strategy to replace Member State registration taxes. The fourth measure concerns a new policy to combat distortions due to fraud and tax evasion (European Commission, 1997).

All the successes I enumerated above represent only minor steps in the field of structural harmonization. In the matter of tax rates, harmonization efforts failed as nowadays tax rates differ very substantially within European Union, ranging from a minimum of 10 % in Bulgaria and Cyprus to a maximum of 59 % in Denmark. (Tabel no.1)

Generally, the new Member States have a different structure compared with the old Member States; in particular, while most old Member States raise roughly equal shares of revenues from direct taxes, indirect taxes, and social contributions, the new Member States often display a substantially lower share of direct taxes in the total. The lowest shares of direct taxes are recorded in Slovakia (only 20.8 % of the total), Bulgaria (20.9 %) and Romania (23.0 %). (Eurostat, 2011). One of the reasons for the low direct tax revenue can be found in the generally more moderate tax rates applied in the new Member States to the corporate income tax and the personal income tax. Several of these countries have adopted flat rate systems, which typically induce a stronger reduction in direct than indirect tax rates. Also among the old Member States (EU-15) there are some noticeable differences. The Nordic countries as well as the United Kingdom and Ireland have relatively high shares of direct taxes in total tax revenues. In Denmark and, to a lesser extent, also in Ireland and the United Kingdom the shares of social contributions to total tax revenues are low. There is a specific reason for the extremely low share of social contributions in Denmark: most welfare spending is financed out of general taxation. This requires high direct tax levels and indeed the share of direct taxation to total tax revenues in Denmark is by far the highest in the Union. Among the old Member States, Germany's system represents in a sense the opposite of Denmark's; Germany shows the highest share of social contributions in the total tax revenues, while its share of direct tax revenues in the total is among the lowest in the EU-15. (Eurostat, 2011).

As a rule, the new Member States display lower top rates, while the highest rates are typical of Member States with the most elevated overall tax ratios, such as the Nordic countries, although the Netherlands show the fourth highest top personal income tax rate while ranking 15th in terms of the tax ratio. The lowest rates are found in Bulgaria and Cyprus, where the tax ratio is respectively the lowest and the second lowest in the Union (Table no. 1).

Tabel 1. Different direct taxes rates within European Union, 2010 Income, in %

Member State	Corporate Income Tax	Top Personal Income Tax
Austria	25	50
Belgium	33.99	50
Bulgaria	10	10
Cyprus	10	30
Czech Republic	21	15
Denmark	25	58
Estonia	20	21
Finland	26	53
France	33.33	41

Germany	15.825 federal plus 14.35-17.5 local	45
Greece	25	40
Hungary	10-16	36
Ireland	12.50	41
Italy	31.40	45
Latvia	15	23
Lithuania	20	21
Luxembourg	28.59	38.95
Malta	35	35
Netherlands	25	34.40
Poland	19	32
Portugal	27.50	42
Romania	16	16
Slovakia	19	19
Slovenia	20	41
Spain	4-30	45
Sweden	26.3	55
United Kingdom	21-28	50

Made by author using data from following sources: (European Commission, 2009), (European Parliament, 2010), (Taxes in Europe database, 2010), (Eurostat, 2011)

In the field of direct taxation, harmonization efforts failed because the member state perceived them as the effort to restrict their fiscal sovereignty. The reason of the failure is also the fact that harmonization measures of the European Commission have to be introduced in the form of directives to be obligatory for all member states. The adoption of directive expects unanimity. It very often happens that the harmonization measure is blocked by one or two member states.

