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Corporate tax harmonisation in Europe: A guide to the debate

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**Corporate Tax Harmonisation
in Europe:
A Guide to the Debate**

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Contents

| | |
|--|-----|
| Summary | vii |
| 1 Introduction | 1 |
| 2 Corporate income taxes in the EU | 6 |
| 2.1 Corporate tax bases | 6 |
| 2.2 Corporate tax systems | 12 |
| 2.3 Corporate tax rates | 14 |
| 2.4 Trends in tax revenue | 16 |
| 3 Some economics of the taxation of international capital income | 20 |
| 3.1 The effective incidence of source-based capital income taxes | 21 |
| 3.2 Forms of tax neutrality | 28 |
| 3.3 Other issues | 34 |
| 4 Potential concerns arising from the lack of harmonisation | 35 |
| 4.1 Loss of government revenue | 36 |
| 4.2 Distortions to real economic behaviour | 41 |
| 4.3 Administrative and compliance costs | 44 |
| 4.4 Co-ordination or competition? | 46 |
| 5 International tax co-ordination initiatives | 48 |
| 5.1 'Harmful' tax competition | 49 |
| 5.2 Legal mechanisms to prevent discrimination | 51 |
| 5.3 The package to tackle harmful competition | 54 |
| 5.4 OECD Forum for tackling tax competition | 62 |
| 6 Future issues | 64 |
| 6.1 Harmonise the corporate tax base | 65 |
| 6.2 Harmonise corporate tax rates | 67 |
| 6.3 A European Union corporate income tax | 68 |
| 6.4 Home State taxation | 71 |
| 6.5 Abolition of corporate income taxes | 74 |
| 6.6 Summary | 75 |
| References | 77 |

Summary

Despite a long history of reports and initiatives on the harmonisation of corporate income taxes within the European Union, the 15 EU countries still operate their own national corporate income taxes, with only limited co-ordination between them. However, the increasing integration of economic activity is placing greater pressures on these corporate income taxes, as the companies whose profits are being taxed operate increasingly across national borders, both within Europe and beyond. Tax differentials may also be assuming greater importance in company decision-making, as other differences between countries within the EU diminish — a trend highlighted by the adoption of a single currency within the Euro zone.

Thus it is not surprising that proposals for greater co-ordination of corporate income taxes are back on the international policy agenda, notably through the development of the EU's Code of Conduct on business taxation. And whatever the outcome of these present policy initiatives, it is unlikely that this issue will go away. The aim of this report is therefore to shed some light on the complex issues that surround this debate.

The European Commission's current interest in corporate tax harmonisation is prompted by a presumption that 'harmful' tax competition is resulting in a shift in taxation away from taxes on mobile capital and towards taxes on comparatively immobile labour, and by a concern that this development is harmful for employment. However, both the presumption and the concern are open to question.

Corporate tax harmonisation

At least so far as taxes on corporate income are concerned, fears of an imminent collapse in government revenues may be overstated. In fact, for the EU as a whole, revenues from taxes on corporate income have increased over the last 20 years, both as a share of GDP and as a share of total tax revenue. Whilst there has been a downward trend in corporate tax rates, this has been accompanied by both a broadening of corporate tax bases and an improvement in underlying company profitability.

Even if corporate tax revenues were to decline significantly in the future, it is not clear that this alters the real balance of taxation between capital and labour, nor that the result would be detrimental for employment. In economies that are open to trade and capital flows, a principal impact of taxes on corporate profits is to raise the required rate of return on investment and to encourage capital to migrate to more lightly taxed locations. The consequences of lower investment — less capital per worker, lower productivity and hence lower wages — may be as harmful for employment as taxes on labour income directly. In any case, much of the burden of taxes on corporate income is likely to be shifted away from the owners of mobile capital and onto relatively immobile workers, as a result of lower investment.

Whether or not the Commission's analysis is accepted, there is no doubt that the continued existence of 15 separate corporate income taxes within the EU has some significant disadvantages. One concern relates to the behaviour of governments, which may find themselves competing to attract mobile forms of investment by offering lower corporate tax rates or special regimes favouring certain business activities. Particularly if it is the case that investment is more mobile between countries within the EU than between

Summary

EU and non-EU countries, there may be a collective gain from greater co-operation over corporate taxation within the EU, although not all countries are likely to perceive benefits from such co-ordination. This uneven distribution of the benefits presents a major obstacle to further corporate tax harmonisation, at least so long as Member States retain a veto over tax matters.

A second concern relates to the behaviour of companies, which can exploit differences between tax rules and tax rates in different countries to reduce their tax bills. The interactions between imperfectly co-ordinated corporate income taxes present numerous opportunities for firms to benefit from perfectly legal forms of tax planning. Simple examples include the manipulation of 'transfer prices' for transactions between affiliated companies, with the effect of shifting profits from high-tax to low-tax jurisdictions, and intra-group borrowing and lending, with the effect that interest payments are deducted against corporate tax at a high tax rate in one country and taxed at a lower rate when received in another country. These opportunities for tax avoidance result in lost revenues for governments and add to the perception that corporate tax revenues are under threat.

A third set of costs stem from the impact of these corporate income taxes on the real behaviour of companies. A leading example concerns firms' location decisions. To the extent that investment is attracted to certain locations by the promise of low tax charges rather than low production costs, production will be less efficient as a result. Another concern relates to the inability of international companies to structure their European operations efficiently as a result of having to deal with 15 national tax systems, favouring a collection of national subsidiaries rather than a truly pan-European organisation. The costs of these distortions to economic

Corporate tax harmonisation

activity are difficult to quantify, but they are likely to become more significant in the future as companies become increasingly international.

In addition, there are likely to be significant administrative and compliance costs, as companies are required to prepare tax accounts for different revenue authorities and as disputes arise as a consequence of tax planning.

The EU's Code of Conduct on business taxation seeks to address some of these concerns by encouraging EU governments to refrain from engaging in 'harmful' forms of tax competition. The Code does not cover corporate income tax rates or general aspects of corporate income tax bases. In practice, it seems to be mainly directed at the proliferation of 'special regimes' for selected business activities, particularly those related to financial centres and other business services provided within multinational groups.

The criteria used to judge whether particular measures are deemed 'harmful' (as distinct from 'potentially harmful') are somewhat unclear. We note that, in some contexts, it may be perfectly sensible to tax highly mobile activities less heavily than more immobile activities, particularly when the likely consequence of not doing so is that these activities will migrate to more lightly taxed locations outside the EU. Indeed, the Code appears to recognise this by clearing special tax measures for some mobile activities, such as shipping.

The development of the Code of Conduct is an interesting attempt to co-ordinate some aspects of business tax policy within the EU. The Code is not legally binding on Member States, and much of its impact will depend on the extent to which this initiative is now translated into changes to legislation in individual countries. But even in the most favourable

scenario, it is doubtful whether the scope of the Code of Conduct will be sufficient to deal with many of the opportunities for tax avoidance and distortions to economic activity that currently exist.

We briefly discuss some more ambitious proposals for corporate tax harmonisation, including the development of a single European Union corporate income tax, and Home State taxation.

The report aims to provide an understanding of these issues rather than to advocate any particular solution. Nevertheless, some conclusions do emerge. As yet, there seems to be little reason for governments to be concerned about an imminent collapse in corporate income tax revenues. But even if corporate tax rates continue to fall and this did lead to a decline in corporate tax revenues in the future, requiring other taxes to rise, it is not clear that this trend would have dire consequences for employment. Nevertheless, there is much in the current taxation of corporate income within the EU that appears to be undesirable. If it were possible to achieve full harmonisation on a single European Union corporate income tax, this would bring many advantages. However, this prospect seems remote, and it is less clear that more limited co-ordination, involving only some elements of corporate tax systems, will yield significant benefits. Finally, whilst EU measures may resolve some of the distortions and difficulties arising within the EU, they can do little to deal with pressures on corporate tax rates, opportunities for tax avoidance and distortions to economic activity that arise from interactions between the EU and the rest of the world.

CHAPTER 1

Introduction

In recent years, the debate about corporate income tax systems within Europe has once again come under policy spotlight. There has been an increase in activity at the international level, particularly within the European Union, which has focused on business taxation and ‘harmful’ tax competition. The increasing integration of trade and capital markets, alongside the introduction of a single currency for some members of the EU, draws attention to the differences that remain between countries within the EU, and in particular to the ways that companies are taxed. This report seeks to provide a guide to the debate over the present state of corporate income taxes and their future.

There are a number of questions that this topic raises. Are corporate income taxes becoming harder to collect? Will corporate tax rates continue to fall? Does it matter if the balance of taxation shifts away from increasingly mobile capital onto comparatively immobile labour? Do national corporate income taxes create distortions to European business? Could relatively limited co-ordination of corporate tax policies within the EU make a significant difference? What effect would more ambitious plans for corporate tax harmonisation have? This report attempts to address these questions in the following chapters.

Before setting out the structure of the report, we should define the difference between tax co-ordination and tax harmonisation that we use in the body of this report. ‘Tax co-ordination’ is used here to describe the process of governments reaching agreements over some

Corporate tax harmonisation

specific aspects of corporate taxation, such as agreements to reduce or remove special regimes that apply reduced corporate tax rates to certain activities. 'Tax harmonisation' is used to describe the equalisation of corporate income tax rates and the standardisation of corporate income tax bases within the EU.

One issue that has been raised in the policy debate over corporate taxes in the EU is the fear that taxes on labour income are rising while taxes on capital income are falling, and that this has in turn affected the level of unemployment. Chapter 2 discusses the evidence, which shows that corporate tax revenues are not declining overall within the EU, either as a share of GDP or as a share of total taxation. There continues to be a varied range of corporate tax systems within the EU, and while there has been a trend towards falling corporate tax rates, these have tended to be offset by changes to corporate tax bases and improvements in underlying company profitability. As a result, corporate tax revenues have not been collapsing.

Even if corporate tax revenues were declining, it is not clear that this would imply that the balance of taxation was in fact shifting away from capital and onto labour. Theories of capital taxation, in a world of relatively small economies open to international trade and international finance, suggest that the incidence of corporate income taxes does not fall on the owners of capital. It is likely to fall on the less mobile factors of production, such as labour, and, as a result, it could be more efficient to tax these less mobile factors more directly. These issues are discussed in Chapter 3.

