AN EU COMPANY WITHOUT AN EU TAX?

A CORPORATE TAX ACTION PLAN FOR ADVANCING THE LISBON PROCESS

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Clear progress is needed in order to fully realise the benefits of the Single Market in the area of corporate taxation. If the EU aspires to become the "most competitive economy in the world" by 2010, as agreed by EU leaders in Lisbon in 2000, corporate tax reform should become a priority on the political agenda.

EU-led harmonisation has affected many sectors, but corporate taxation has not been among the beneficiaries. The jungle of EU member state tax systems hinders competitiveness of European industry, big and small, through high compliance costs, double taxation and protectionist regulations. It also reduces the pressure on European tax administrations to adapt.

The formal adoption of the European Company Statute (ECS) by the EU Council makes coordinated European progress in this area even more important. The ECS will allow single incorporation for firms in the EU, single governance and single reporting structures, but in the absence of a tax leg, it may not change much for cross-border business in the EU. Moreover, there is a danger that member states will grant special tax regimes to these European Companies (*Societas Europaea* in Latin; or SEs as they are called) in an uncoordinated way, as has already been suggested in certain capitals. This would be counterproductive indeed.

In a recent communication, the European Commission outlined the contours for a more coordinated tax policy in the EU. The Commission proposes immediate action in a series of well-defined areas, and is initiating a debate on a set of wider comprehensive measures with the objective of providing EU business with a single corporate tax base.

EU member states seem to be lukewarm about further progress in this area, however, and the basis for rapid action is not there. Decisive support from business is therefore needed. Overall, a more harmonised tax system should improve fairness, efficiency, simplicity and transparency for operators. It should reduce the home bias and render investment decisions more efficient, which should contribute to overall economic effectiveness and welfare.

Although the evidence is limited, the cost of compliance with the tax rules amounts to about 2-4% of total corporate tax revenues raised. Assuming that these figures hold true for the EU as a whole, the cost of the current complexity would fall in the range of €4.3bn (2%) to €8.6bn (4%). This figure may still underestimate the cost of compliance with 15 different systems in the EU.

To gain momentum towards EU corporate tax reform, we propose the following steps:

- The EU Council should set a timetable for EU corporate tax reform in a Corporate Tax Action Plan. This schedule should categorise and prioritise the different policy steps, with deadlines established for adoption and implementation by the member states. By 2010, a new regime should be in place.
- Immediate action should be undertaken to adapt the current EU corporate tax directives to include the European Company Statute. In a second step, the 1992 merger directive should be extended to further ease cross-border restructuring of corporations.

- A process should be set in motion for moving towards an optional corporate tax base either through Home State Taxation or Common Base Taxation. This requires agreement by the member states on the definition of groups of companies and on some formula to apportion profits. It also requires study of the related administrative implications.
- The Convention on the Future of Europe should attack the institutional problems underlying the lack of progress in taxation, notably by extending qualified majority voting in the tax domain. Enlargement will otherwise render any progress in the tax domain at EU level virtually impossible.

The coming into force of the European Company Statute provides a unique opportunity to develop a more coordinated European corporate tax system. Failure to act now will most likely hold back future progress as the EU devotes more of its energy to enlargement.

Corporate Tax Action Plan

Timing	Proposal	Advantages	Deadline
Long-term	Common Tax Base	Transparency Efficiency Effectiveness	
Medium-term	Home State Taxation	Politically feasible Simplification compared to status quo	2010 Lisbon target
	Optional Common Base Taxation	Politically feasible Deliberate step to a Common Tax Base	2010 Lisbon target
Short-term	Adapt parent/subsidiary and merger directives to existence of ECS	Include SEs in the list of applicable entities	2003
	Improve implementation of current directives	Make effects more visible	2003
	Expand scope of merger directive	Ease cross-border restructuring (transfer of assets, cross-border loss compensation)	2003
	Harmonise intra-EU terms of tax treaties in the EU, and move to common EU-rest of world model	Adapts tax treaties to reality of the EU and reduces tax planning.	2005
Immediate	Coordinate implementation of the ECS	Ensure that the benefits of the ECS materialise	Now
	Adoption of the draft interest/royalty directive	Harmonise tax treatment of transfers between associated companies	Now
	Ratification of the prolongation of the Arbitration Convention	Orderly resolution of disputes in the area of transfer pricing	Now
	Prolongation of the Code of Conduct beyond 2002	Ensure continuation of attempts to dismantle harmful tax practices	Now

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INTRODUCTION

Tax harmonisation has decisively returned to the agenda of the European Commission, and is now viewed as one of the main outstanding issues for a well functioning Single Market. After years of substantial neglect by the member states and deadlock in the EU Council, Commissioner Mario Monti achieved considerable progress in the discussions and managed to reconcile the divergent interests of the member states under the "harmful tax competition" approach. As a result, member states have started to discuss corporate tax matters on a multilateral basis and to meet regularly to evaluate their respective tax systems. Moreover, at the Feira European Council (June 2000), an agreement was reached on the principles of the savings taxation directive, which takes the exchange of information between tax administrations as its basis. Momentum has been created, and it is now highly unlikely that the dossier could ever return to the sterility that characterised the debate in the mid-1990s.

In the meantime, progress has also been realised on two separate, but not unrelated dossiers, the decision to move to International Accounting Standards (IAS) for all EU listed corporations, and the agreement on the European Company Statute (ECS). By 2005, all EU listed corporations should move to IAS as the accounting standard, thereby creating a single European standard. The agreement on the European Company (known by its Latin name of *Societas Europaea* and abbreviated SE) will allow a single incorporation for EU firms, reducing the cost and burden of having to comply with different company law regimes. Combined, these three elements could radically ease the way of doing business in Europe, but they are interdependent, and failure to achieve progress on one may make the other two much less attractive.

Probably the most uncertain element at this stage is corporate taxation. Member state tax systems are widely heterogeneous, and a more common European tax system will only be possible as a result of comprehensive European tax reform. So far, EU initiatives in the area of corporate taxation are limited to eliminating harmful tax regimes in the member states. The concept of an EU corporate tax system is beginning to take shape, but the thinking is still in a very preliminary phase. Broadly speaking, experts see two possibilities: Home State Taxation (HST) or Optional Common Base Taxation (CBT). Both proposals would allow companies to compute their EU profits under a single set of rules (rather than under 15 different rules as at present) and to apportion those profits EU-wide to be taxed in the individual member states. But both HST and CBT require agreement by the member states on the definition of a group of companies and a uniform formula to apportion profits, which raises a number of complex questions. This will most likely not be in place for the entry into force of the European Company Statute in 2004, but it should not hinder all those concerned to start preparations as soon as possible.

The benefits of more tax coordination are clear. The purpose of this paper is to discuss the "ideal" corporate tax scenario for the EU and to calculate its cost and benefits for business and public administrations (Sections II and III, respectively). Section I provides an overview of corporate taxation in the EU, and Section IV offers a brief conclusion.

I. BACKGROUND

All member states in the EU and most other countries in the world tax company profits. This is a matter of some controversy. It goes without saying that corporations fulfil an important economic role and, as only individuals and not companies can bear taxes, the taxes that companies do pay will be passed on in the form of higher prices or lower payments for inputs (labour, capital, etc.). The question can therefore be asked why states tax them. The justifications for corporate taxes are manifold. Corporate taxes can be seen as *benefit taxes,* i.e. corporations pay for the public services they use as a company (e.g. infrastructure). Another argument in favour of taxing corporations is that it would otherwise create incentives for individuals to accumulate income in corporations in order to avoid paying tax. Corporate taxation has also been defended as a *rent tax*. The aim is then to capture the economic benefits that the owner of fixed factors earns (Mintz, 1996).

A corporate tax is levied on the "taxable profits" of a company, i.e. the difference between the revenues of a company and its expenses, as ascertained through the company accounts. There are, however, significant differences between countries in the way taxable profits are calculated and the level of corporate taxation.

This section begins with a description of the inherent differences in tax policy in the EU, where taxation largely falls within the competence of the member states. It evaluates the adverse economic effects of maintaining taxation along national lines in the EU's Single Market. Finally, it presents what the EU has done up to this date to address these adverse effects.

1. The current corporate tax situation in the EU

The EU's member states retain full control over the formulation and implementation of corporate tax policy. Tax policy in general has been regarded as a basic prerogative of national sovereignty and thus not the object of any Community competence.[1] There are thus 15 different tax systems in the EU. Each member state must, however, exercise its national competence in corporate tax matters in a manner that is consistent with the various "freedoms" established by the EC Treaty (e.g. freedom of establishment). The fact that the European Court of Justice is hearing an increasing number of tax cases is an indication of the frictions that exist between the two. But its decisions do not necessarily lead to more convergence among tax rates.

Over the last two decades, nominal corporate rates have decreased in the EU, and the practice of multiple tax rates is disappearing. Nevertheless, there continue to be wide differences between the rates. For example, in 2001 tax rates varied between 10% (Ireland) and 39% (Belgium). See Table 1 below.

[1] Some indirect taxes, such as VAT, fall within Community competence and have thus been the subject of EU legislation.

Table 1. Corporate income tax rates in the EU and US (%)

	1980	1985	1990	1994	1997	1998	1999	2001
BE	48	45	43	40.17	41.17	40.17 [a]	39	39
DK	37	50	40	34	34	34	32	30
DE	61.7-44.3	61.7-44.3	50-36	45-30	45-30	45-30 [b]	40 [c]	25
ES	33	33	35	35	35	35-30 [d]	35	35
GR	49	49	46	40	40	40-35 [e]	40	37.5
FR	50	50	37-42	33	36.6-41.6	36.6-41.6 [f]	33.33	33.33
IE	45	50-10	43-10	40-10	36-10	32-10 [g]	10 [h]	10
IT	36.3	47.8	47.8	52.2	53.2	31.2-41.2 [i]	37	36
LU	45.5	45.5	39.4	33.3	32	32	30	30
NL	46	42	35	35	35	35	35	35
AU	61.5-38.3 [j]	61.5-38.3	61.5-38.3	34	34	34	34	34
PT	51.2-44	51.2-44	39.6	39.6	39.6	37.4	34	32
FI	50	50	40	25	28	28	28	29
SE	40	52	52	28	28	28	28	28
UK	52	40	35	33	31	31	30	30
US							35	35

[a] A rate of 39% with a surtax of 3%.