FISCAL POLICY, A DISCRETIONARY INSTRUMENT FOR INFLUENCING THE MACROECONOMIC INDICATORS

The role and the dimension of the state involvement in the economy depends on the way the state use as an instrument the fiscal policy. In the context of analyzing the impact of fiscal policy on economic growth it must be taken into consideration that fiscal policy is an instrument for reducing the short-term fluctuations, taxes and budgetary expenses are being used for influencing the aggregate demand in order to direct the economy to the potential GDP. (Braşoveanu şi alţii, 2009)

According (Fabrizio şi Mody, 2006), fiscal policy represents more a political priority than an economical one. The results of the estimated regression of his econometrical study for 1997-2003 period, using data for Romania, Bulgaria, Lithuania, Latvia, Estonia, Poland, Hungary, Czech Republic, Slovakia and Slovenia show that not even 50% of the changes in fiscal revenues could be explained through the macroeconomic variables' changes.

The estimated regression:

$$yit = \alpha + vi + \beta t\ ut + \delta xit + \varphi wit + \gamma sit + \varepsilon it\ , \qquad (1)$$

yit – fiscal revenues on GDP in country *i* in year *t*;
vi – a set of specific effects for the country *i*, in this model considered exogenous;
ut – common effects for all the countries in the year *t*;
xit – economical variables;
wit – political variables;
sit – fiscal institutions index.

According (Braşoveanu şi alţii, 2009), 1% change of fiscal revenues corresponds to a change of Economic Growth in the opposite direction by 1.5533%, a change of Public Debt in the opposite direction by 2.1336%, a change of Unemployment in the opposite direction by 0.5362% and a change of Inflation Rate in the same direction by 11.053%. As quotes (Braşoveanu şi alţii, 2009), 39.47% of the variance of economic growth rate's change is explained by the change of overall tax burden, 46.26% of the variation in public debt over GDP is explained by the change of overall tax burden, 20.17% of the variance of the unemployment rate is explained by the change of overall tax burden and 12.22% of the variance of the inflation rate is explained also by the change of overall tax burden. The correlations between these variables were tested by applying the regression technique, Granger causality and interval analysis on the data base contains annual values of the indicators in the period 1990-2007, in Romania.

Starting with the Fabrizio's conclusion and continuing with Braşoveanu's research results, I conclude that Fiscal policy is used by political and executive authority as a discretionary instrument for influencing the macroeconomic indicators.

As quotes (Smith, 1999), the declaration that the tax harmonization is needed due to the internal market or monetary union, is incorrect. The above mentioned supports by the example of the U.S.A., where there are remarkable differences in taxation, even though it is the area with higher economic and political integration than European Union. The fears from spillover effects to the low tax jurisdictions are according to the author not just. Higher tax jurisdiction in the EU offer qualified labor force and stable business environment. On the contrary, low tax jurisdictions try to establish on the internal market. The author adds, that in case that the process would be stopped by the tax harmonization, the European Union would be less converged than ever before.

According to (Mitchell, 2001) tax competition generates responsible tax policy. Lower tax burden of business subjects creates the fertile soil for higher economic growth. Without the tax competition the governments could behave as the monopoly – to levy the excessive taxes. As the mention (Mitchell, 2002), the tax competition always results in decrease in the statutory tax rates. The increased capital mobility results in situation, when the taxpayer can move the capital in the low tax jurisdictions very easily. From that reason the tax competition can be considered as very important factor supporting the liberalization of the world economics, for it creates the pressure on decrease in tax rates and in budget expenditures.

Based on the above stated literature review, following conclusions can be done: Tax competition cannot be considered as the competition in real sense. Therefore it is not possible to search for the parallels between the market competition and tax competition. While in market competition, the law of supply and demand dominates, the tax competition is the play of political and economic interests. Therefore fiscal policy could help to increase the national competitiveness and the competitiveness of the EU as a whole. The declaration that the tax harmonization is needed due to the internal market or monetary union is incorrect. Moreover, considering the introduction of European Monetary Union and the "Europeanization" of monetary policy, fiscal policy remains one of the few tools at the disposal of national governments in their effort to influence their own economies, making taxation perhaps the final component with which individual countries can deal with asymmetric shocks.