Although economic theories also suggest that it may be efficient for no corporate income taxes to be levied in the source country (i.e. in the country where the capital is located), these taxes continue to exist and to raise significant amounts of revenue. There are important

reasons why source-based capital income taxes still exist, including the fact that not all forms of capital are perfectly mobile. For some activities, profits can only be generated in specific locations, allowing the country to tax those profits without driving the activities away. The overall tax system may also be more robust when corporate income taxes exist to provide a back-up to personal income taxes.

Given that corporate income taxes do still exist, what types of distortions are created by the existence of 15 different corporate tax systems within the EU? Chapter 4 sets out the possible costs or distortions that are currently created by maintaining these different systems within the EU, and more generally within the wider world. The three main issues considered are the potential loss of government revenue, distortions to real economic activity and the creation of administrative and compliance costs. The costs of co-ordination should also be considered: there is a potential loss from greater co-ordination provided that there are good reasons for the tax rate to vary between different countries.

This leads on to an assessment in Chapter 5 of what measures of co-ordination are being attempted, particularly within Europe. The EU Code of Conduct on business taxation is part of a broader initiative to reduce 'harmful' tax competition. But what exactly is 'harmful' tax competition? It is not helpful to think of tax competition in the same way as economists traditionally think of price competition. If the underlying costs of raising tax revenue from other sources differ between different countries, for example, or the location-specific profits mentioned above vary between countries, it could be that optimal corporate tax rates do vary in different countries. There may also be good reasons to tax very mobile activities at lower rates than less mobile activities.

Corporate tax harmonisation

Before considering the EU's political package for tackling 'harmful' tax competition, we briefly consider two of the existing legal mechanisms to prevent discrimination within the EU — the work of the European Court of Justice and measures in the Treaty of Rome to prevent the use of state aids to distort competition within the EU. The Code of Conduct on business taxation is discussed in some detail, including the progress that has been made on the initiative to date and the potential effects it might have on the types of distortions that were outlined in Chapter 4.

The concluding chapter of the report looks at the possible future developments within European corporate tax systems. What are the alternatives? Co-ordination could stop at the current level, or the Union might move towards more ambitious plans, such as harmonisation of corporate income tax rates or bases, development of a European-wide corporate income tax or even abolition of corporate taxes within the EU. We highlight the fact that any measures introduced in the EU alone, although possibly reducing some of the existing distortions to the operation of business activities within Europe, would not address the distortions arising for businesses operating beyond Europe in the wider world. And, finally, plans to expand the European Union, to include a wider group of countries over the medium term, raise more questions about how feasible, and desirable, such tax co-ordination is likely to be.

The report aims to provide an understanding of these issues rather than to advocate any particular solution. Nevertheless, some conclusions do emerge. As yet, there seems to be little reason for governments to be concerned about an imminent collapse in corporate income tax revenues. But even if corporate tax rates continue to fall and this did lead to a decline in corporate tax revenues in the future, requiring other

Introduction

taxes to rise, it is not clear that this trend would have dire consequences for employment. Nevertheless, there is much in the current taxation of corporate income within the EU that appears to be undesirable. If it were possible to achieve full harmonisation on a single European Union corporate income tax, this would bring many advantages. However, this prospect seems remote, and it is less clear that more limited co-ordination, involving only some elements of corporate tax systems, will yield significant benefits. Finally, whilst EU measures may resolve some of the distortions and difficulties arising within the EU, they can do little to deal with pressures on corporate tax rates, opportunities for tax avoidance and distortions to economic activity that arise from interactions between the EU and the rest of the world.

CHAPTER 2

Corporate Income Taxes in the EU

Each of the 15 EU countries operates its own corporate income tax. Whilst some limited aspects of these taxes have been harmonised, most of their central elements have not. National governments continue to determine their corporate tax rates, the nature of various allowances that can be deducted from revenues in determining the corporate tax base, the treatment of foreign-source income and the relationship between corporate taxation and personal taxes on dividend income.

This chapter briefly describes the main features of the corporate income taxes currently in operation within the EU, highlighting some of the more important differences between countries.¹ We then comment briefly on recent trends in corporate tax rates and in government revenues raised from these taxes on corporate income.

2.1 Corporate Tax Bases

The corporate tax base is the measure of profits or income on which corporations are taxed. This is often referred to as 'taxable profits' or 'taxable income'. It is important to realise that differences across countries in the tax base could lead to significant differences in tax payments on the same underlying activity, even if corporate tax rates were common. For example, relatively generous allowances for depreciation could make one country a more attractive location for

¹Cnossen (1996) provides a more detailed description.

investment, whilst a relatively generous treatment of profits earned abroad could make another country a favoured location for the (European) headquarters of international companies.

We first consider the measurement of taxable profits for a firm that only has operations in the domestic jurisdiction and then consider some further issues that arise for firms with activities in more than one country.

Domestic issues

The definition of taxable profits varies between countries in important respects. Where commercial accounting practices are accepted for tax purposes, this can reflect differences in accounting conventions between EU countries. In other cases, these differences can reflect deliberate tax policy choices or historical differences between countries in the way their tax systems have evolved.

Taxable profits are the difference between revenues and a set of allowable costs. Income from all sources, including trading and non-trading income, is normally taxable. Current expenses generated in the course of doing business are usually deductible. Interest payments can generally be deducted from the tax base, and all countries provide some allowances for depreciation on capital assets. In principle, in all the EU countries, taxable profits thus correspond to a measure of profits after interest and depreciation. However, there are important differences in the application of this principle.

One such difference concerns the treatment of dividends received from other companies. To avoid double taxation, most countries make special provision for the taxation of dividends received, either exempting them entirely or giving some relief to reflect the corporate income tax already paid. Some jurisdictions

Corporate tax harmonisation

provide for a full participation exemption and also exempt capital gains on the sale of substantial investments in other companies.

The treatment of financing costs does not vary greatly between countries. Nominal interest payments to creditors can normally be deducted from taxable profits. Dividend payments to shareholders cannot be deducted from taxable profits, although Germany applies a lower tax rate on profits paid out as dividends than on profits retained by the firm.² Only in Italy does the corporate tax base impute any cost to the use of equity to finance the firm's investments.³ However, defining which payments on which instruments constitute 'interest' is becoming increasingly difficult as financial securities become increasingly complex, particularly in the international context.

Trading losses can usually be carried forward to be set against future profits — in some countries indefinitely, in others for a fixed period only. Some countries also allow losses to be carried back and set against a previous year's profits, usually for only one year. The treatment of losses also differs according to whether losses on any activity can be offset against the total profits earned or whether losses from one type of activity can only be offset against profits from that activity, and whether losses can be shared between associated companies.

Capital gains are usually included in taxable income and taxed at the full corporate rate, although that tax payment can sometimes be deferred if those capital gains are reinvested, and, in some countries, a

²Current reform proposals in Germany propose to abolish this 'split-rate' system in 2001.

³Italy provides a partial allowance for the imputed cost of using equity finance, for profits retained and shares issued since 1998.

participation exemption may apply. There are some differences in the treatment of capital losses: for example, some countries treat them as ordinary losses while others only treat them as ordinary losses under certain circumstances.

Depreciation — the decline in the value of a capital asset — is usually recognised as a cost in the tax code and given some form of depreciation allowance. These vary considerably across countries, in some countries following accepted accounting practices, in others following the rate (or range of rates) prescribed in the tax code. Some countries give accelerated depreciation allowances and/or additional first-year allowances for certain assets. The treatment of intangible assets, such as goodwill, ranges from no depreciation allowance to treatment similar to that given to tangible assets. The allowances and credits available for research and development (R&D) expenditures also vary widely across countries.

Finally, the tax on branch income is usually the same as that on corporate income, with no additional (withholding) tax applied on transfers back to the parent of the branch. A group of companies operating within the same country can usually calculate their tax liability on a group basis. Such arrangements are generally not possible when the group includes companies operating in different countries, as tax credits and loss provisions are usually granted only to transactions between domestic firms.

Cross-border income flows

When one firm (the parent company) has subsidiaries in other countries, the taxation of dividends and interest paid by the subsidiary to the parent raises further issues. In general, the tax treatment varies according to the type

Corporate tax harmonisation

of income flow, and the treatment of some of these flows is more harmonised within the EU than is the treatment of others.

Dividend payments from a subsidiary company to its parent company fall under the EU parent/subsidiary directive, which ensures that dividend payments from an EU subsidiary that is at least 25 per cent owned by an EU parent are free from any dividend withholding tax (provided that the parent is subject to a 'similar' corporate income tax in its own state).

Interest and royalty payments between associated companies in different Member States are sometimes subject to withholding tax at source, and an EU directive to eliminate these taxes is currently being considered.

Repatriated dividends and interest may be subject to further corporate taxation in the residence country of the parent, depending on whether this country operates an exemption system, a credit system or a deduction system. Various systems are found in different EU countries, with France and Germany, for example, exempting foreign-source dividends and applying a credit-by-source treatment to foreign-source interest and with the UK operating a credit-by-source system for both dividends and interest.

Most Member States operate anti-avoidance measures, such as controlled foreign company (CFC) legislation, thin capitalisation rules and transfer pricing rules. CFC rules allow a country to tax foreign profits as if they had been earned domestically, in cases where the foreign company is a passive company controlled by domestic residents and subject to a significantly lower level of taxation than that applying to domestic companies. Thin capitalisation rules allow a country to restrict interest deductibility, to prevent international companies from reducing or eliminating the tax liability

of foreign subsidiaries in high-tax locations (by funding them with excessive amounts of debt, the interest on which is paid back to a parent company in a lower-tax jurisdiction). Transfer pricing rules determine the allocation of profits between countries when non-market transactions take place between affiliated companies. Their purpose is to deter international companies from shifting taxable profits into low-tax jurisdictions.

Provisions for taxing CFCs vary between Member States, as do thin capitalisation rules. Transfer pricing in theory operates under the OECD arm's length principle, but different states can in practice apply this principle rather differently.