[b] The ordinary rates are 45% (undistributed profits) and 30% for distributed profits, there is a solidarity contribution of 5%.

[c] For distributed profits, the corporation tax rate is reduced to 30% and the statutory tax rate to 43.65%

[d] The rate of 30% is reduced for small enterprises.

[e] 35% for listed non-financial companies.

[f] The ordinary rate is 33.3%, the surtax of 10% (15% for large enterprises).

[g] 10% is the preferential rate for Shannon airport.

[h] General available tax rate for the manufacturing sector. The general corporation tax rate for other sectors such as services is 28% and considered in the sensitivity analysis.

[i] The first rate is the lower for the manufacturing sector. The general corporation tax rate for other sectors such as services is 28% and considered in the sensitivity analysis.

[j] The first rate applies to undistributed profits, the second to distributed profits.

Source: European Commission (2001).

The various methods member states apply to calculate taxable profits differ in many respects, both for domestic and foreign income. Differences in the calculation of domestic income may be due to, among other things, different accounting systems, different treatment of dividends received from other companies, different treatment of capital gains or losses and different treatment of depreciation. The calculation of income differs due, for example, to the existence of special regimes concerning particular sectors of the economy, particular economic activities or particular regions.[2] Once all these differences are taken into account, a very different picture emerges. This is partly captured by calculating the *effective* tax rates a company faces in a particular member state.

[2] Bond et al. (2000).

Effective tax rates are generally lower than the nominal rates (see Table 2). Moreover, the divergence between the countries is lower when measuring effective rates as compared to nominal rates. Nevertheless, the difference between effective and nominal rates has decreased over the years. This is a reflection of the convergence of the underlying tax base, meaning that the effective rate is increasingly determined by the nominal rate.

Table 2. Effective average tax rates (EATR) and corporate income tax rates (CITR) in the EU (1999-2001)

	EATR (1999)	CITR (1999)	CITR-EATR	EATR (2001)	CITR (2001)	CITR-EATR
BE	34.5	39	4.5	34.5	39	4.5
DK	28.8	32	3.2	27.3	30	2.7
DE	39.1	40	0.9	34.9	25	-9.9
ES	31	35	4	31	35	4
GR	29.6	40	10.4	28	37.5	9.5
FR	37.5	33.3	-4.2	34.7	33.3	-1.4
IE	10.5	10	-0.5	10.5	10	-0.5
IT	29.8	37	7.2	27.6	36	8.4
LU	32.2	30	-2.2	32.2	30	-2.2
NL	31	35	4	31	35	4
AU	29.8	34	4.2	27.9	34	6.1
PT	32.6	34	1.4	30.7	32	1.3
FI	25.5	28	2.5	26.6	29	2.4
SE	22.9	28	5.1	22.9	28	5.1
UK	28.2	30	1.8	28.3	30	1.7
EU average[a]	29.5	32.4	2.8	28.5	30.9	2.4

[a] Average is indicative only.

Source: European Commission/Eurostat (2001).

In sum, while nominal tax rates have decreased, EU governments have widened the tax base (see Figure 1 below). In other words, the discrepancy between taxable profits and real economic profits has decreased (Lodin, 2001). The latest example of this general trend is Germany, which in 2000 decided to fundamentally change its corporate tax system.[3] While the overall effect on the effective tax burden has been limited, national tax systems have tended to become more transparent, less distorting and less costly to comply with.

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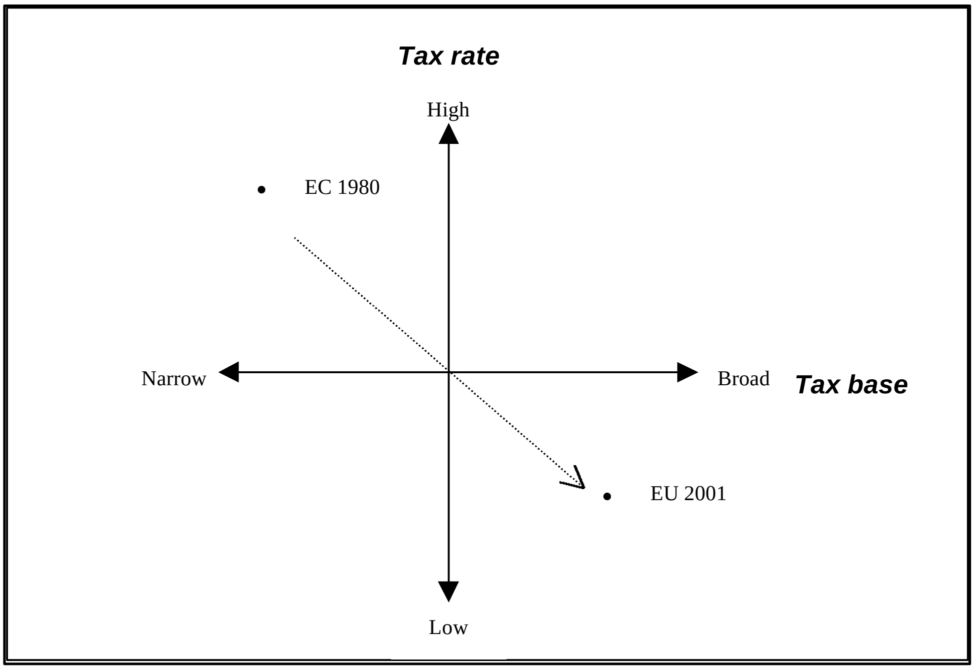
[3] German tax rates (split rates) went down from over 40% to a single rate of 25%. The base is broadened by tightening the criteria for accelerated depreciation, increasing the time of amortisation of assets and reducing the depreciation of business buildings. For further analysis of the German tax reform, see Lodin (2001) and Rädler (2000).

Figure 1. Tax dichotomy: Lower but broader



2. Consequences of the current situation

The diverse tax picture that emerges from the preceding discussion may be attractive to for those who favour subsidiarity and national sovereignty. In the EU there is indeed a relatively broad political consensus that tax policy falls within the competence of member states, not the Community. As economic integration has deepened and widened, however, it has become increasingly clear that national tax rules create obstacles to achieving a true Single Market.

This section evaluates the effects of this discrepancy between national tax rules and economic integration. It focuses on the question whether national tax policies will lead to a race to the bottom, whether they may lead to a shift in the tax burden, whether they may create economic distortions and what kinds and levels of costs it imposes on society.

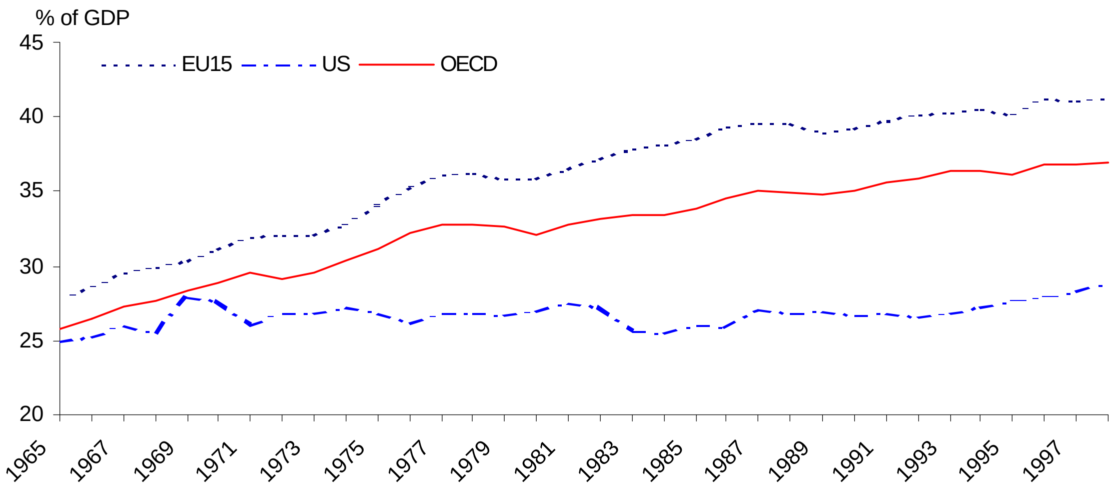
<u>The effects of tax competition on tax levels</u>

States compete among themselves to attract economic activity. One of the instruments by which they compete is taxes. Concern has been expressed, however, that by maintaining national tax sovereignty in times when economic activity is highly mobile that states may excessively compete with each other for the location of economic activity and thus not be able to finance an optimal level of providing public goods. It is asserted that such tax competition could lead to a "race to the bottom" in tax rates or revenues.

The claim that tax competition may be harmful is contentious, however. Many economists tend to regard tax competition as beneficial. It ensures that taxes are efficiently used and puts a downward pressure on the price, in this case tax levels. Moreover, there is a legitimate case for differences in taxation between countries, as countries have different preferences over the level and type of taxation. Indeed, in a seminal article on tax competition, Charles Tiebout stated that societies desire different levels of public services and therefore are prepared to pay different taxes optimal (Tiebout, 1956). An international tax system that allows a company to locate in one country because this country provides a level of public services to its liking is thus optimal. Is tax competition therefore always beneficial according to Tiebout's logic? Tiebout's assumption only holds if the companies benefit from *less* public service if they go to a low-tax jurisdiction. However, the problem with the flurry of special regimes targeting specific sectors or activities is that companies that benefit from lower taxes continue to benefit from a high level of public services (Ani-Yoanh, 2000).

Empirical evidence of a race to the bottom is limited. As has been depicted above, there has indeed been a general decrease in the nominal and effective corporate tax rates, but this has not affected tax revenues. As can be seen from the figure below, EU member states' total tax revenues as a percentage of GDP increased until the mid-1980s and have since remained stable at around 40%.