ARGUMENTS FOR FISCAL COMPETITION

The presence of supranational international organizations led to flourishing of multinationals corporations and the pursuing cross border investments. In this scenario, capital tax policies gained a significant role also due to the lack of other means of competition such as interest rates and currency fluctuations. The effort of jurisdictions to attract capital and foreign investment will induce them to lower the direct tax burden and gain a higher share in the international division of capital.

The competition between different fiscal systems can lead to the diminishing of some public expenditure or to the rethinking of the fiscal pressure. This way every country will re-examine its one fiscal system and will try by cutting off the fiscal pressure on the mobile factors, labor and capital, to increase the foreign investments or just to sustain the cost and the development of the present ones.

The migration of national tax bases as firms move between Member States in search of the most favorable tax regime must not be seen like harmful effect of tax competition, but contrary like an objective of the fiscal policy for each member state. Having this goal, governments have to make their economy more attractive for all categories of mobile factors like capital and labor. Seeing like this, the fiscal competition represents a positive effect on EU market integration denying that tax harmonization is critical to the operation of the Single Market so that goods, services, people and capital can move freely around the EU

Being able to move across the European Union everybody can establish the residence in that state that will offer the optimal combination between the fiscal pressure to be felt and public goods received. The brain drain phenomenon is influenced by both the citizen and central authority according to their choices. If education is a public service and the states are not efficiently administrating their public financial resources and at the same time the public expenditures used to cover the demand of public goods and services it can easily appear the negative externalities. This means that in the source country the lower public revenues will generate a decrease in expenditures a lower redistribution of revenues and all these will have as consequence a lower economic growth. Only using the fiscal policy into a real and transparent fiscal competition process, the national authorities can efficiently administrate their public financial resources and at the same time their the public expenditures in order to avoid the appearance of the negative externalities and to attract the mobile factors like capital and labor from all over the world. More attracted labor and capital are, more performing national fiscal policy is!

FROM TOTAL HARMONIZATION TO COORDINATION

EC Treaty in Art 93 and 94 considers as the aim of the harmonization process the establishment and smooth functioning of the internal market. If we consider the tax harmonization as the tool for reaching of smooth functioning of the internal market, then we can divide tax harmonization further on positive and negative. Positive tax harmonization represents the process of the convergence of the national tax systems of EU member states by the implementation of directives, regulation and other legislative tools. The result of positive harmonization is the same rules in all member states. On the contrary, negative harmonization is the result of the activity of the European Court of Justice (hereinafter as ECJ). Negative tax harmonization cannot be considered as the harmonization in real sense, for it does not provide the set of common rules, binding for all EU member states. The ECJ case law is binding for the parties involved in the case. ECJ case law does not comprise the means of remedies. That is the reason why the result of the negative tax harmonization cannot be the situation when there will be the same rules in all EU member states.

In comparison with the initial aims of the European Commission in the field of the direct taxes it is necessary to highlight, that the European Commission is not trying to achieve the tax rates harmonization anymore but only the harmonization of the tax basis. The aim in this field is only the structural harmonization. In the situation, when the tax basis is defined uniformly, companies themselves are able to identify the tax burden in individual states that opens the space in the field of the tax rates for the fair tax competition.

SOLUTION: CONSOLIDATION OF THE TAX RULES

Given that tax harmonization is an almost impossible goal for European Union, and on the other hand so many national different tax regulations pose problems for all companies doing business abroad, the solution would be consolidation of the tax rules.

Already in 2001, the European Commission, in the Communication COM (2001) 582, presented its view on a Common Consolidated Corporate Tax Base CCCTB, considering that it is the only way of eliminating obstacles from the cross-border activities of the European Union companies (International Chamber of Commerce, 2007). The idea of a common tax base for the European Union companies was accepted neither by all Member States nor by the whole business area. 20 countries out of 25 supported the idea. Germany and France have largely supported the implementation of a common corporate tax base given that this would end “tax dumping “of

Member States with very low company taxes The small and medium entrepreneurs Union, (SME Union), oppose tax harmonization, saying that it would have negative impact on tax competition. (Parker, 2005).