Bilateral tax treaties have been negotiated between EU Member States, as they have between EU and non-EU countries. Many of these treaties pre-date membership of the EU, and some gaps remain in the network of treaties between EU countries. The treaties determine what credit is given for foreign taxes already paid and the level of withholding taxes between countries.

Special regimes

There are a wide variety of special regimes operating within EU corporate income taxes, varying from those addressing the operation of financial services (such as Belgian co-ordination centres, Dutch holding companies and Dublin financial service centres), those addressing particular sectors of the economy or particular types of investment (such as small and medium-sized enterprises (SMEs), R&D expenditures, the lower rate of tax on manufacturing in Ireland and special incentives for the film industry and agricultural assets) and those addressing particular regions that policymakers have targeted for special consideration. It is useful to

Corporate tax harmonisation

distinguish between special regimes that have the effect of reducing the number of occasions where the same profit is taxed several times as it crosses international boundaries (for example, holding company regimes) and those that have the effect of reducing the level of tax below the level that would have been paid under the normal tax rules. We discuss the current EU Code of Conduct initiative to limit the proliferation of these special regimes in Chapter 5.

Administration and compliance

The issue of administrative and compliance costs arises from the existence of 15 different tax administrations within the EU, resulting in a maze of different rules and processes that have to be adhered to by companies operating in several different jurisdictions.

2.2 Corporate Tax Systems

The corporate tax system is often characterised by the method adopted to tax dividend payments to the shareholder. Under a classical system, profits earned by a company are taxed once through corporate income taxes and, if the profits are paid out as dividends, they are taxed again through personal income taxes. There are a variety of alternative approaches that countries have adopted to alleviate this ‘double taxation’, through some form of integration of their personal and corporate tax systems.⁴

These approaches can usually be classified into one of two categories: imputation systems and shareholder

⁴To the extent that retained profits generate capital gains that are subject to taxation, this also produces a form of ‘double taxation’, although effective rates of capital gains taxation are generally lower than tax rates on dividend income.

relief systems.⁵ Under an imputation system, part or all of the corporate tax paid is explicitly taken into account when calculating the personal income tax owed on dividend receipts. This imputed tax often comes in the form of a credit which can be set against the shareholder's income tax liability on dividend income and which can be refunded if, for example, the shareholder is tax-exempt. Shareholder relief schemes tend to simply reduce the personal income tax levied on dividend receipts, without explicitly relating that tax relief to an underlying corporate tax payment — for example, by reducing the tax rate on dividend income below usual income tax rates or by only taxing part of the dividend income to achieve a similar effect.

All of these types of system are currently found within the EU. The Netherlands operates a classical system; Finland, France and Germany have imputation systems; Ireland, Portugal, Spain and the UK give tax credits on dividend payments; while the remaining Member States (Austria, Belgium, Denmark, Greece, Italy, Luxemburg and Sweden) operate some other form of shareholder relief.

Recent developments appear to be away from imputation systems. The UK has reduced dividend tax credits for taxpaying shareholders and stopped refunding these credits to most tax-exempt shareholders; Ireland is in the process of moving from an imputation system to a classical system; and Germany has announced proposals to replace its imputation system by a shareholder relief system.

⁵Germany also operates a split-rate corporate income tax, under which distributed profits are taxed at a lower rate than retained profits.

2.3 Corporate Tax Rates

Corporate income tax rates vary widely within the EU. Table 2.1 reports the main statutory tax rates that apply under national corporate income taxes. Typical corporate tax rates paid, which are higher in countries that have local taxes and/or surcharges on corporate income, are also presented.

TABLE 2.1
EU corporate tax rates in 1999

| | <i>Statutory corporate tax rates (%)</i> | <i>Typical corporate tax rates (%)</i> |
|----------------------|--|--|
| Austria | 34 | 34 |
| Belgium | 39 | 40.2 ^a |
| Denmark | 34 | 34 |
| Finland | 28 | 28 |
| France | 33.3 | 40 ^b |
| Germany ^c | 40 / 30 | 51.6 / 42.8 |
| Greece ^d | 35 / 40 | 35 / 40 |
| Ireland ^e | 28 / 10 | 28 / 10 |
| Italy ^f | 37 / 19 | 37 / 19 |
| Luxemburg | 30 | 31.2 ^g |
| Netherlands | 35 | 35 |
| Portugal | 34 | 37.4 ^h |
| Spain | 35 | 35 |
| Sweden | 28 | 28 |
| UK | 30 | 30 |

^aIncludes an austerity surcharge of 3%.

^bIncludes surcharge of 20% for large firms (smaller companies pay 10% surcharge).

^cThe higher rate shown is for retained profits, the lower rate for distributed profits. The typical corporate tax rate includes both an average local corporate income tax of 16.2% and a surcharge of 5.5%.

^dVaries according to the type of company — for example, quoted companies are usually charged 35%, but quoted banks are charged 40%.

^eThe higher rate applies to trading income from non-manufacturing activities, the lower rate for manufacturing activities and certain financial activities. The rate is reduced to 24% from 1 January 2000, and will reduce to 12½% (25% on non-trading income) from 2003. The 10% rate is to be phased out.

^fItaly operates a 'dual income tax' regime, where the lower rate is charged on income from increased equity capital (including retained earnings). There is also a non-deductible regional tax on productive activities of 4.25%, which replaced the previous local corporate income tax in 1998.

^gIncludes a surcharge of 4%.

^hA surcharge of 10% is levied in most regions.

Corporate income taxes in the EU

TABLE 2.2
Typical corporate tax rates over time^a

| | 1980 | 1990 | 1999 |
|----------------------|-------------------|------|-------------------|
| France | 50 | 37 | 40 ^b |
| Germany ^c | 62.2 | 57.7 | 51.6 ^b |
| Ireland ^d | 45 | 10 | 10 |
| Italy ^e | 36.3 | 46.4 | 37 |
| Japan ^f | 52.6 | 50.9 | 40.9 |
| Sweden | 56.8 ^e | 52 | 28 |
| UK | 52 | 34 | 30 |
| US ^e | 49.6 | 38.4 | 39.3 |

^aThe rate given applies to retained earnings for a manufacturing company.

^bIncludes a surcharge on corporate income tax.

^cIncludes a deductible local corporate income tax.

^dThe 10% rate for certain manufacturing activities and financial services was introduced in 1981. It is being phased out, and the standard rate of corporate tax is being reduced to 12½% on trading income from 2003.

^eA deductible local corporate income tax of, on average, 16.2% was replaced in 1998 by a regional tax on productive activity of 4.25%, calculated on the net value of production rather than taxable profits, which is not deductible from the corporate income tax.

^fIncludes two local taxes: the enterprise tax (which is deductible) and the inhabitants tax (which is not deductible).

Statutory corporate income tax rates range from 10 per cent on manufacturing and certain financial activities in Ireland to 40 per cent, for example on retained profits in Germany. The highest corporate tax rates tend to be found in the larger EU countries (for example, Germany and France) and the lowest tend to be found in the smaller countries (for example, Ireland and Finland), although there are clearly some exceptions to this pattern.

Table 2.2 indicates how corporate tax rates have changed over the last 20 years in the US, Japan and a number of EU countries. There has been a clear downward trend in most developed countries, which started with major reductions to corporate tax rates in the UK in 1984 and in the US in 1986.

Two important and related questions that we take up in later chapters of this report are:

Corporate tax harmonisation

Does this trend reflect an efficient response by governments to increased mobility of international capital flows or an inefficient process of competition between uncoordinated governments over mobile investment activities?

Are current levels of corporate tax rates sustainable over the medium term or are these reductions in corporate tax rates only part of a 'race to the bottom' that will see tax rates fall much further?

Whilst we do not have a definitive answer to either question, it is worth noting that the trend towards lower corporate tax rates is showing no signs of stopping. Recently announced or proposed reforms in Australia, Germany and Ireland share the theme of reducing corporate tax rates or extending very low rates to a wider range of business activities.

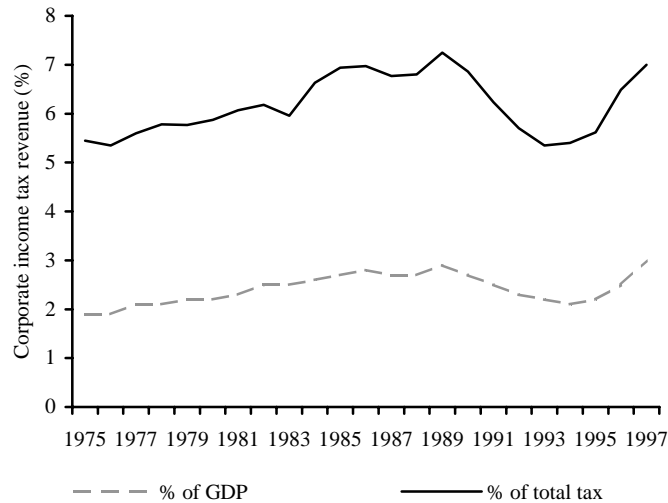
2.4 Trends in Tax Revenue

Despite these reductions in corporate tax rates, there has not been a similar downward trend in government revenues from corporate income taxes over the same period. Figure 2.1 shows that, in the EU as a whole, corporate tax receipts have increased marginally over the last 20 years, both as a share of GDP and as a share of total tax receipts. Figures 2.2 and 2.3 show these revenue measures for the US, Japan and three of the larger EU countries. Corporate tax revenues have also risen in the US after the recession of the early 1980s. These figures indicate that corporate tax revenues fluctuate considerably with the economic cycle. Fears expressed in the mid-1990s that corporate tax revenues were rapidly disappearing now look to have been premature.

Corporate income taxes in the EU

FIGURE 2.1

Corporate income tax revenue in the EU



Note: These show the weighted averages for the 15 Member States from 1989 to 1997, and 14 excluding Portugal prior to 1989. The GDP series has been weighted by GDP in each country; the total tax series has been weighted by total tax revenue in each country.