Figure 2. Total tax revenues as a percentage of GDP, 1965-1997



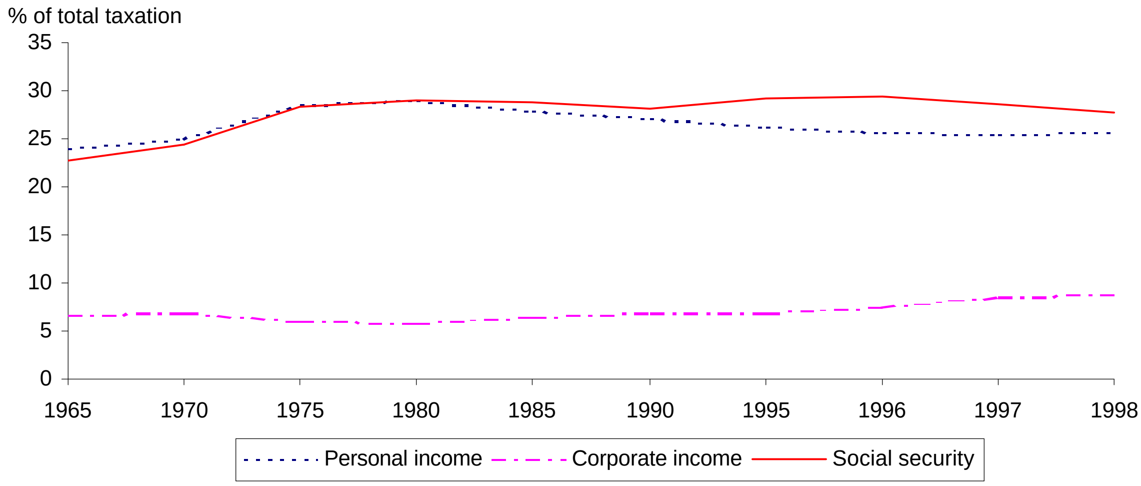
Source: OECD (2000).

Effects on the distribution of the tax burden

If the problem is not one of a collapse in revenues, then it might be a shift in the distribution of the tax burden. While corporate tax revenues as part of total tax revenues have remained stable over time, it is often claimed that labour has come to carry more of the tax burden.[4] Apart from any equity argument that the tax burden should be more evenly borne by labour and capital, the increased taxation of labour would hamper employment creation as it increases the cost of labour. This argument needs, however, to be qualified.

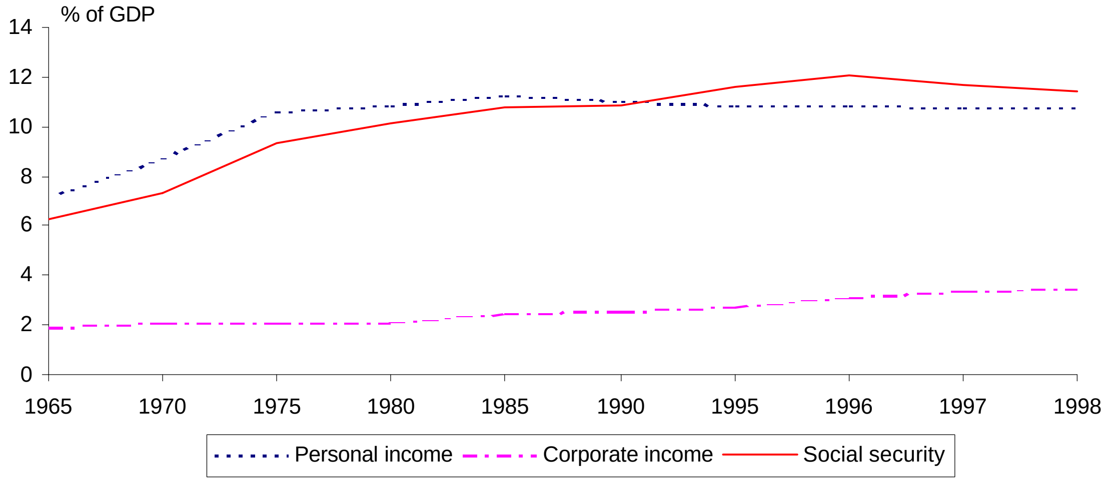
[4] See for example OECD (1998) and CEPS (2000).

Figure 3. Different taxes as a share of total taxation in the EU



Source: OECD (2000).

Figure 4. Different taxes as a share of GDP in the EU



Source: OECD (2000).

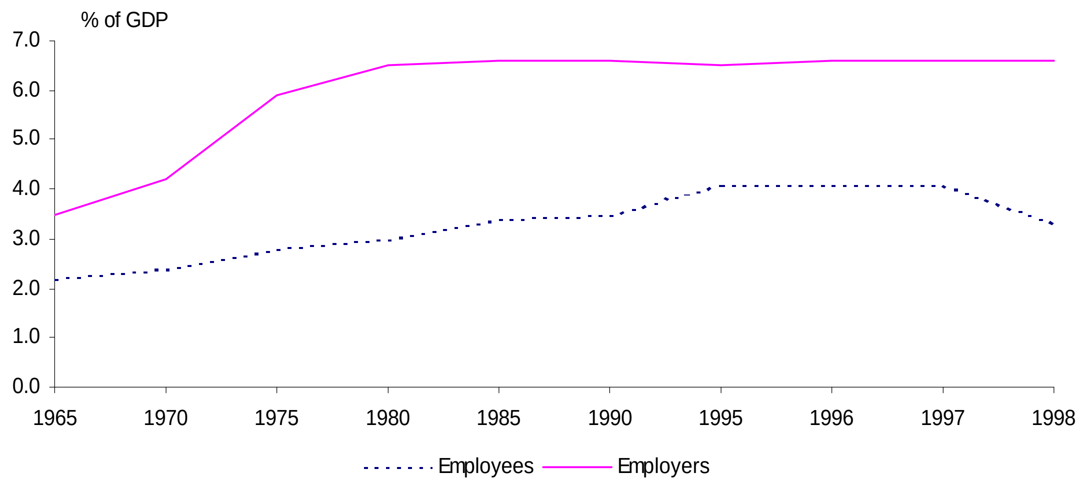
As can be seen from the figures above, labour yields substantially more tax revenues than corporations.[5] However, the difference, which increased markedly until 1975, has since remained stable, or even decreased. This would imply a refutation of the argument of a wide shift of the tax burden towards labour. However, if one looks at another measure of taxation, a different picture emerges. The effective tax burden on *capital* has decreased from 45 to 35% between 1981 and 1996. During the same time, the effective tax burden on labour has increased from 35 to 42%.[6]

[5] There are several problems with the statistics however. For example, the measure for labour taxation – personal income – includes taxation of personal capital income.

[6] Lautenberg (1999). Capital taxes, however, are borne both by individuals and companies. It is therefore not conclusive evidence of a shift in burden.

The most marked change, however, has been in social security contributions. Revenues from social security contributions have increased from 6.3% of GDP in 1965 to 11.4% in 1998 (from 22.8 to 27.8% as share of total taxation). The reasons behind this increase can be found in pressures on welfare states as a result of higher unemployment, ageing populations and increasing spending on healthcare. But employers have come to carry the large bulk of these contributions, while the share of employees – having increased since 1965 – have decreased since 1995.

Figure 5. Social security charges



Source: OECD (2000).

The variations in taxation may not necessarily be a result of corporate tax competition. There are various possible explanations of the increasing gap between personal and corporate income taxation in the 1970s. Since the statistics are based on tax revenues, it is likely that the rise in personal income taxation was caused by the rapid inflation of the 1970s (i.e. revenues in nominal numbers increased). At the same time, corporate income taxes remained constant in nominal terms, and decreased in real terms, as stagflation in the wake of the oil price shocks depressed corporate profits. It may also be a pro-active and perfectly rational choice by governments in open economies to tax mobile factors less and immobile factors more (IFS, 2000).

Distortions to economic behaviour

The ambition for the EU's Single Market is that national borders should play no role in the decision of where to invest. As long as corporate taxes remain national, however, divergences in the effective tax levels remain large. Therefore, the investment decisions of companies remain affected by tax considerations: the effective tax burden depends on the home country of the parent company and the location of foreign affiliates. The result may be that investments become more and more tax driven, i.e. they take place in the lowest tax jurisdiction, not the lowest cost jurisdiction.

Tax arbitrage

The current situation, characterised by 15 different tax systems in the EU, offers corporations plenty of opportunities to "shop around" for the best effective tax rate. The extent of tax arbitrage depends on the mobility of corporate investment. Although it is often claimed that all factors of production are entirely mobile in today's globalised world, there are reasons not to overstate the argument. Mobility is increasing but there are still several factors that continue to hamper it. Physical installations such as factories are not that easy to move, for example. In addition, there are reasons other than taxes why companies tend to favour a particular location, e.g. proximity to the market, well-adapted regulations, stable and predictable political climate, etc.

Nevertheless, it has become increasingly easy to move financial capital. There are already policy measures that are supposed to prevent tax arbitrage: there are rules governing how companies should count the value of transfers between the different entities of a company group (*transfer pricing* rules). In principle these transactions should be priced on an *arms-length* basis, i.e. the value a company attributes to an internal transaction should reflect the current market value of a similar transaction between two independent companies. Nation states have also developed a vast number of bilateral double taxation treaties, intended to eliminate double taxation, but also to counter international tax planning and avoidance.

Compliance costs

Even though the continued existence of 15 different tax systems offers opportunities to companies to minimise their taxes, tax planning comes at a cost, as it is time-consuming and complicated. It also risks diverting the attention of companies from profitability to tax minimisation (Lodin, 2001). The time spent by senior management on tax issues instead of other issues directly related to the operating of the company represents a huge hidden cost. The activity of tax planning is unproductive and economically inefficient.

Assessments of compliance costs are difficult to make. For the UK it has been measured that compliance costs amount to 2.2% of a company's income tax revenues (European Commission, 2001). In the Netherlands, compliance costs have been found to make up 4% of total tax revenues (ibid.). The Ruding Report (European Commission, 1992) also assessed compliance costs. More than 85% of the companies participating in the report's survey estimated that compliance costs represented 3% of their company's total income. The Ruding Report and later surveys have also found that compliance costs are particularly burdensome for SMEs.