Today a common consolidated corporate tax base seems to be the only solution for the simplification of the complex and different national tax regulations. There are still some obstacles: First, the unanimity vote of the Council of Ministers could be an obstacle, but would possibly be resolved by closer cooperation of Member States in form of enhanced cooperation. Second, complicated technical implementation of the Common Consolidated Tax Base made the Member States' governments more reluctant. Moreover, some Member States fear that a common corporate tax base could imply harmonization of tax rates**.** For many countries the competitive tax policy is a comparative advantage. A competitive European tax policy is beneficial to the SMEs which are considered as the biggest growth and employment creators (SME Union of the European People's Party, 2010).

The priority must be given to the problem of reducing compliance costs and the problems with cross-border loss-offset which are due to the divergence of corporate tax systems between the Member States. These problems are more significant in the small and medium-sized enterprises' activities.

Some of the important benefits of the implementation of a common corporate tax base are: reducing the number of associated cross border disputes, enhancing economic efficiency of cross-border activities and reducing the risk of double taxation.

To overcome the reluctance of some member states, it should be underlined that the objective is not to harmonize tax rates, but the tax base and rules in order to obtain uniform tax regulation, simplicity and transparency of national tax systems. On the contrary, tax sovereignty with respect to tax rates is instrumental to ensure sound tax competition among Member States and thus to promote efficiency. The objective is, rather, to create a more efficient market and tax system for companies operating within the European Union by providing for a common and competitive tax base.

Also to overcome the reluctance of some national governments, it is better that only some Member States in the EU will initially introduce the common tax base. Other Member States can then join the regime at a later stage. Anyway, Member States control the European Union tax legislation because the Treaty requires unanimity vote and because the principle of subsidiary allows Member States keeping taxation under national legislation.

CONCLUSIONS

Based on my research I conclude that tax competition cannot be considered as the competition in real sense. Therefore it is not possible to search for the parallels between the market competition and tax competition. While in market competition, the law of supply and demand dominates, the tax competition is the play of political and economic interests. The migration of national tax bases as firms move between Member States in search of the most favorable tax regime must not be seen like harmful effect of tax competition, but contrary like an objective of the fiscal policy for each member state. More attracted labor and capital are, more performing national fiscal policy is! Therefore fiscal policy could help to increase the national competitiveness and the competitiveness of the EU as a whole.

I also came to the conclusion the declaration that the tax harmonization is needed due to the internal market or monetary union is incorrect. Moreover, considering the introduction of European Monetary Union and the "Europeanization" of monetary policy, fiscal policy remains one of the few tools at the disposal of national governments in their effort to influence their own economies, making taxation perhaps the final component with which individual countries can deal with asymmetric shocks. Fiscal Policy became a very special tool for the economic development of each state and in this context national governments have been reluctant to make any major steps towards the harmonization of taxation within the Community, and to adopt the tax harmonization measures by unanimity in Council, as is required.

It is true that international trade and capital mobility will lead to tax competition on mobile factors, but it is not true that the tax competition will harm the efficient supply of public goods, and should therefore lead to total tax harmonization. Although tax harmonization might reduce transaction costs and remove internal barriers within the EU, such measures might increase the negative aspects of tax competition and impede the creation of a level playing field in the Continent. Moreover, the European Commission abandoned most of its past efforts at creating full harmonization through legislation and focus on minimum coordination instead.

Tax coordination under the principle of subsidiary refers to the compatibility of national legislation with treaties. The tax consolidation rules must be based on mutual recognition of the Member States' tax rules. This is the only solution to more harmonize measures on direct taxation in the EU, without affecting tax rates.

Specifically, this paper encourages the Commission and member states to accept the beneficial role of tax competition in limiting the over-expansion of EU jurisdictions and to focus their efforts mainly on tax base uniformity rather than rate harmonization, thus leaving member states with full discretion in setting their direct tax rates.

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