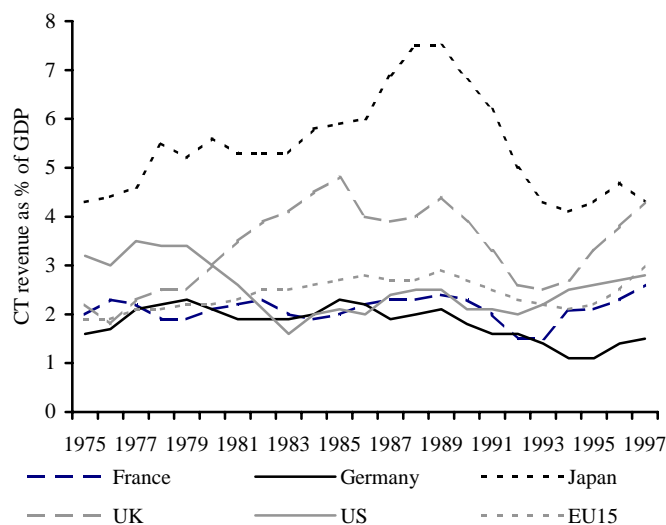
Source: OECD, *Revenue Statistics*, various years.

This buoyancy in corporate tax receipts partly reflects a trend towards broader corporate tax bases that has accompanied the trend towards lower corporate tax rates in recent years. Several countries have financed rate reductions by making depreciation allowances less generous and/or by eliminating other deductions. The recovery in underlying corporate profitability after the oil price shocks of 1973 and 1979 has also been a significant factor.

Whilst corporate tax revenues have not collapsed over this period, there remains a serious concern that they may do so in the future. It seems unlikely that

Corporate tax harmonisation

FIGURE 2.2
Corporate tax revenues as a share of GDP



Note: EU15 is an average of the 15 Member States from 1989 to 1997, and 14 excluding Portugal prior to 1989. The average is weighted by GDP.

Source: OECD, *Revenue Statistics*, various years.

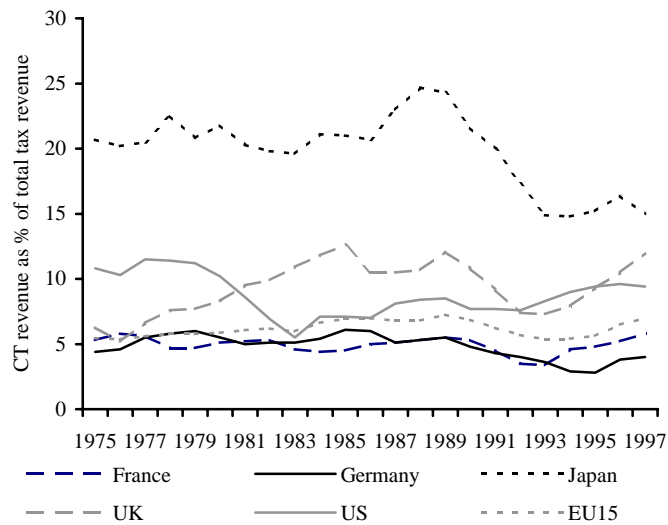
corporate tax revenues can go on rising as a share of GDP if corporate tax rates continue to fall. The scope for protecting tax receipts by widening the corporate tax base is less now than it was in the 1980s, and it is doubtful whether the underlying rates of profit earned by companies can go on rising.

Nevertheless, Figure 2.1 indicates that, if there is to be a serious decline in corporate tax revenues within the EU, this is a development that has not yet begun. The impression that government revenues from taxes on

Corporate income taxes in the EU

FIGURE 2.3

Corporate tax revenues as a share of total tax revenue



Note: EU15 is an average of the 15 Member States from 1989 to 1997, and 14 excluding Portugal prior to 1989. The average is weighted by total tax revenues.

Source: OECD, *Revenue Statistics*, various years.

capital income have fallen sharply over the last two decades is inaccurate, at least so far as corporate income taxes are concerned.⁶

⁶In particular, we note that Eurostat's measure of the 'implicit tax rate on other factors of production' is potentially misleading in this respect. The apparent fall in this implicit tax rate for the EU as a whole after 1981 is strongly influenced by a huge fall in this measure for the UK. This fall was not the result of any decline in UK corporate tax receipts, as Eurostat's own figures confirm. See Eurostat (1998), especially pages 9, 55 and 114.

CHAPTER 3

Some Economics of the Taxation of International Capital Income

Taxes typically impose costs over and above the amount of money handed over to the tax authorities. These costs may take different forms: economic behaviour may change as a result of tax, affecting total pre-tax income, and there are costs of complying with the rules of the tax system. The economic literature on capital income taxation has primarily focused on the distortions to behaviour — and hence costs — arising from different forms of taxation. Important elements of this literature analyse, for example, the impact of tax on the saving decisions of individuals and on the investment and financing decisions of domestic firms.

The literature on taxing domestic capital income proposes two alternative broad ways of dealing with capital income. The first — a comprehensive income tax — would seek to tax all forms of capital income (including capital gains, as they accrue) at the same rate for each taxpayer. The second — achieved, for example, by an expenditure tax — would tax economic rents but would leave normal income from capital essentially untaxed. Most tax systems fall somewhere between the two extremes.

The economic literature on the taxation of international flows of income from capital has focused mainly (although not exclusively) on the impact of taxation on the allocation of capital among countries. Economic models have been developed in attempts both to understand the distortions to the behaviour of individuals and firms created by taxation and to identify

ways in which the tax system might be designed to minimise such costly distortions.

This chapter provides a brief review of the most relevant aspects of this economic literature.⁷ It concentrates primarily on the impact of source-based taxation of capital income: that is, taxation in the country in which capital is located. The existence of corporation taxes makes this by far the most significant form of capital income taxation. However, the discussion also briefly considers the role of residence-based taxation: that is, taxation in the country of residence of the owner of the capital. There are also significant costs other than distortions to economic behaviour arising from the taxation of international capital income flows, and they are discussed in Chapter 4.

3.1 The Effective Incidence of Source-based Capital Income Taxes

In a closed economy, increases in the capital stock must be financed by the saving of domestic residents. But in an open economy, this is not so: here, investment may be financed by net inflows of capital from other countries. Such flows of capital generally increase the welfare of residents of the country into which the capital flows, as well as that of the non-resident investors.⁸

To see this, take the simplest economic model of a small open economy. For the purposes of the analysis

⁷This chapter provides only a brief indication of the issues. Readers who would like more detail could turn to two recent surveys: Hines (1999) and Wilson (1999).

⁸The analysis here considers only inflows of capital that raise the capital stock in the domestic country. This may not be the case for all inward foreign direct investment, much of which takes the form of the acquisition of existing domestic companies.

Corporate tax harmonisation

here, it is open in the sense that there are no legal restrictions on the movement of capital or other goods into or out of the country. It is small in the sense that events in that country have no impact on the price of goods traded internationally. Individuals and companies in the country therefore take ‘world’ prices as given. Specifically for the case of capital, the country faces a given world interest rate; domestic residents cannot affect the interest rate charged elsewhere.⁹

Suppose that labour is immobile; there is no net emigration or immigration. However, capital is free to move into and out of the country: that is, capital is mobile. If costs of moving capital between countries are very low (strictly zero), then there is ‘perfect’ capital mobility. In this case, residents could save abroad and earn the world rate of interest. They would therefore not be willing to finance domestic investment that earned a rate of return less than the world rate of interest. Similarly, non-residents would be willing to provide capital only in return for at least the same world rate of interest. Together, these imply that the size of the aggregate domestic capital stock is determined by the degree to which domestic investment opportunities can provide a return at least as high as the world rate of interest. The marginal investment project will earn the world rate of interest.

Now suppose there is a shift in technology that increases the productivity of capital located domestically, or a reduction in any existing source-based capital income tax (thereby increasing the post-tax return to domestic capital). Either of these would attract new inward investment — into previously

⁹We will ignore risk here, so that the world rate of ‘interest’ becomes the required rate of return on investment. The principles of the argument hold in the presence of risk.

Taxation of international capital income

uneconomic projects — up to the point at which the marginal post-tax rate of return on such capital is again equal to the world interest rate. In both cases, the higher level of capital per worker will also tend to increase the productivity of labour, thereby driving up the wage rate or increasing employment.

This is the essence of most simple economic models of the international taxation of capital income. That is, source-based capital income taxes raise the required pre-tax rate of return on capital, so that at the margin the post-tax rate of return is unchanged and still equal to the world rate of interest. In turn, such taxes tend to drive away capital and consequently to depress wages or to reduce employment. This additional cost of a source-based capital income tax should in principle be taken into account in designing the tax system. To the extent that other taxes result in lower additional costs, they should be preferred.

But there is another important feature of this analysis. That concerns the *incidence* of the tax — that is, who bears the true burden of the tax? In general, the *formal incidence* of a tax is completely independent of the *effective incidence*. For example, the owners of the shop that pays VAT to revenue authorities (and who therefore bear the formal incidence) probably pass on the cost of the tax to their customers in higher prices (who therefore bear the effective incidence).

The effective incidence of a source-based capital income tax is also very different from its formal incidence. The owners of capital may have responsibility for paying the tax to the revenue authorities and hence bear the formal incidence. But in a small open economy, they must earn the world rate of interest post-tax; if they did not, they would simply invest elsewhere. Hence they cannot bear the effective incidence of the tax. Instead, they invest less capital,

Corporate tax harmonisation

investing only in those projects with a sufficiently high pre-tax rate of return to yield the same post-tax rate of return. It must therefore be the domestic labour force, which sees lower wages — or higher unemployment — as a result of the tax, that bears the effective incidence.

What does this analysis imply for the impact on wages and employment of, say, a switch away from source-based capital income taxes towards taxes on labour income?¹⁰ The analysis so far suggests that, in a small open economy, a source-based capital income tax would result in lower wages or higher unemployment — and that in any case the domestic labour force would bear the effective incidence of the tax. What about a tax directly on labour income? It is, of course, the case that an income tax levied at a high marginal rate will affect labour supply decisions (although changes in the pre-tax wage caused by a source-based capital income tax will also affect labour supply decisions). However, if labour is immobile internationally, then there is little flexibility in labour supply decisions compared with the flexibility in the location of capital investment decisions by the owners of capital. Because of this lower flexibility, the labour force is also likely to have to bear the effective incidence of the labour income tax — that is, the tax will drive down post-tax wages.¹¹

In both cases, then, it is the immobile labour force that is likely to bear the effective incidence of the tax. However, there is one important difference between these two taxes. The owners of capital passed on the

¹⁰For this purpose, taxes on labour income may include personal income taxes on wages and salaries and both employees' and employers' social security contributions (payroll taxes).