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Overall, the problems presented above are becoming increasing important as European economic integration proceeds. With the launch of the euro, yet another obstacle to cross-border activity has been removed and this is likely to propel more European companies to enter European markets other than their home country. Thus, more and more companies will suffer from the remaining aspects of fragmentation, such as tax. The next section presents what the EU has done so far to try to alleviate the negative effects of taxation along national lines.

3. Developments in EU tax policy

Harmonisation of direct taxation has been one of the least successful parts of the Single Market programme. To date, only two harmonising measures, the parent/subsidiary and the merger directives, and a Tax Arbitration Convention, have been agreed, whereas other proposals have been stalled or were withdrawn. The adoption of the tax policy package by the December 1997 EU Council of Finance Ministers (Ecofin) signalled a change of track: namely, the EU would focus on tax coordination, rather than harmonisation, and it would link the different elements in a tax package: savings taxation, harmful tax measures and a revised interest and royalties directive. This change of track has been successful in reviving the debate on tax issues,[7] but the package approach remains a drawback. Progress can only be achieved simultaneously across the different components of the package.

The Single Market programme

The 1992 programme in the area of direct taxation produced two directives and a tax Arbitration Convention, while several other proposals had to be abandoned. The two directives deal with the abolition of double taxation of enterprises operating on a cross-border basis in the EU. The parent/subsidiary directive (90/435/EEC) exempts dividends paid between associated companies from taxation; the merger directive (90/434/EEC) eases cross-border company restructuring operations from a fiscal perspective. While both directives have proven useful, they are fairly narrow, and earlier attempts by the European Commission in 1993 to expand their scope failed. Moreover, implementation by the member states has been problematic.[8] The Arbitration Convention created a mechanism for the settlement of disputes between enterprises.[9]

Another significant element in the earlier attempts to proceed with tax harmonisation was the 1992 *Ruding Committee Report*. This Committee, set up by the European Commission to give a new impetus to tax harmonisation, concluded that differences in corporate taxation distorted the functioning of the internal market. It argued for a minimum corporate tax rate of 30% in the EU, coupled with a series of measures in three phases designed to produce significant convergence in company tax systems. Member states showed no desire, however, to take these steps or even to continue discussion on corporate tax measures.

[7] The Commission now even has a special web page devoted to corporate tax reform (http://europa.eu.int/comm/taxation_customs/taxation/company_tax/index.htm).

[8] See European Commission (2001, pp. 225-242) for a detailed discussion of the working of the directives.

[9] Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/436/EEC). The extension of the Convention to Austria, Finland and Sweden is still pending ratification in some member states, as also does its prolongation, having formally expired in 2000.

The Ruding Committee of Independent Experts

The Ruding Committee was established in 1990 by the European Commission to address the following questions:

1. Do the different company tax systems cause major distortions in the internal market, particularly with regard to investment decisions and competition?
2. If such distortions arise, will market forces and tax competition eliminate the distortions, or will Community level actions be required?
3. Should the Community concentrate on all areas of company tax, or solely on particular areas such as company tax system, legal status, or the tax base and rates?
4. Is it necessary for the Commission to harmonise, approximate or establish a Community-level national tax?

The Ruding Committee issued its final report in 1992. It noted that taxes appear to distort investment allocation, and that the tax component of the cost of capital is higher on average for both inward and outward investment than for domestic investment. Although market forces had led to some convergence of systems, it was unlikely that these forces would eliminate existing distortions, meaning that Community action was needed. The Committee therefore proposed a three-pronged approach, i.e. the definition of a common tax base, encouraging transparency of tax incentives, and eliminating distortions to cross-border investment flows. Unfortunately, the report also proposed setting a minimum and maximum tax rate, which attracted the most attention, and diverted the debate onto the wrong track.

The Monti package

The definite initiative to relaunch the EU tax policy debate was taken by Commissioner Monti at the informal Ecofin Council (EU finance ministers) in Verona in April 1996. The Commissioner started from the overall assessment that taxation on income from labour was becoming too heavy as a result of a downward spiral in capital taxation created by unfair tax competition between the member states to attract investment. This was considered harmful since it led to a loss of tax revenue, distorted the Single Market and undermined employment. The Council agreed to create an ad hoc group of special representatives of finance ministers under the chairmanship of Commissioner Mario Monti, known as the Taxation Policy Group, whose deliberations resulted in the Ecofin agreement of 1 December 1997.

The Ecofin agreement includes four elements:

1. The first is a voluntary Code of Conduct in business taxation. Over a period of five years (1977-2002), this code was intended to initially provide a standstill on special tax regimes, and later a rollback. It defines at a very general level what constitutes damaging tax measures. In 1999, a special ad hoc Council group published a first list of 66 harmful tax regimes, but this report has never been discussed nor formally endorsed by the Ecofin Council. The Code of Conduct will need to be extended or renewed at the end of this year.
2. The second component of the deal is the commitment to ensure a minimum level of effective taxation of savings within the EU. Subsequently, the Commission

presented a proposal for a 20% withholding tax on interest paid to non-resident EU citizens in May 1998. In the meantime this proposal was altered following the Feira European Council agreement (June 2000) in a new draft, which is based upon the exchange of information between fiscal administrations.

3. The third element is the decision to take a closer look at special tax regimes from the point of view of the Commission’s powers in the area of state aid. Special tax regimes can be tackled as illegal state aid policy, which the European Commission has started to do.[10]

4. Finally, the fourth element of the ECOFIN deal is the decision to resume proposals for a corporate tax directive on interest and royalty payments between enterprises operating on a cross-border basis. This directive was first proposed as part of the Single Market package in 1988. A new proposal was submitted to the Council in March 1998, but it has not fared well so far.[11]

The new approach led to important progress in the area of direct taxation. Probably one of the most significant developments is that heads of the fiscal administrations have started to meet on a regular basis for the first time since the creation of the EU. The side effects of such meetings cannot be underestimated, since it is the first step towards a more elaborate system of exchange of information between fiscal administrations. The combination of soft law (codes of conduct), hard legislation and the use of existing Community powers in the area of state aids has brought more progress than reliance on directives alone, which have to be adopted unanimously by the member states.

The new approach has three important drawbacks, however. First, the basic premise underlying the whole package, i.e. that tax competition is harmful, is weak. As mentioned above, there is no strong distinction to be drawn between harmful and beneficial tax competition. Secondly, the package approach always requires balanced progress. Blockage in one element can hold up progress in the others, and possibly threaten the whole package. Thirdly, there is the heterogeneity of the package.

The assertion that tax competition is harmful finds no support in the academic literature or in the facts, as indicated above. Taxes are not the main driving force behind foreign investment, but only one of the factors, meaning that it is difficult to isolate taxes in an overall process of competition for foreign investment. In general terms, tax competition is seen as beneficial as it forces policy-makers to adjust (CEPS, 2000, pp. 16-26). The facts also do not demonstrate that corporate tax income would have declined. While corporate tax *rates* have come down, the overall level of corporate tax revenues as a percentage of GDP has slightly increased over time in the EU. This reflects the fact that tax reforms in EU countries, and in OECD countries in general, have combined cuts in tax rates with measures to broaden the corporate profit base. As can be seen from Table 1, the statutory tax rates have fallen in all EU member states except one, Spain. As

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[10] Press Release of the European Commission, 11.07.2001, “Commission launches large scale state aid investigation into business taxation schemes”, IP/01/982. Formally, it is difficult to consider state aid as part of the package, because it already falls within the competence of the Commission.

[11] Proposal for a Council directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states, COM (1998) 67 final, 4 March 1998.

shown in Figure 4, corporate tax as a percentage of GDP in the industrialised countries has experienced a slight upward trend, rising from 2.5 to 3.5%.

The package approach has probably been a clever way to achieve consensus in tax decisions at EU level. It could rapidly become the victim of its own success, however, with some important decisions to be taken in the coming months. The package has so far progressed more or less in parallel in the different areas. But the situation persists in which some countries attach more importance to the corporate tax side, others to the savings tax element, and still others to the distortions caused by special tax regimes. Blockage can thus still be expected, with important negotiations with third countries still ongoing on the savings taxation directive, and the draft interest and royalty payments directive before the Council.

There is finally the heterogeneity of the package, both in sense of the issues and the legal instruments used. From the perspective of the business community, for example, it is hard to understand why the draft interest and royalties directive is part of such an uncertain and complicated process. The directive aims to correct a manifest tax distortion in the Single Market, which should have been approved by the Single Market 1992 deadline. It is a simple correction to double taxation and tax discrimination, and has nothing to do with a tax package against harmful tax competition. The combination of different forms of regulatory instruments in one package has also raised problems. The policy process for a directive is clear, but less so for a code of conduct. The latter has been criticised for being an opaque and undemocratic way of decision-making (see e.g. CEPS, 2000). The relationship between the code and state aid actions is also unclear.

A second element in the drive towards more integrated tax systems is the Lisbon process. The Lisbon European Council (March 2000) set an ambitious strategic goal for the EU, namely "… to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion". The reforms contemplated in the context of the Monti package are, however, certainly insufficient to provide for this more long-term ambition. Rather they have managed to get member states back around the table, and solved some short-term problems. But they are not the basis for a greater convergence of national tax systems, which would be more in conformity with the strategic goal set in Lisbon.

The European Company Statute

In the meantime, the agreement on other important elements of the Single Market programme, 1) the European Company Statute (ECS) and 2) the move to the application of International Accounting Standards (IAS) for listed companies, gives a further reason to come up with a long-term strategy. Both elements will largely facilitate the environment for doing business in the EU.

After more than 30 years of negotiation, the member states of the EU finally endorsed the European Company Statute on 8 October 2001. The ECS will allow companies operating in two or more member states of the Union to work within the framework of a single European incorporated entity. The regulation thus promises substantial savings for European companies, and has widely been regarded as a crucial measure to complete the Single Market and to improve the competitiveness of European companies. The regulation will come into force three years after the final agreement.