¹¹To the extent that the labour force has bargaining power which allows it to pass on the tax in the form of higher pre-tax wages, the owners of capital are again likely to shift capital away in order to generate the world rate of return post-tax again.

incidence of the source-based capital income tax by shifting capital elsewhere, reducing the level of capital per worker in the economy. But this effect is absent in the case of the tax on labour income. This analysis therefore suggests that, in a small open economy, the level of capital in the economy will be higher with a tax directly on labour income than with a source-based capital income tax. In turn, since there is more capital per worker, this suggests that the pre-tax income of the labour force will be higher. That is, domestic residents would be better off with a labour income tax than with a source-based capital income tax.¹²

This analysis contradicts the views of the European Commission set out in European Commission (1997). As noted in the Introduction, the Commission argued (a) that, within the EU, there has been a shift of taxation away from taxes on capital towards taxes on labour and (b) that this shift has a negative impact on employment. However, even if part (a) of the Commission's argument is true (and Chapter 2 casts some doubt on this), the analysis here suggests that the conclusion in part (b) does not follow. In fact, the analysis suggests that the reverse is more likely to be the case — by raising capital per worker, such a switch in taxation is likely to be beneficial for employment.

Why do corporate income taxes exist?

Given these economic arguments, why then do source-based taxes on capital income persist?¹³ There are several possibilities, which take two different forms.

¹²This was effectively pointed out by Zodrow and Mieszkowski (1986) — although strictly they compared the capital income tax with a poll tax rather than with a labour income tax.

¹³Gordon (1992), among others, addresses in greater detail the issue of why source-based taxes continue to exist.

Corporate tax harmonisation

The first set of possibilities arise from the rather restricted nature of the analysis, which has considered only the case of a small open economy and implicitly a single type of capital and perfectly competitive markets. The second set of possibilities arises from other considerations, absent from the analysis altogether. We discuss these in turn.

First, what is the importance in this analysis of the assumption of ‘openness’ that capital is mobile and labour is immobile? Certainly the analysis depends crucially on the relative mobility of these two factors. The conclusions would be the opposite if labour were mobile and capital immobile. However, introducing some relatively limited labour mobility and less-than-perfect capital mobility reduces the force of the arguments but does not overturn the basic conclusion.

The other explicit assumption in the analysis is that the country is ‘small’ and hence cannot affect world prices. This assumption could be relaxed in a number of ways. The simplest would be if the country were large enough to have some effect on world prices. Again, this would reduce the extreme nature of the conclusions but would not overturn them. Another possibility is to consider the ‘world’ as a relatively small number of large economies whose governments play strategic tax-setting games with each other. The outcome of such games usually depends on the precise conditions involved.¹⁴ But certainly in the context of games that are repeated, it is possible that a small group of players may end up with positive source-based taxes.

Another important possibility is that a firm may be able to generate a profit solely because it sites its capital in a particular location. In that case, such profit can be

¹⁴There is a large theoretical literature studying strategic tax competition games — for an introduction, see Wilson (1999).

thought of as ‘location-specific’. An extreme example of this is North Sea oil. To the extent that the profit cannot be generated anywhere else, the government could tax such profit away (in principle, up to 100 per cent) without affecting the firm’s choice of location. However, this opportunity has to be set against the fact that tax policy is not usually specific to a firm, or even to an industry. Any general taxes levied to capture location-specific profits will also drive away mobile capital in other areas of the economy.

The possible existence of location-specific profit ties in closely with the discussion of mobility. Activities with a location-specific profit are not mobile; hence governments can tax them. But the more mobile is an activity, or an input to production, the less governments can tax them without driving the activity or input away.

These observations seem to be in line with current practice. For example, financial activities are particularly mobile and (hence) tend to be taxed more lightly than many other activities. But if this is true, then the basis of the policy underlying the EU Code of Conduct on business taxation, discussed in Chapter 5, which appears to require that countries do not discriminate between different types of activity, is likely to be self-defeating. It would require a country either to impose a higher tax on the more mobile activities (in which case these activities would migrate elsewhere, and if necessary out of the EU altogether) or to give up the possibility of taxing less mobile activities.

A second group of possible reasons for the continued existence of source-based capital income taxes concern the nature of tax systems. For example, it is commonly argued that the existence of a corporate income tax is useful in collecting domestic personal income tax. This is because for many small companies, for example, the distinction between profit (taxed by the corporate

Corporate tax harmonisation

income tax) and salary (taxed by personal income tax) is far from clear. Differences in tax rates on profit and labour income are likely to be exploited by taxpayers.

A final possibility concerns the fact that many countries tax foreign-source capital income but give a credit for source-country taxes already paid. In the simplest case, this implies that a foreign company that does not pay a source-based corporate income tax would instead be liable to a residence-based corporate income tax (usually on the repatriation of the profit). Given this, by levying a source-based corporate income tax at a rate no higher than that of the 'residence' country, the 'source' country would simply switch tax revenue to itself and away from the residence country, with no effect on capital flows. Of course, there are many caveats to this argument. For example, the source country may have capital inflows from a number of other countries, at least some of which may exempt foreign-source income. And multinational companies can, to some extent, avoid the residence-country tax by choosing the timing, the type of income and the route of any repatriation of profit.

3.2 Forms of Tax Neutrality

Taxes on capital income exist. Given that they do, it is useful to explore the properties that they would require in order to minimise their distortions to economic activity. The existing economic literature is reasonably clear on this issue: it is optimal to have only a residence-based tax on the capital income accruing to individuals.¹⁵ This is because such taxes can leave the allocation of capital between countries unaffected.

¹⁵Or a set of taxes that have the same effect.

Taxation of international capital income

The rationale for this is essentially the same as the rationale for a comprehensive income tax. In the absence of taxes, each resident would allocate his savings between alternative assets up to the point where the marginal return on each asset were the same. If this were not true, a higher total return could be generated by switching from an asset generating a low rate of return to an asset generating a higher rate of return. In the presence of a comprehensive income tax levied on the capital income of all residents,¹⁶ each individual would invest in different assets up to the point at which the marginal post-tax rates of return were equal. But since the effective rate of tax for each individual would be the same on all forms of investment, this would be equivalent to investing up to the point at which the marginal pre-tax rates of return were equal, as would be the case in the absence of the tax. Hence there would be no distortion between types of investment, including between domestic and outbound investment.

The presence of source-based capital income taxes complicates this analysis. Suppose that each government is interested only in the welfare of its own residents and does not co-operate with other governments. Then a source-based tax levied by a foreign government should be treated as an expense in determining the home-country tax base — that is, foreign taxes levied on foreign-source income should be deductible for the home country's residence-based tax. Such a tax would generate an equality between the marginal pre-tax rate of return on domestic investment and the marginal post-foreign-tax rate of return on

¹⁶Since this is a comprehensive income tax, all forms of return to investment — including capital gains — would need to be taxed on accrual.

Corporate tax harmonisation

outbound investment. This is known as ‘national neutrality’.¹⁷

If, however, governments acted co-operatively, then the benefits of foreign taxes in providing revenue for foreign governments should also be taken into account. In this case, an efficient set of taxes would result in the marginal pre-tax rate of return on all investments being equal. In turn, this implies that the overall rate of tax on all investments undertaken by an individual investor must be the same — this is ‘capital export neutrality’. In this case, residence-based taxes should be designed to offset any source-based taxes exactly. In effect, this implies that residence-based taxes must give a full credit for any liability to a source-based tax.¹⁸

But this analysis applies only to individual taxation. Consider the situation in which individuals undertake portfolio investment in domestic and foreign companies, and companies use these sources of finance to undertake domestic and outbound real investment projects. Suppose that individuals face a residence-based tax on the returns earned from such investments.¹⁹ This would imply that all companies — domestic and foreign — would need to earn the same rate of return after corporate income tax.

¹⁷It was first formulated by Richman (1963) and was formalised by Feldstein and Hartman (1979).

¹⁸If there is no source-based taxation of capital income in any country, national neutrality and capital export neutrality become the same thing: the optimal policy is the same whether governments act co-operatively or not.

¹⁹The argument also holds if individuals pay no tax. If individuals paid different effective tax rates according to the type of investment, then there would still be no effect on the allocation of capital as long as all companies were able to raise finance at the world rate of interest. If income from *some* companies were taxed lightly in the hands of *all* individuals, however, there would need to be an offsetting effect within the corporate income tax (see Devereux (2000)).

What does this imply for the design of corporate taxes? Consider again the two possible aims of each government. If each government acted non-cooperatively and in the interests of only its own residents, then the main implication is that source-based corporate income taxes should be deductible for the purposes of residence-based corporate income taxes; this is a form of national neutrality, although it applies only to corporate taxes.

In the case in which governments act co-operatively, it remains true that the marginal pre-tax rates of return on all investment should be the same. This implies two things. First, each company must face the same effective tax rate on investment opportunities in all possible locations. This is a form of capital export neutrality, but again one that applies only to corporate taxes. Second, since all companies must earn the same post-corporate-tax rate of return, they must all face the same effective tax rate. In turn, this implies a form of ‘capital import neutrality’ — that is, that all companies locating in a particular country face the same effective tax rate.

These conditions to ensure an optimal allocation of capital between countries are exacting. In effect, they require corporate income taxes to be the same for all Member States. And even if that were the case, this would only imply a non-distorted allocation of capital within the EU; it would not eliminate distortions between Member States and other countries.

The analysis in Chapter 2 shows clearly that these conditions do not currently apply within the European Union, let alone between Member States and other countries. An important — and unresolved — question, then, is the size of the economic costs that result from existing distortions. Such costs are extremely difficult to measure and we know of no direct evidence on this question. However, there is indirect evidence. That is,

Corporate tax harmonisation

there is both econometric evidence²⁰ and survey evidence²¹ to suggest that, in choosing the location of economic activity, companies do respond to differences in taxation. The evidence of the impact that low taxes on capital income have had in the case of Ireland would seem to support this view.

A choice for the European Union

The discussion so far has considered the appropriate form of taxation when all governments co-operate. In the extreme case, the problems inherent in maintaining a source-based capital income tax in an open economy — discussed in Section 3.1 — disappear. That is, if *all* governments in the world levy the *same* rate of tax, then the effective incidence of the tax can fall on the owners of capital, as it could in a closed economy. Although capital is mobile between countries, the tax cannot be escaped by shifting capital to another country. This is clearly not an accurate description of the issues facing the European Union, though, since even with complete uniformity of source-based taxes within the EU, owners of capital can choose to invest elsewhere. However, complete uniformity of source-based taxes within the EU would leave the allocation of capital within the EU undistorted by these taxes, and this would be a prima-facie reason for moving in this direction.

However, there are two other aspects to this issue. Would a uniform source-based capital income tax within the EU drive away capital from the EU as a whole, with the effective incidence in any case being passed on to the relatively immobile labour force? This argument probably has less force when considering the EU as a

²⁰See, for example, Devereux and Freeman (1995), Hines (1996) and Devereux and Griffith (1998).

²¹Ruding Committee, 1992.

whole, compared with individual Member States. First, the EU could not really be described as a ‘small’ open economy, so the stark analysis above does not apply with so much force. Further, the other reasons given for the continued existence of source-based capital income taxes depend to some extent on the nature of the economy. For example, whether profits are location-specific depends on the nature of the location: a car plant may need to be sited within the EU, and so its profits are specific to the EU, but they may not be specific to any individual Member State. That would imply that a common tax levied by all Member States could be successful in raising revenue without driving the activity away from the EU, although a tax levied by any individual Member State would shift the activity to another Member State. In turn, this implies that, acting collectively, Member States would be able to maintain a higher rate of source-based capital income tax. This consideration further supports the case for harmonisation within the EU.

There is a counter-argument, however. The reasons for maintaining a source-based capital income tax may differ from country to country — for example, the degree to which a corporate income tax is required to limit personal income tax avoidance may vary between countries. In the absence of co-operation, these factors could explain existing differences in corporate tax rates across the EU. But if this is true, this constitutes a case for maintaining *different* rates of source-based taxation, depending on the characteristics of their economies.

Another consideration is that smaller countries and larger countries within the EU may face different trade-offs between their ability to tax location-specific profits in their own jurisdictions (by setting a high corporate tax rate) and their ability to attract mobile activities from elsewhere (by setting a low tax rate). A small

Corporate tax harmonisation

country with few activities that are specific to its territory may see no advantage for its residents in moving from a low national corporate tax rate to a higher uniform EU corporate tax rate. Unless its government gives a high weight to the welfare of the residents of other EU countries, such a country would need to be compensated or persuaded to adopt the harmonised corporate income tax.

The EU must therefore balance the gains that would arise from harmonising source-based capital income taxes — the removal of distortions to the location of activity within the EU and the probability that a common tax within the EU could be levied at a higher rate — against the possible benefits that exist as a result of Member States being able to choose tax rates in the light of their own specific economic circumstances.

3.3 Other Issues

The EU Code of Conduct on business taxation is expressly directed towards the distortion of economic activity, and such distortions have been the main focus of this chapter. However, there are clearly other concerns that should influence the design of policy. These include the tax revenues that may be lost if taxpayers are able to shift taxable income between countries, and the compliance costs associated with the taxation of international flows of capital income. These issues are addressed in the next chapter.

CHAPTER 4

Potential Concerns Arising from the Lack of Harmonisation

There have been a number of detailed reports examining the lack of harmonisation of corporate income taxes in Europe and the resulting problems and suggesting potential solutions.²² Despite these efforts, there are still 15 different corporate tax systems operating within the EU, as we described in Chapter 2. It is extremely difficult to quantify the costs that the lack of harmonisation imposes upon the Union. And harmonisation, or even co-ordination, requires individual governments to relinquish control over at least part of their ability to raise tax revenue. To date, European governments have not demonstrated great enthusiasm for corporate tax harmonisation, and earlier proposals for greater co-ordination of corporate income taxes within the EU met with considerable resistance. However, the recent growth of international policy initiatives on business taxation indicates a desire to address at least some of the issues that have been causing concern.

There are three main areas to consider. The first is the threat of lost tax revenue, or revenue erosion, arising through competition (between governments) for international business and increased mobility of the corporate tax base. This has been a particular focus of governments and revenue authorities and is affected by

²²These include Neumark Committee (1963), Van den Tempel (1971), European Commission (1967, 1975, 1980 and 1988) and Ruding Committee (1992).

Corporate tax harmonisation

the behaviour of both governments and companies. The second area of concern is the potential effect on real economic activity caused by differences in tax systems, influencing where companies do business, which companies do it and the way that it is done. The final concern is the level of compliance and administrative costs generated by these differences between tax systems, both for businesses and for governments.

These issues are discussed in turn in this chapter, although they are clearly closely related to one another. A company's decision to locate its new plant in a low-tax country will result in lower (overall) tax revenue than would have been raised if it had located in a high-tax country, while fears of tax avoidance can lead to increased activity by revenue authorities which increases compliance costs. The chapter closes with a brief discussion of the issue of political co-ordination, since the current lack of harmonisation does provide some benefits, for example in maintaining an element of discretion for national governments over tax matters.

4.1 Loss of Government Revenue

Governments are concerned with threats to their corporate tax revenue, largely because reductions in the amount of revenue raised from that source might require increases in other forms of taxation or borrowing or reductions in public spending. There are two main channels through which revenues can be threatened: the actions of governments that compete with one another to offer the lowest tax rate and the most preferential regimes in order to attract and retain footloose investment; and the actions of companies using methods of tax planning to exploit opportunities to minimise their tax payments. These are discussed in turn below.

Government policies

As was highlighted in Chapter 2, statutory corporate tax rates have been falling over the last 20 years, from relatively high rates of over 50 per cent in several European countries in the late 1970s, to statutory rates ranging from 10 to 40 per cent today. Governments have often accompanied reductions in the tax rate with extensions to the tax base, so that although the rate charged on each £1 of taxable profits is lower than before, the amount of profit that is liable to tax at that rate increases. This helps to explain why government revenues from corporate taxes have not collapsed. Of course, it may be getting harder to actually collect that tax revenue, as the share of total economic activity taking place in multinational companies increases.

The trend of falling tax rates could reflect many considerations. One possibility is that it reflects pressures generated by increasing globalisation: as companies find their activities becoming less geographically constrained, they find it more feasible to shop around for favourable tax regimes, and governments respond to that mobility by reducing their tax rates to preserve levels of investment. Increased economic integration has made countries more like the ‘small open economies’ of the analysis sketched in the previous chapter, and governments have responded by reducing the rates of source-based taxes on capital income. There is also likely to be an element of competitive tax reduction: as one country lowers its corporate tax rate, its neighbours and competitor countries could feel that they need to follow suit (leading to fears of a ‘race to the bottom’).

In addition to cutting their overall tax rates, governments now operate a bewildering array of special tax regimes, some of which are designed to attract real

Corporate tax harmonisation

economic activity, some of which are designed to attract financial activities and some of which are designed to reduce elements of double taxation that might otherwise occur through the interaction of several countries' tax systems. Over 280 special regimes relating to countries in the EU and their dependent territories (such as the Channel Islands, Netherlands Antilles and French Polynesia) have been identified and described in the work of the EU Code of Conduct group on business taxation.²³

This type of tax competition — over special regimes rather than the overall tax rate — can affect both the location of real economic activity and the amount of income shifting to avoid tax that occurs.

Business behaviour

Although special tax regimes exist, they are not essential for tax-planning opportunities to arise. It is enough for there to be different tax rates across countries and/or different rules for different types of income flows. The result is that individual businesses can quite legally exploit these differences to reduce the tax payments that they would otherwise make, contributing to the revenue erosion about which governments are concerned. This tax planning can occur without changing the underlying real activities that are being carried out or their location (except that it tends to increase the amount of resources being devoted to the activity of tax planning itself).

The existence of different tax rates in different countries is likely to create opportunities for minimising

²³The full list of measures considered by the Code of Conduct group can be found in Council of the European Union (1999). This also indicates which of the measures are considered to be 'harmful' tax competition, as discussed in Chapter 5.

Potential concerns

tax, for example through the manipulation of transfer prices. Transfer prices are the prices charged between related companies for goods or services provided. For example, if Company A is based in a country with a relatively high corporate income tax rate, and its subsidiary, Company B, is based in a low-tax country, their total tax bill can be reduced by lowering the prices charged for goods and services supplied by Company A to Company B, which shifts the group's profits to the lower-tax jurisdiction.

Transfer pricing rules, which require the prices charged between connected companies to mimic those that would have been charged between two unconnected companies (the 'arm's length' approach), reduce this problem but do not completely remove it. There may, in fact, be no comparable market price for the item — the two companies might be integrated precisely because this is the most efficient way to organise the activity, which makes it difficult to find an external price to compare to the transfer price. The cost of having such rules is greater administrative complexity, both for companies — to ensure that their arrangements can withstand scrutiny from the revenue authorities — and for revenue authorities themselves — which have to examine transfer pricing agreements and are increasingly asked to give advance approval of them.

Company financing can also be structured to take advantage of differences in tax rates. If a parent Company A is based in a low-tax country, while its subsidiary, Company B, is based in a high-tax country, the financing of Company B can be arranged to make the most of this difference. If Company B can receive a loan from Company A, the interest payments made on the loan are deductible from profits in the high-tax country, while the interest payments received by

Corporate tax harmonisation

Company A are taxable at a lower tax rate, resulting in a lower total tax payment.²⁴

Differences in the types of deductions given against tax (set out in Chapter 2) can also be exploited to reduce tax payments. For example, the fact that interest payments on loans are deductible from the corporate tax base creates incentives for companies to label some of their equity finance as debt, in order that payments for the finance qualify for interest deductibility. This becomes more problematic as the development of complex financial instruments blurs the traditional distinction between debt and equity.²⁵ Similar types of issues are raised by the use of other deductible items, such as royalty payments for the use of patents, management fees paid to associated companies and leasing agreements. As noted in Chapter 2, depreciation rates given for investment spending, as well as the treatment of losses, can also vary significantly between countries. Different approaches to allocating the ownership of assets in different countries may enable an international company to claim depreciation allowances in two jurisdictions on the same underlying asset, a practice known as ‘double dipping’. Wherever possible, companies will want to route flows of income in order to take advantage of the highest available deductions.