The agreement on the SE came as a surprise, since support from business for the very complex compromise proposals that were discussed under previous Council Presidencies had evaporated. The final version of the regulation is less complicated and may lead European business to consider re-incorporating as a European company. It should simplify the organisational structure of European multinational enterprises and thus lead to substantial cost savings and efficiency gains. It will, for example, allow large corporations to rethink their organisational structure, and to re-organise themselves along specific lines of activity, rather than having to incorporate on a country-by-country basis. The legal structure could in this sense coincide much better with the effective business configuration.

The European Company Statute (ECS)

The ECS will give companies operating in more than one member state the option of being established as a single European company (S*ocietas Europaea* or SE*)* under Community law. This will enable them to operate throughout the EU under one set of rules and with a unified management and reporting system, rather than being subject to all the different national laws of each member state in which they have subsidiaries. The EU regulation will allow four different forms of creating an SE. An SE can be established:

- as a holding company promoted by public or private limited companies from at least two different member states;
- as a joint subsidiary of companies from at least two different member states;
- through the merger of two or more existing public or private limited companies located in at least two member states; or
- by transformation of a national company that has operated in two (or more) member states for at least two years, without the need to dissolve the company.

The SE must have its registered office in the same member state as the head office. It can be moved from one member state to another on the basis of a simple procedure. The SE incorporates the possibility of one-tier and two-tier boards, in view of the fact that both are common in the EU. The minimum capital of an SE is €120,000, in order to ensure that SMEs have the opportunity to make use of it. Many items are left to national law, however, the most important element being taxation.

An SE can only be created if there is consensus on the degree of worker involvement, which is defined in a separate directive. If it proved impossible to negotiate a mutually satisfactory arrangement, then a set of standard principles, laid down in the annexe to the directive, will apply.

Nevertheless, there are some important drawbacks. Apart from the worker involvement issue, which we will not develop in this context, a major problem is the frequent referrals to national law. The SE is a framework regulation, in the sense that only some core elements are harmonised at European level. Issues such as securities law, bankruptcy law and taxation are not covered and left to national law. The question has in this sense been raised whether the directive will be workable. To the extent that mutual recognition will work, it could become a flexible and attractive instrument. As with other elements of the Single Market, it should give rise to competition between jurisdictions and stimulate member states to adapt. However, member states may bring up elements that will hinder effective use of the SE as a single European incorporation.

Taxation will certainly be the test case for the effective use of the SE. In a company law sense, the ECS should allow an enterprise to publish a single account, to move the head office, and thus the assets, or to consolidate losses EU-wide. However, this will imply adaptations in tax law to make this possible. This is discussed in more detail below.

The second element highlighting the need for progress on the tax side is the move to International Accounting Standards (IAS). Under a proposed regulation, published in February 2001, all listed EU companies will be required to prepare consolidated accounts in accordance with International Accounting Standards (IAS), rather than having to comply with their home accounting standard, and an international standard. This requirement should enter into force no later than 2005. Member states will have the option to extend this requirement to unlisted companies and to the production of individual company accounts. The regulation will help eliminate barriers to cross-border trading in securities by ensuring that company accounts throughout the EU are more transparent and can be more easily compared. This would in turn increase market efficiency and reduce the cost of raising capital for companies, since one accounting standard should be acceptable for the whole of the EU.

At present, accounting standards in the EU are governed by two directives, the fourth and seventh company law directives, which were adopted in the 1970s. They deal with annual accounts and the consolidation principles. These directives accommodate the basic practices in place in member states, but do not establish European accounting standards, as too many implementation options are left to the member states: 62 in the 4th directive, 50 in the 7th. Moreover, substantial differences exist between EU states with respect to the interpretation of these provisions.

<u>Enlargement</u>

Tax issues have been difficult to address at an EU level for a number of reasons. If nothing is done in terms of decision-making, enlargement will further add to these difficulties. The enlarged Union will be more heterogeneous in terms of their members' national interests. The new members are different in their economic structure. Their tax systems are shaped in accordance with their stage of economic development, thus using taxes as a means to stimulate investments and to penalise the repatriation of profits. Tax breaks and special regimes are also widespread. A Union of 27 members will cripple the EU's decision-making process unless the European Convention or another forum manages to simplify it. All this means that the EU, while reaping the substantial benefits of enlargement in numerous areas, will be in a worse position to tackle *tax* issues.

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Important elements will thus be in place to enable companies to work in the EU as a truly Single Market. Enlargement may, however, consume a substantial amount of the EU's energy for an extended period of time. There is thus a pre-enlargement "window of opportunity" to expand and advance the debate on tax measures beyond the issues that are currently under discussion as part of the tax package to seek a long-term solution for European business. The implications of this opportunity are presented in the next section.

II. THE IDEAL CORPORATE TAX SCENARIO FOR THE EU

Let it be clear from the beginning, the ideal scenario for the EU is not a single corporate tax *rate*. The EU is a federation of sovereign states, which have, in the Treaty of the EU, agreed to form an "ever-closer Union". Integration started with different sectors of the economy, and has recently been pursued in other areas such as foreign and security policy. The basis of economic integration remains anchored, however, in the economics of fiscal federalism and the politics of subsidiarity. Local provision of locally efficient levels of public goods will always ensure that welfare provision is at least as high or higher than would be the case under central provision at a single uniform level. In policy terms, things should not be done at a higher political level if they can be done more efficiently at a lower level. An important implication of this model is regulatory and jurisdictional competition: what states have not agreed to do in common will be subject to competition. This is a cornerstone of the Single Market, but it is also its Achilles heel, since member states may not accept cross-border trade on the grounds that the standards applied in other member state are not equivalent – they will argue there is unlawful competition.

The theories of fiscal federalism and subsidiarity also apply to tax policy. Following the Leviathan State of public choice theory, decentralised taxation enhances the chance that levels of regulation and public services provision are matched with citizen's preferences. Furthermore, it is a useful protective device against over-taxation and "greediness" by the state. Decentralised taxation triggers interstate competition, which keeps taxes in line. Moreover, states have a different mix in factors of production, which they need to exploit in attracting foreign direct investment, which is influenced by the geographical location, the composition of the population, the level of education of the workforce, etc. States should thus be in a position to exploit these differences, which should also be apparent in their tax system. This is of great importance in a European context, where levels of economic development and the mix of production factors still differ importantly.

At this point, the discussion launched by Commissioner Monti comes into play. The decentralisation can be such that it creates distortions in economic behaviour. Whereas capital in the EU is mobile, labour is not, or much less so. Thus, worker migration cannot respond to differences in wage levels. According to the Commission's analysis, taxes on capital income have declined as a result of this competitive process, which has been recuperated through increased taxation of labour. This has led to higher real wages, and higher unemployment. However, although the latter assumption seems to be correct according to certain sources (see e.g. Daveri and Tabellini, 2000), the literature is less conclusive on the former. Tax competition seems to have beneficial effects, and not only harmful consequences. A single answer cannot be given (CEPS, 2000; Bratton and McCahery, 2001).

This may change in the future. As member states' economic policies become more similar and economic interconnections between them increase in number and depth, these policies (particularly taxing and spending policies) will cause more fiscal externalities. The allocation of capital will become more ineffective, thereby highlighting the negative distributional consequences of tax competition. The Code of

Conduct is a first step in tackling these externalities but it is vulnerable to challenge. The link with an empirically verifiable set of justifying conditions is tenuous (Bratton and McCahery, 2001). The Code, and the actions undertaken by the European Commission against fiscal state aid, have been useful in contributing to a process that will eliminate distortive preferential measures. The Code is not sufficient, however, as it will not by itself lead to a more coordinated regime in the EU.

1. The ideal long-term scenario

Given these assumptions, the ideal tax scenario for the EU is one in which a form of basic harmonisation is undertaken, in line with the foundations of the Single Market. So far, the harmonisation undertaken at EU level, although embryonic, has tackled tax obstacles. In a second phase, one should try to shape the market, that is, to devise policies aimed at governing or directing the market. An EU corporate income tax (EUCIT) at a uniform rate is not considered, since it is difficult to reconcile with the basics of economic and political federalism. What the Single Market needs is a *common corporate tax base*, a single standard on the basis of which corporate profits would be taxed, as exists at national level in most member states. To a significant extent this would eliminate competition between the member states for the tax base. Member states would still be able to compete, however, on the basis of differences in the tax rate.

A common corporate tax base involves agreement on three principal elements:

- A common method of measuring corporate profits;
- Agreement on the business entity (company/group) to be used for the purposes of that measurement; and
- Agreement on a uniform formula for splitting corporate profits between the member states (the formula apportionment – see box below).

This will not be easy to achieve. Firstly, the legal basis to harmonise corporate taxes in the EU Treaty is much less evident than it is for turnover taxes (VAT). Art 93 of the EU Treaty requires member states to harmonise legislation regarding turnover taxes, whereas there is no equivalent for corporate taxes. Secondly, a corporate tax base is not as objectively verifiable as other forms of taxes. The measurement of corporate tax profits depends only peripherally on cash transactions. More importantly, it depends in practical terms upon the subjective judgements of accountants in arriving at commercial accounting profits and on the different adjustments that countries make to profits thereby ascertained. In comparison, the tax base for VAT is objectively verifiable, which has allowed the EU to progress relatively easily in this area, although there remain differences in the VAT rates among the member states (CEPS, 2001).

Already the first step, a common method for measuring tax profits, is a huge task. It raises the question of how profits are measured and which accounting standard is used. Generally speaking, two traditions exist in the EU. Accounting standards in some countries are driven by the needs of financial markets, and agreed upon by standard-setters, and in others, they are primarily driven by law – the former represented mainly by English-speaking states and the latter by continental European countries. In the former, accounts are expected to convey information of an adequate quality, in accordance with the accepted standards and practices developed by the accounting profession. In the latter, it is based on compliance with statutory requirements. Tax authorities have retained a strong influence on the accounting regulation processes in those countries, as national law states that taxable profit should be close to the profit reported in individual financial statements.

What is formula apportionment?

Under formula apportionment, a taxable profit of a company in a certain state is apportioned by applying a certain formula to the state(s) where the profit was realised. Rather than having to file tax accounts in the different states of a federation, and to apply complex transfer pricing rules for intra-company transactions, a company files only a single account and pays a single tax, which is distributed according to a certain share over the states where the profit was realised. The formula attaches a specific weight to factors such as assets, sales and payroll in the apportionment of profits. A host of studies exists, mainly focused on the US, which analyse changes in the weights of the different factors and the implications for employment and investment (see Weiner, 1999, for a survey of the literature).

The US and Canada have been using the apportionment method and the unitary tax method for nearly 100 and 50 years, respectively. The US system has been widely analysed, but it is not an example of the best functioning and most uncontroversial system available. While the US federal tax base is the standard, the US states vary in their tax rates, formulas and definitions. Canada is probably a more appropriate example. All the provinces adopted the same two-factor formula and have the same tax base, in exchange for the federal government incurring all of the administrative costs associated with collecting the provincial tax. This system has proven remarkably stable, and may provide the best model for the EU.

The acceptance of International Accounting Standards (IAS) as the standard for all listed companies in the EU does not immediately change this situation. It has been suggested to use the IAS as a basis for taxing profits, but this has not been welcomed by the accounting profession, which has expressed concern that it will have to take tax matters into consideration as well, not only pure accounting issues. Nevertheless, it has been argued that work should be started to recalculate taxable profits on certain critical items, such as depreciation, stocks, equity stakes on other companies, allowances for various risks and other reserves, in order to compare the results obtained under the assumptions of both the IAS and the national accounting standard. Based on the results, the tax bases could be brought closer (Micossi, 2001).

The second step, the definition of a group, is also bound to raise controversy and disagreement, as there is no clear-cut way to define the entities/boundaries for tax purposes. The simplest way to define a unitary business would be to combine all affiliates that exceeded a certain threshold, say 50%. This idea is appealing primarily for its administrative simplicity, but it may be circumvented easily. It may lead companies to split up their business to avoid EU taxation. They would thus be arranging their corporate structure for tax, rather than business purposes, an action that is not consistent with the goals of reforming EU company taxation. The problems experienced with defining group structures in discussions on draft EU company law or financial regulation directives indicate that these are not easy issues to tackle.

A third step from here would be even more difficult. Once profits have been determined according to a common tax base for a certain company group, they should be divided amongst the member states, using a uniform formula, for taxation at the local rate of the member state in question. The introduction of formula apportionment would thus require a very high degree of cooperation and exchange of information among fiscal authorities in the member states. This means that member states will have to give up their absolute sovereignty in tax matters, since a tax authority of one member state should be allowed to control the accounts of a company incorporated in another member state, if it has questions of the taxable profit apportioned.

2. An alternative medium-term scenario

Faced with these problems, the question thus emerges what strategy should be followed to move in the direction of a common tax base. Two ideas were recently put forward by a CEPS Task Force on EU Corporate Tax Reform.[12] The first is the *Home State Taxation* (HST) idea, the second an *Optional System of Common Base Taxation* (Optional CBT).

Optional Common Base Taxation (Optional CBT)

Under this model, an Optional Common Tax Base would be derived from international accounting standards, a synthesis of taxation rules of the member states, or a combination of both approaches. Accordingly, the issues to be agreed in arriving at an Optional CBT seem no different from those for a non-optional or mandatory common base. Under Optional CBT, however, corporate entities within Europe would be allowed the choice between the common tax base and the corporate tax base (if different) defined in each member state. The advantage of this parallel approach is that member states should be more inclined to agree a common tax base than if they were seeking to define a common tax base to replace their domestic tax systems. member states will also retain sovereignty over their domestic tax base, and business will not be faced with the burden of having to change their tax declarations.

Home State Taxation (HST)

Under HST, the taxable base is the taxable profits of the entity as determined under the rules of the entity's home state. Thus, an entity uses one measure of taxable profits only, even though every entity can in theory at the outset select between 15 different methods of measuring taxable profits. Although each tax system differs in its detail (at the outset at least), HST envisages that the different systems will produce substantially similar results of taxable profits over time. This is because each member state's system would conform to agreed parameters – effectively a common corporate tax model – and member states would not be free to change their system unilaterally so as to no longer conform to that model.

Both approaches, however, still require member states to agree on a formula to apportion profits. Optional CBT also requires member states to agree on a definition of a group, whereas HST offers the possibility to extend the group definition under each member state's domestic legislation, subject to agreement on some common principles. Neither is the ideal solution for Europe, however. Rather they should be seen as practical steps towards a system that is consistent with the Single Market. According to the CEPS Task Force on EU Corporate Tax Reform (CEPS, 2001), the real difference

[12] Chaired by Malcolm Gammie, barrister at the Chambers of Lord Grabiner, QC; see CEPS (2001).

between HST and a common base lies solely in their approach to implementing a common objective. The former emphasises mutual recognition at a Community level of similar (but not identical) domestic measures. The latter emphasises the adoption at the domestic level of any one of several approaches that have been agreed at Community level to be similar. Thus, the difference between both systems is more apparent than real, since the more member state's corporate tax systems diverge, the more difficult it is to think of adopting HST or agreeing a common base. Conversely, the more they converge, the easier it is both to contemplate HST and to envisage reaching agreement on a common base.

3. The short- to medium-term scenario

One of the most significant forces in shaping tax developments over the next five years is likely to be the European Court of Justice (ECJ). Over the last few years, the Court has become increasingly active in striking down a number of tax measures as incompatible with the Single Market. ECJ action is not sufficient, however, as it is too piecemeal and ad hoc, and therefore unlikely to lead to a coherent overall result. A pragmatic scenario should therefore be outlined to arrive at more coordination of corporate tax policies in the member states. It consists of different steps going beyond the strategy adopted by the Ecofin Council in December 1997. In view of the difficulties in harmonising corporate taxation in the EU, it can be assumed that this might take at least five to ten years. This is at the limit if the EU wants to respect the 2010 target it set itself at the Lisbon European Council in March 2000. EU action on the points below is therefore urgently needed:

1. A first step would be to streamline the implementation of the current tax directives (merger and parent/subsidiary directives), and to adapt them to make them also applicable to the *Societas Europaea*.
2. In a second step, possibly in combination with step one, the merger directive should be expanded to take full account of the implications of the European Company Statute. This should broaden its scope to ease the restructuring of corporations and the transfer of assets between corporations in the EU. A company should not be penalised for liquidation of a subsidiary if it serves to bring the assets of the liquefied company into another corporation incorporated in another member state. Also cross-border loss-compensation should be considered in this context;
3. Ensure that a coordinated approach prevails in the attitude of the member states towards the implementation of the European Company Statute. Some member states have hinted at the possibility of making the SE more attractive on their territory by granting it a special favourable tax regime. This would clearly go against the spirit of the ECS.
4. Complete coverage and harmonisation of intra-EU terms of bilateral tax treaties, following as closely as possible the OECD Model Convention. This should in a second step lead to a single common EU-rest of the world tax treaty model.
5. Set process into motion for moving towards a common corporate tax base through Home State Taxation or Optional Common Base Taxation. A first step could be to study the effects of harmonisation of certain critical items in companies' balance

sheets, such as depreciation, stocks, reserves and provisions, which are a major source of divergence in profit determination for tax purposes.

Overall, the appropriate policy mix at EU level should focus on both long-term and short-term measures. An appropriate comparison can be made with the current attempts to forge a seamless single financial market in the EU. In order to root out the current obstacles to a Single Market, the European Commission drew up a Financial Services Action Plan (FSAP) in 1998. The FSAP contains 42 legislative measures grouped in four different areas: wholesale finance, retail finance, supervisory arrangements and wider conditions for financial integration (e.g. corporate governance and certain tax issues). The FSAP detailed the legislative measures and provided a roadmap with clear priorities and deadlines for each and every proposal. Progress of the FSAP is reviewed once every six months (progress reports are published by the European Commission).

A similar plan should be drawn up for the area of corporate tax policy. A rough version is outlined in Table 3 below.

Corporate Tax Action Plan

Timing	Proposal	Advantages	Deadline
Long-term	Common Tax Base	Transparency Efficiency Effectiveness	
Medium-term	Home State Taxation	Politically feasible Simplification compared to status quo	2010 Lisbon target
	Optional Common Base Taxation	Politically feasible Deliberate step to a Common Tax Base	2010 Lisbon target
Short-term	Adapt parent/subsidiary and merger directives to existence of ECS	Include SEs in the list of applicable entities	2003
	Improve implementation of current directives	Make effects more visible	2003
	Expand scope of merger directive	Ease cross-border restructuring (transfer of assets, cross-border loss compensation)	2003
	Harmonise intra-EU terms of tax treaties in the EU, and move to common EU-rest of world model	Adapts tax treaties to reality of the EU and reduces tax planning.	2005
Immediate	Coordinate implementation of the ECS	Ensure that the benefits of the ECS materialise	Now
	Adoption of the draft interest/royalty directive	Harmonise tax treatment of transfers between associated companies	Now
	Ratification of the prolongation of the Arbitration Convention	Orderly resolution of disputes in the area of transfer pricing	Now
	Prolongation of the Code of Conduct beyond 2002	Ensure continuation of attempts to dismantle harmful tax practices	Now

III. COST-BENEFIT ANALYSIS OF MORE TAX COORDINATION

As outlined above, the short- and medium-term aim for EU policy-making should consist of a more coordinated tax regime, with Home State Taxation (HST) or optional Common Base Taxation (CBT) as medium-term objectives, and some form of apportionment of taxable profit among member states. A single EU tax regime with a single tax base would offer several positive aspects (e.g. neutrality and simplicity), but it is still a long-term option.