²⁴This can lead to ‘thin capitalisation’, where companies are financed largely through debt rather than equity capital. Revenue authorities attempt to prevent this by refusing to give deductions for some borrowings between related companies. The exact details of these ‘thin capitalisation’ rules vary within EU member countries (and, of course, in the wider world).

²⁵For a discussion of the difficulties of taxing complex financial instruments, see Alworth (1998).

Evidence

Not surprisingly, it is difficult to find direct evidence of this type of activity, since the information provided in company accounts would already reflect the financial planning that had occurred. There is a lot of evidence from economic studies, however, that companies behave in ways that are consistent with tax-minimising activity. For example, some studies have found that foreign subsidiaries of US multinational firms are more likely to use debt finance when based in high-tax countries than when based in low-tax countries (see Hines and Hubbard (1990) and Grubert (1998)).²⁶ There is also some indirect evidence that tax-motivated transfer pricing occurs, through studies that have found that companies' *pre-tax* profits tend to be inversely related to the tax rate (i.e. the higher the tax rate, the lower the pre-tax profits reported — see Grubert and Mutti (1991) and Hines and Rice (1994)).

4.2 Distortions to Real Economic Behaviour

What is the effect of the lack of harmonisation on real economic activity? The way that corporate taxes operate can affect several aspects of company behaviour: how much to invest and where to locate that investment, which companies will carry out the investment and how those companies are likely to be organised.

Differences in corporate tax systems can affect the decisions made about which companies carry out what activities in which locations. For efficiency, investment should be located in the area where production can be

²⁶Most of the studies on the subject concentrate on US-based multinationals, due to the large amount of foreign direct investment carried out by US firms and the resulting greater availability of data.

Corporate tax harmonisation

carried out at the minimum cost, by the company able to produce at the minimum cost.²⁷

Companies are likely to locate in the country with the highest after-tax return on their investment. If differences in the amount of tax payable change a company's decision about where to locate, this could result in production being carried out in a country with higher costs but lower taxes. For example, a car company deciding where to expand could choose to locate in a low-tax country where production costs are high, because the lower tax payment more than offsets the higher cost of producing each car. Although the low-tax country gains from the increased investment, resources are wasted on each car produced — directly as a result of the difference in tax. As explained in Section 3.2, this means that capital export neutrality does not hold.

Equally, if the tax treatment varies between investors based in different countries, a less efficient company might end up producing a product, because its investors are taxed less heavily than those of the company that could produce most cheaply. Again, because of the tax differential, a company with a higher cost of production could be the one making the investment. In this case, capital import neutrality does not hold (see Section 3.2).

Of course, tax is not the only factor that influences where companies choose to invest or how much investment they choose to do. Other aspects, such as the quality of local services and infrastructure, the availability of a suitable work-force, the proximity to customers and the characteristics of the regulatory regime, are likely to be important in these decisions. But

²⁷'Production' is used here in a very broad sense to include all activities related to providing goods and services, including, for example, transport and distribution.

Potential concerns

where these other factors are similar, so that the underlying costs of the activity are similar, the level of tax to be paid becomes a more important consideration.

Finally, the existence of 15 separate tax systems, revenue authorities, accounting standards and legal structures makes it difficult for multinational companies to operate on a truly European basis. Although differences in tax regimes are not the only important feature preventing multinational firms from organising their European operations as if they were a single company, they do make some contribution. If, as a result, companies do not operate as efficiently as they would otherwise be able to, this is a real economic cost, in addition to the compliance costs involved. But the advantages of having a single invoicing system, a single set of accounts, a centralised sales force and so on are very difficult to quantify, as are the advantages that would derive specifically from changes to the tax system that would allow companies to ignore national boundaries when designing their organisational structure.

Evidence

Once again, the evidence suggesting that corporate income taxes do influence where investment is located comes mainly from the US. Several studies have found that levels of foreign direct investment (FDI) are sensitive to the tax rates in the country where the FDI is located (see, amongst others, Swenson (1994) and Slemrod (1990)).²⁸ Another study found that the decisions of US multinationals over where to locate

²⁸Hines (1999), in his survey paper, suggests that the degree of responsiveness of FDI to changes in the tax rate is around -0.6 . In other words, if the tax rate increases by 1 per cent, the level of investment will fall by 0.6 per cent.

Corporate tax harmonisation

within Europe are affected by the average effective tax rate faced (Devereux and Griffith, 1998), while another study into the location of investment within the US found that differences in the local (state-level) corporate income tax rates did affect where investments were located (Hines, 1996).

4.3 Administrative and Compliance Costs

The type of tax-reducing behaviour described above is both widespread and very complex. These techniques require specialist knowledge of the tax, legal and accounting systems relevant to the particular scheme, both for businesses to attempt to exploit any potential opportunities and for revenue authorities to attempt to reduce those opportunities wherever possible. This undoubtedly increases the costs of compliance and administration, relative to a world in which the European Union acted as if it were a single country for the purposes of transacting business within its common boundary. Moreover, those costs are largely ‘dead-weight’ costs — the costs of complying with the systems are not matched by any corresponding benefits to the economy.

The types of costs that companies incur in complying with 15 different corporate tax regimes include:

- issues surrounding the allocation of revenue and expenses between jurisdictions;
- treatment of taxes on cross-border income flows between companies, such as withholding taxes on dividends and interest and corresponding tax credits;
- the treatment of elements of the tax base, such as interest costs, depreciation and tax ownership of assets, and capital gains; and

Potential concerns

the interaction of systems that give some credit to individual shareholders for corporate taxes paid and those that do not.

As we discussed in Section 4.1, some of these discrepancies that lead to increased costs of compliance might also yield benefits to companies — in the form of a lower tax payment as a result of tax planning.

There are some developments that point towards the mitigation of some of these costs over time, particularly as legal and accounting systems become more similar. However, unless progress is actually made over the operation of tax systems, simply allowing a company to register once and file its commercial accounts once will not address many of the tax issues discussed in Sections 4.1 and 4.2.

For governments, effort has to be expended to close gaps in their tax systems to reduce the loss of revenue caused by tax avoidance activities. Revenue authorities seek to find ways to prevent deductions for financing costs being given in more than one jurisdiction, for example, and to prevent ‘double dip leasing’, where two separate jurisdictions treat different companies as owning the same asset. Effort is also exerted in creating adequate rules for taxing controlled foreign companies (CFCs), to reflect the amount of tax that would have been paid in the taxing country, had the company not sheltered much of its income in a low-tax country. These attempts to make tax systems more robust increase the costs of maintaining the basic system for governments.²⁹

²⁹It is difficult to find reliable estimates of compliance costs, although both Ruding Committee (1992) and Blumenthal and Slemrod (1995) provide indirect evidence.

4.4 Co-ordination or Competition?

As discussed in Section 3.2, there are both costs and benefits associated with co-ordinating tax policies within the European Union. There is a potential loss from co-ordination provided that there are good reasons why the optimal corporate tax rate differs between different countries. There is a potential gain from co-ordination if the optimal corporate tax rate for the EU as a whole is significantly higher than the optimal corporate tax rates for countries operating individually. For example, if it is the case that location-specific rents for Europe as a whole are substantially higher than those for European countries acting individually, then it may be possible for co-operation between European countries to sustain a significantly higher corporate tax rate than those that would be chosen in the absence of co-ordination.

However, persuading smaller countries that benefit from lower corporate tax rates to adopt a (higher) harmonised European rate would be difficult without some compensation for the potential cost (in terms of investment forgone). There is clearly a trade-off between the respective costs and benefits of further competition or further co-ordination.

Political co-ordination is most likely to occur in areas where, in fact, national governments do not have complete freedom to set their own tax rates. The taxation of multinationals is a good example of this, since profits are earned and shareholders are located in several different tax jurisdictions, all of which claim some taxation rights. As a result, countries are prepared to reach agreements over the treatment of cross-border income flows — for example, through the extensive

Potential concerns

network of bilateral tax treaties that has developed since the first model treaty was drawn up in 1928.³⁰

The acceptability of any move to harmonisation will depend upon issues such as the allocation of tax revenues derived from taxing particular cross-border activities. Any government will expect some share of the tax revenue from activities carried out within its national borders or by its residents, even if it no longer determines the actual regime being used. If the proposed allocation of revenue is not acceptable to any individual country, it would be difficult for that system to be introduced within the EU, at least so long as Member States have a veto over tax matters. Governments might also wish to retain the right to exert influence over some types of economic behaviour, such as encouraging foreign direct investment. The tension between allowing some autonomy over taxation policy and reducing the degree of distortions created by the current level of autonomy is discussed in more detail in the next chapter.

³⁰Although these attempts to agree on taxation rights can themselves provide opportunities for income shifting due to differences between the treatment of cross-border income flows in different bilateral agreements.

CHAPTER 5

International Tax Co-ordination Initiatives

Recent international policy initiatives in the field of corporate taxation have concentrated on measures to prevent 'harmful' tax competition. Both the EU and the OECD have been developing proposals since the late 1990s, although the definition of 'harmful' competition being used is more implicit than explicit. Neither of these initiatives is concerned with the overall statutory tax rate or the general corporate tax regime. Thus, to the extent that differences in tax rates are an important source of economic distortions and opportunities for tax avoidance, and competition over tax rates is an important form of tax competition between governments, these proposals cannot address all the concerns that we discussed in the preceding chapter.

Both the EU and the OECD packages are essentially political initiatives, which have the potential to add to the existing legal mechanisms within the European Union designed to prevent discrimination within the single market. The European Court of Justice, for example, acts to enforce the fundamental freedoms of the Treaty of Rome, while the mechanism for monitoring state aids seeks to prevent governments from using their revenues to distort the operation of the single market.

This chapter discusses the concept of 'harmful' tax competition, and goes on to describe existing legal mechanisms to prevent discrimination within the EU. The European Union's 'package to tackle harmful tax competition' is considered next, concentrating on one of its three strands — the Code of Conduct — and the

extent to which this is likely to address the concerns set out in Chapter 4. Finally, and briefly, this is compared with the developments within the OECD.