The cost-benefit analysis follows from this assessment, and will thus have to be judged in that perspective. Starting from the view that some degree of tax competition is beneficial, HST and optional CBT are beneficial as both systems retain some "competitive" aspects. However, there will also be some drawbacks of a HST or optional CBT. The cost of running 15 (or more) different tax systems will have declined for private business, while it will increase for governments, which will have to learn to live with the exchange of information and formula apportionment. The experience of the Canadian provinces suggests that a simple system will need to be designed, which is no easy task in the context of the EU decision-making process.

It may be surprising, but there has so far been very little if any empirical research on the effects of more tax coordination or harmonisation for the Single Market. Overall, it is assumed that the fact of having to work with many different tax systems in the EU is costly. The 1987 Cecchini Report on the cost of non-Europe did not really quantify the costs of having different tax regimes in the EU. It described differences in corporate tax regimes as one of the many barriers to the Single Market, and estimated very roughly that this would amount to 10-30% of the costs of companies. The Ruding Report (1992) noticed a convergence in the corporate tax component of the average cost of capital across member states, but attributed this to downward convergence of interest and inflation rates, rather than deliberate action on the part of the authorities.

A 1992 CEPS report on corporate tax harmonisation saw the gains from a greater degree of convergence of corporate tax regimes coming partly from administrative simplicity and partly from organisational and financial restructuring. Secondly, it expected that gains from achieving greater Capital Import Neutrality (CIN), defined as no difference in the tax on similar companies in a particular country and Capital Export Neutrality (CEN), in which there is no difference in the tax on the same investment located in different countries, would be potentially more important. However, full CIN or CEN would not be required, since the corporate tax rate must reflect traditional distortions in the choice of assets and finance, and must not encourage or discourage economic activity where inappropriate. A good corporate tax structure in this context is one that does not distort economic behaviour and is tax neutral. This can best be seen by considering the investment decision of firms in the absence of corporate taxes. They would invest if the rate of return on investment were sufficient to provide financiers with a reasonable return on their capital, after covering all expenses, including depreciation of assets. A corporate tax that only taxed profits over and above the profits required to give financiers a reasonable return and that allowed for depreciation of assets at true rates would be a neutral tax. This is theory, however, as many elements distort this neutral situation. Deduction costs for investments, for example, are either too small or too large, nominal depreciation rates can differ systematically from real rates, and are often used as a hidden incentive (fiscal state aid), etc.

This section starts by assessing the overall effects of tax base harmonisation. It then continues by assessing the effects in five key areas: competitiveness of the tax system, the European Company Statute, labour markets, public finance and capital markets.

1. Overall effects of tax base harmonisation

The harmonisation of the tax base is likely to have both positive and negative effects on the tax burden faced by companies. *No research exists, however, on the quantitative benefits from tax base harmonisation*. Indeed, the issue is very complex, involving both static and dynamic effects. This section will take as its point of departure the concerns detailed above and assess how a common base would alleviate those concerns.

Positive effects

There are certain attributes of an ideal tax system. It should be fair and equitable. It should be economically efficient and neutral, i.e. not distort investment decisions. It should be simple and transparent, the rules should be certain and well known. Finally, it should improve economic welfare. A single consolidated corporate tax base would bring the EU's currently fragmented tax systems closer to the ideal.

- *Economic efficiency*

A single tax base would reduce the current differences in treatment of taxable profits between the member states. As such, it would ensure a fairer and more equitable treatment of companies all over the EU. For example, it would eliminate the current problem of not being able to offset losses across borders in the EU.

A single tax base would eliminate the possibility of competing for tax bases. The location of investment is currently often responding to the special measures that states set up to attract companies. Therefore, investments are often tax-driven instead of cost-driven, which is unproductive. A single tax base would increase tax neutrality and make the rationale of an investment location decision more transparent. Moreover, firms are currently engaged in the complex, costly and, from a social welfare point of view unproductive activity of calculating transfer prices. A single tax base within the EU would largely remove the need to engage in this company activity within Europe. It would remain for third countries, however.[13]

- *Administrative simplicity and transparency*

A single tax base will reduce the number of tax systems from 15 to one, with maintenance of different tax rates, of course. It will therefore hugely increase simplicity and transparency, as the taxable profits will be calculated in the same way all over the EU. It will thus reduce compliance and administration costs. Compliance costs are difficult to estimate, but may be as much as 2 to 4% of total tax revenues.[14] In 1992, 85% of some 965 companies in the EU and EEA countries surveyed by the Ruding Committee estimated compliance costs at 3% of a company's total income, and there is some evidence that the compliance cost ratio is higher for foreign income than for

[13] Tax-planning opportunities may not disappear completely under the new system. Instead of planning according to rates, however, companies may use the formula in order to minimise their tax burden.

[14] European Commission (2001, Annex II, p. 74) lists the results of some country surveys of compliance costs.

domestic income.[15] Several surveys indicate that compliance costs are especially burdensome for SMEs, which often need to rely on outside professional assistance to comply with their tax declarations.

A numerical example to highlight the size of these costs may be useful. As such exercises are fraught with methodological problems, the figures should be seen as purely indicative.

Table 4. The size of the compliance cost, € million

	Corporate tax revenues[a]	Cost of compliance (2%)[b]	Cost of compliance (4%)[b]
BE	8,690	173.8	347.6
DK	4,359	87.2	174.4
DE	30,979	619.6	1,239
ES	12,936	258.7	517.4
GR	2,122	42.4	84.9
FR	34,733	694.7	1,389
IE	2,618	52.4	104.7
IT	31,864	637.3	1,274
LU	1,336	26.7	53.4
NL	15,189	303.8	607.6
AU	4,032	80.6	161.3
PT	3,866	77.3	154.6
FI	4,769	95.4	190.8
SE	6,243	124.9	249.7
UK	51,021	1,020	2,040
EU15	214,764	4,295	8,590

[a] As reported in OECD (2000, code 1200).

[b] Percentages based on European Commission (2001).

The single base will also reduce the costs of administering the tax system. Currently tax administrations have to verify foreign source income, be aware of the tax systems in other EU member states and monitor the transfer pricing system. With a single tax base, those costs will disappear for intra-EU business. On the other hand, running an apportionment system may be burdensome for administrations, as is evident from the US experience. A single tax base would also enhance legal certainty in tax matters, as the tax base would be codified at EU level.

- *Effectiveness and economic welfare*

It is very difficult to assess what effects the current system will have on economic welfare and effectiveness (i.e. the ability to achieve the stated objectives of the Community). Over time a single base is likely to decrease the effective tax and administrative burden faced by companies and may decrease the cost of capital. In that sense, it will contribute to the target set by the Lisbon Council of making EU economies

[15] European Commission (2001, pp. 74-77).

more competitive. Economic analysis suggests, however, that there is a difference between the static and immediate effects of the imposition of a single base and the more long-term and dynamic effects.

As mentioned above, effective tax rates are a function of nominal tax rates and the tax base. Normally, countries with high nominal rates compensate by having a narrow base, and vice-versa. Research by the European Commission shows that the initial effect of tax base harmonisation is an increase in the divergence of effective tax rates and an increase in the effective tax burden faced by companies.[16] This reflects the fact that if the tax base is harmonised in an expansive way but tax rates remain national, *ceteris paribus*, the effective tax rate will increase.

Over time the effect is likely to be different. The increased divergence and level of EU corporate taxes may trigger a process of convergence, as companies arbitrage away this price difference. As nominal rates are also likely to decrease (unless there is a political decision to harmonise at the upper end), the overall economic effect of tax base harmonisation is highly complex to assess. Without political intervention, base harmonisation is likely to lead to rate decreases and thus a lowering of the effective tax burden. With political intervention, the burden is likely to remain stable or increase.

<u>Potential drawbacks</u>

A single tax base thus engenders substantial benefits for companies. There are certain drawbacks as well, however. First, there will be less potential for tax planning, and companies may thus find it more difficult to minimise their taxes. It is also uncertain how a single tax base will affect the revenues of governments. Even though the Commission’s results above suggest that the initial result of a harmonised tax base may be an increase in the effective tax rates of companies, the impact differs from one country to another. Moreover, base harmonisation is likely to lead to a convergence of nominal rates. The direction this convergence takes (upper or lower end) determines the eventual impact on government revenue. Essentially, fiscal authorities are faced with increasing costs, as they have to engage in cross-border enquiries and audits. These and other administrative issues therefore need to be well researched and calculated.

In sum, a single tax base will be fairer, more efficient, simple and transparent. It is likely to have a positive effect on effectiveness and economic welfare. The final outcome depends on the forces unleashed by the interplay of the processes of base harmonisation and rate convergence. The impact of these processes on tax burden and tax revenues ultimately depends on choices made by policy-makers. Since the European economies will continue to differ in factors of production and in attractiveness for foreign investment, policy-makers will continue to apply different tax rates, and European countries will differ in the overall composition of tax revenues.

The effect of tax harmonisation is further discussed in four areas: competitiveness, legal structures, labour and capital markets.

[16] European Commission (2001, p. 171) finds that the standard deviation increased from 10.4 to 12.4.

2. Tax reforms and competitiveness of European industry

As indicated above, there exists no empirical quantification of the cost of not having a more harmonised European tax system and of its impact on the competitiveness of European enterprises. The evidence is based on the numerous obstacles that inhibit cross-border business. Companies working in the EU are faced with 15 widely different sets of rules, which have developed under different circumstances. This complex of rules entails substantial compliance costs for business. The importance of these variations are difficult to document systematically since almost every country and every instrument is a special case, and there is virtually no rule without an exception. A few examples (see below) will suffice, however, to illustrate the significance of these differences in tax regimes.[17]

- **Loss-compensation** is only available to differing degrees on a cross-border basis, depending on the definition of "loss" in national law, the legal form of the business in the host country and the existence of double taxation treaties. On a national basis, losses in branches can fully be carried forward and set off against future profits. According to a survey by the Federation of Swedish Industries, the difficulty in setting off these losses on a cross-border basis leads in more than half of the cases to permanent double taxation.[18]
- **Transfer pricing** rules for attributing company profits between countries, while being based on OECD guidelines and principles, leave considerable room for different uses and interpretation by member states. A number of examples can be given where member states apply the guidelines differently. Furthermore, a number of member states have not issued their own statement of practice on the implementation of the guidelines.
- **Taxation treaties** exist to remedy double taxation. However, the network of treaties is incomplete and insufficient in scope. Not all EU member states have tax treaties with each other, the scope differs and the rates applicable are not consistently applied across countries.
- **Depreciation systems** differ profoundly for the different items (machinery and buildings) as well in the method of depreciation used (straight or declining over time) and in the rates applied. Not one system is equal to another in the EU.[19]

These are only a few examples from the tax jungle which companies face when working on a cross-border basis in Europe. The wide variation between member states leads to a situation where taxes are an important reason behind a location decision. Normally, the location of investment should be dependent upon the overall cost, not only the tax cost. If European companies tend to locate according to tax cost, the overall profitability of European companies may be hampered, which will have welfare effects. If this is the case, as is quite likely, the overall competitiveness of European companies is at risk.

The recent Commission study analysed effective levels of company taxation in the EU, and found differences in the magnitude of 37 percentage points in case of a marginal

[17] Examples are largely drawn from European Commission (2001, Part III, pp. 223-304).

[18] European Commission (2001, p. 252).

[19] European Parliament (2000, p. 64).

investment (where the post-tax return rate just equals the alternative market interest rate), and around 30 percentage points for more profitable investments.[20] These differences imply large inefficiencies in the allocation of resources.

Overall, the key problems can be summarised as follows:

- Tax systems have a enormous bias towards domestic investment and disadvantage foreign investment and income.
- Within European-wide group structures, profits have to be allocated on an arm's-length basis, which gives rise to problems of transferring income streams and possible double taxation.
- Cross-border restructuring of business is hampered because capital gains and transfer taxes are often prohibitively high, and because of the limited availability of loss-compensation. If a company in a restructuring process is closed down and its assets are transferred to a company in another member state, the assets are taxed at a dissuasive rate.
- The network of bilateral taxation treaties is no longer adapted to the level of market integration in the EU. With *n* being the number of member states of the EU, *n(n-1)* or 210 different modalities of compliance can theoretically be needed with tax treaties in the EU. It is obvious that such a framework is no longer consistent with the nature and level of European integration. Moreover, tax credits often take years to be paid.

Some of the problems have been addressed in the parent-subsidiary and merger directives, but the scope of these directives was too narrow, and their implementation in the member states was distorted because of the wide differences in tax systems. Also the Arbitration Convention has been a useful tool to settle disputes between firms and tax authorities, but it contains numerous technical difficulties and provisions that are dissuasive to companies.[21] Some other issues have been addressed by the European Commission, but they are still before the EU Council (draft interest and royalty payments directive), or had to be withdrawn (cross-border compensation of losses).

Recent rulings of the European Court of Justice have also had a positive effect in reducing tax obstacles. In the AMID case, for example, the Court ruled that the impossibility to compensate losses on a cross-border basis in the EU is in violation of the EU Treaty, since it hinders the freedom of establishment.[22] However, Court rulings

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[20] European Commission (2001, p. 4).

[21] The Arbitration Convention formally expired in 2000, and its extension must still be ratified by several member states.

[22] The ECJ has analysed cross-border losses and taxation on a number of occasions. In the case of AMID vs. the Belgian state (C-141/99), the Court found that Belgium treated companies differently for tax purposes depending on whether the company had an establishment outside the country or not. AMID was forced to set off the losses of its Belgian head office against the profits of its Luxembourg permanent establishment although these profits were exempt from tax in Belgium under a double tax agreement. As a result, AMID Belgium could not set off its losses against its Belgian profits. Had AMID had its permanent establishment in Belgium, however, it would have been able to offset its losses. The Court found that there was no objective difference motivating this difference in treatment and that therefore this amounted to discrimination and hindrance to the freedom of establishment under Article 52 of the EC Treaty. For further details see European Commission (2001, p. 252).

do not necessarily lead to a more European tax system, as the adjustments made at national level in response to these rulings will not be coordinated. The increasing number of cases on taxes brought before the ECJ is an argument in itself for more tax coordination.

In the longer term, a single tax base and an EU-wide definition of group of companies are the only means to significantly reduce these compliance costs. They should eliminate problems related to EU-wide allocation of profits, transfer pricing and double taxation, reduce discriminatory situations and ease European-wide restructuring. Multinational firms will no longer need to almost artificially identify the geographical location of their profits, which by the same token will help them to think more "European".

There is a real danger, however, that a coordinated effort at European level to harmonise tax bases will lead certain companies to shift profits and investments outside the EU, as the scope for shifting profits in the EU is reduced. However, the scope for tax competition will be limited, since 1) most states of Central and Eastern Europe will soon become members of the European Union, and will thus apply the same standards; 2) the incentive to conclude comprehensive bilateral agreements with third countries will be enhanced, as is being discussed in the area of savings taxation, and 3) tax rates will not be harmonised, meaning that there will remain scope for competition between countries within the EU.

3. Tax reform and legal structures of doing business

A single European tax base would give real life to the European Company Statute. Today, companies are required to incorporate separately in the EU member states because of tax, social and legal reasons. On the legal side, the ECS is the first act of truly European company law, allowing for a single incorporation, but if this is not accompanied by measures on the tax side that allow for single reporting, e.g. single profit filing, the Statute will not be of much use.

The non-existence of European company law has so far limited the possibility for firms to take full benefit of the two existing EU tax directives, most importantly for the merger directive. As from October 2004, when the ECS comes into force, cross-border mergers will be considerably eased, and a wave of company restructuring can be expected to happen. A prerequisite, however, is that the existing two directives are first updated to take the ECS into account, and second, that the scope of the merger is expanded. In this sense, structures of incorporation can be expected to be less driven by tax considerations in the future.

The implementation of the worker involvement procedures, contained in a separate directive, will be crucial for the success of the ECS. An SE can only be constituted if

See also Centros Ltd vs. Danish state (C-212/97). While not directly applicable, as it deals with company formation rules in general and capital requirement rules in particular, it may have analogous effects in the field of taxation. The ECJ ruled that Denmark broke EU law when it refused to allow Centros Ltd to register a branch in Denmark. Centros, run by Danish citizens, had registered its office in the UK but intended to carry out all its activities in the Danish branch. The benefit for Centros would be to escape the capital requirements imposed by Denmark and instead register under the UK's more lenient regime, which required an initial capitalisation of only £100).

some form of worker involvement is instituted, unless workers waive these rights. A substantive assessment of these procedures is needed to judge whether the SE will be usable. A comparison can be made with the use of Workers Councils directive.

4. Tax reform and EU labour markets

The evidence of the lack of tax coordination is probably the clearest for European labour markets. This one factor was the principal reason behind the European Commission's decision to initiate action on harmful tax competition in 1996. While the effective tax rate on retained corporate income has remained constant over the last decade, the increase in the overall tax burden has been shifted towards these more immobile factors of production. However, this does not necessarily mean that more tax coordination would lead to more employment. Governments will first need to make sure that increases in government expenditure are no longer passed on to labour. Secondly, to realise a possible positive effect on employment, the tax burden on labour will have to be decreased, which will need to be recouped elsewhere in the tax system, or be compensated through less government spending. Neither step is easy.

Recent research has shown a link between the cost of labour and unemployment. Faced with growing competition for one of the more mobile factors of competition, capital, governments have shifted the rising cost of the generous European welfare states, essentially in pension expenditures, onto the least mobile factor of production, labour. This has contributed to higher unemployment, slower growth and investment (Daveri and Tabellini, 2000).

A single corporate tax base and formula apportionment could reduce the pressure to recoup the growing costs of Europe's welfare states from labour, as those costs would then be more transparent. It is by no means guaranteed, however, that this would lead to higher revenues from corporate taxes. In any case, this should also not stop governments from reforming Europe's welfare state. The apportionment system will also need to be designed in a flexible way to take account of the differences in the cost of labour in the EU. Moreover, the cost of compensation will need to be defined carefully, to include all the different factors affecting payroll costs.

5. Tax reform and capital markets

Capital markets are global, and not directly affected by changes in the corporate tax system. Indirectly European capital markets would certainly benefit from a more harmonised tax system. The use of International Accounting Standards for EU listed companies from 2005 onwards will also highlight the lack of harmonisation on the corporate tax side. Comparability of corporate accounts will be further enhanced if corporate profits would be measured in the same way across countries, and the work of financial analysts would be eased. Contrary to what may be expected, analysts are not served by profits calculated under different taxable bases, and will not bother to re-calculate how the profits would have looked under another system. Profits may thus look more or less attractive to a potential investor if they were calculated under another system, but since this work is so complicated, the job is not undertaken, and the stock may not be properly priced. Hence, international portfolio diversification is constrained and the willingness to invest abroad is significantly reduced. Tax harmonisation thus also affects the integration and competitiveness of European capital markets.

III. CONCLUSION

The way corporate taxation is currently organised in the EU is both complex and costly. As European integration advances, the complexity and costs increase and become more striking. Numerous attempts have been made to reduce the complexity, but most of them have failed. This is regrettable, as the benefits to be reaped from a more coordinated corporate tax regime are significant.

A number of recent developments provide a window of opportunity to remedy this situation and to devise a strategy to arrive at a more coordinated EU tax system.

1. A follow-up to the Monti tax package is needed. The package helped in providing a new impetus to tax coordination in the EU and in reducing tax obstacles. A positive integration strategy is now needed to set a new target.

2. Taxes form an important component of the ambitious agenda agreed in Lisbon in 2000 to make the EU more competitive. If the EU is serious about the Lisbon process, it needs to set a timetable for EU corporate tax reform as well.

3. The European Company Statute opens new opportunities for European business, but demands a tax leg to be really attractive.

The European Convention could give the EU the means to advance more rapidly, if qualified majority voting can be extended to the area of corporate taxation as well. This is almost a *conditio sine qua non*, as all tax matters will otherwise be relegated to a virtual standstill after enlargement, with an EU of 27 or more member states.

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