5.1 'Harmful' Tax Competition

The EU and OECD policy initiatives on corporate taxation both focus on the concept of 'harmful' tax competition. Whilst these initiatives are motivated by the aim of reducing economic distortions, their main effects appear to be to encourage governments to act in ways that will minimise the loss of corporate tax revenue from competition and tax avoidance. Countries are not economically independent of one another, and their tax systems adapt over time to take account of that. So is there any meaningful way in which we can distinguish between changes to tax systems that compete in a 'harmful' way and changes that compete in a 'beneficial' way?

In most economic markets, competition is encouraged because it increases efficiency and leads to lower prices for consumers. In the case of tax competition, the prices involved are tax rates on mobile tax bases, such as investment or taxable income. Reducing the price of locating in a particular country makes that country more attractive relative to others, but in the long run other countries are likely to respond by reducing their tax rates too. The result of this competitive process could be that prices fall to zero, i.e. tax rates fall to zero in a 'race to the bottom'. As we discussed in Chapter 3, this is not necessarily an efficient outcome.

In a global economy, countries' tax systems are not independent of each other: a change in the tax system in one country is likely to affect the welfare of citizens of

Corporate tax harmonisation

other countries. There are at least two distinct ways in which this might happen.

A tax cut in one country that increases the likelihood of a multinational firm locating there makes it less likely that the firm will choose some other location. In practice, most leading industrial nations aim to encourage real investment into their countries and seek to publicise the attractiveness of their particular tax regime. For example, when the UK Chancellor of the Exchequer announced a cut in the UK corporate income tax rate from 31 per cent to 30 per cent from April 1999, he stated that this would 'contribute to making Britain the best place in the industrialised world in which to invest'.³¹ Reductions in the corporate tax rate, it is hoped, will increase the welfare of its citizens through increased investment and employment, or increased productivity, for example.

The operation of a low-tax regime (which may mean a low general tax rate or a favourable treatment of certain activities) is also likely to attract mobile taxable *income* through a variety of devices, some of which have already been described in Chapter 4. Attracting taxable income *per se* might have little or no effect on real economic activity but can increase the tax revenue of the country hosting that mobile income, at the expense of higher-tax countries.

These two mechanisms have somewhat different effects on welfare, since the first primarily concerns transfers of real economic activity and the second principally concerns transfers of tax revenue. Both the EU and OECD initiatives appear to suggest that 'fair competition' (i.e. competition over general corporate income tax rates) has potentially positive effects, while

³¹Budget Statement by the Rt Hon. Gordon Brown MP, Chancellor of the Exchequer, 17 March 1998.

competition over special low-tax regimes for specific activities is potentially harmful.

We know of no general economic justification for the view that one type of tax competition is ‘harmful’ while another is not — distortions to behaviour are generated by differences in tax systems in many dimensions, including differences in overall tax rates, differences in deductions available from the tax base and differences in special regimes. Moreover, as we noted in Chapter 3, in an open economy context, it may be perfectly reasonable to tax very mobile business activities at lower rates than more immobile (location-specific) activities, and special regimes may be a way of achieving this outcome. This is particularly relevant where that mobility extends to locations outside the EU or OECD. Thus the ‘specificity’ of a particular tax regime does not imply that it is necessarily harmful, and one needs to look at its wider effects in the context of the tax system as a whole in order to make such welfare judgements.

5.2 Legal Mechanisms to Prevent Discrimination

One of the goals of the EU package against ‘harmful’ tax competition appears to be the prevention of special tax measures that provide a particular advantage, in the form of lower tax, to particular types of company, or particular industries, or companies locating in particular countries or regions within the EU. To a certain extent, the EU has an existing legal framework for preventing discrimination in tax matters between countries within the EU. This section briefly considers the two main mechanisms: rulings of the European Court of Justice and restrictions on the use of state aids.

European Court of Justice

Community law prohibits discrimination on the grounds of nationality and guarantees freedom of movement within the Community, whether it is movement of goods and services, of workers, of companies or of capital. In the case of company taxation, disputes between individual companies and revenue authorities have been resolved on a case-by-case basis, leading to a build-up of precedent over subjects such as the taxation of branches of multinational companies by comparison with local subsidiaries, the treatment of multinational groups by comparison with domestic groups and the granting of dividend tax credits to foreign parent companies by comparison with domestic parent companies.³²

The European Court of Justice has not accepted attempts to justify tax discrimination based on arguments that tax systems are not harmonised within the EU, or that a measure is administratively convenient, or that it aims to counter the risk of tax avoidance.³³ In short, the effect of European Court rulings is to encourage Member States to co-operate with one another to ensure that the basic freedoms of the Union are upheld, rather than using potentially discriminatory measures.

The difficulty with a court-based approach to resolving disputes is that it tends to occur on a somewhat piecemeal basis: rulings are given on the

³²See, for example, *R v. Inland Revenue Commissioners, ex parte Commerzbank* (Case C-330/91); *Halliburton Services BV v. Staatssecretaris van Financiën* (Case C-1/93); *Imperial Chemical Industries plc v. Colmer* (Case C-336/96); *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt* (Case C-307/97); *Metallgesellschaft Ltd v. IRC* (Case C-397/98).

³³*EC Commission v. France* (Case 270/83).

basis of legal challenges, rather than reflecting any attempt to develop a coherent tax structure within the EU. The Court can also only take prohibitive actions, by ruling against existing tax provisions. It has no power to make positive recommendations for reform on matters of taxation.

State aids

Under the Treaty of Rome, the EU has the power to take measures to eliminate state aids that affect the operation of the common market. In order to be classified as a state aid, a tax measure has to give a reduction in tax, to be made possible out of state resources, to affect competition and trade between Member States and to be selective or specific, favouring 'certain undertakings or the production of certain goods'.³⁴

However, general measures (i.e. those open to all economic agents within the Member State) are not classed as state aids. A measure targeting all sectors subject to international competition, for example, would be state aid, and recently the Commission ruled that a reduced corporate income tax rate for the manufacturing sector also constituted state aid.³⁵ Some particular sectors, such as agriculture and fisheries, are exempt from this, however. Also, some specific measures, such as reduced rates for small and medium-sized enterprises, are considered to be justified under objectives inherent to the tax system itself, according to the recent guidelines issued (European Commission, 1999).

In fact, the Commission refuses permission to less than 2 per cent of the potential examples of state aid it is

³⁴See European Commission (1999).

³⁵The Irish 10 per cent corporate tax rate on manufacturing was ruled illegal by the Commission in July 1998 (Commission Decision of 22 July 1998 in the 'Irish Corporation Tax' case (SG(98)D/7209)).

informed about (see Besley and Seabright (1999)). As a by-product of the Code of Conduct on business taxation, guidance on the application of state aids rules to business tax measures has been issued by the Commission, and the competition commissioner, Mario Monti, has recently asked his department to investigate business tax measures that are out of line with state aid rules.³⁶

The fact that these existing legal mechanisms are now being augmented by a political initiative suggests that they are perceived to have failed, at least in part, to prevent the build-up of potentially discriminatory tax regimes. This is perhaps not surprising, given the reactive role of the European Court and the number of exceptions enshrined in the details of the state aids rules. The next section describes the new, more political approach to the issue in some detail.

5.3 The Package to Tackle Harmful Competition

The recent EU ‘package to tackle harmful tax competition’ encompasses three different areas: business taxation (the Code of Conduct), taxation of savings income and taxation of cross-border interest and royalty payments between companies. The Code of Conduct has thus emerged as part of a political initiative to take ‘co-ordinated action at the European level to tackle harmful tax competition’ (European Commission, 1998). The package was seen as necessary to achieve certain objectives, such as reducing continuing distortions in the single market, preventing excessive loss of tax revenue and encouraging tax structures to

³⁶See ‘EU ready to investigate unfair business taxation’, *Financial Times*, 22 February 2000.

develop in a way that is thought to be more favourable for employment.

In earlier chapters, we have already discussed some of the potential distortions arising within the European Union (and beyond) from the lack of co-ordination between governments over corporate income taxes, as well as the pattern of corporate tax revenues over the last 20 years and the potential impact of corporate taxation on employment. Distortions to economic behaviour and opportunities for tax avoidance are numerous, although corporate tax revenues have remained buoyant and lower corporate income taxes may promote rather than threaten employment. This section discusses the Code of Conduct itself in more detail and briefly comments on the two other elements of the package.

The Code of Conduct

The Code of Conduct was agreed by the Council of Ministers in December 1997 and is designed to curb ‘those business tax measures which affect, or may affect, in a significant way the location of business activity within the Community’ (European Commission, 1998). The Code specifies that tax measures that allow a significantly lower effective level of taxation, including paying no tax at all, than those levels that generally apply in the Member State should be regarded as potentially harmful. In other words, the Code is not aimed at the overall rate or level of corporate taxation in individual Member States; it is aimed at more specific, targeted measures that reduce the level of tax paid below the usual level.³⁷ Although the overall tax rate

³⁷Early drafts of the Code of Conduct allowed for the Code to develop eventually towards considering countries’ general business tax systems,

Corporate tax harmonisation

might be one of the most effective ways of using tax measures to attract investment away from rival jurisdictions, this was explicitly excluded. The Code potentially has quite a broad scope, nevertheless — it is aimed at any type of measure that affects location, whether the location of real activity or the location of taxable income.

Once the low-tax measures have been identified, the Code sets out several criteria to be taken into account when assessing whether those measures are actually harmful, including:

- (i) whether the lower tax level applies only to non-residents or for transactions by residents with non-residents; or
- (ii) whether the tax advantages are ‘ring-fenced’, i.e. insulated from the domestic market; or
- (iii) whether advantages are granted without any real economic activity and substantial economic presence within the Member State; or
- (iv) whether the rules for profit determination within the multinational company concerned follow internationally accepted principles; or
- (v) whether the tax measures lack transparency, including where legal provisions are in fact relaxed at the administrative level.

A working group, chaired by UK Treasury Minister Dawn Primarolo, examined a list of over 200 potentially harmful regimes within the EU (and Member States’ dependent territories) and examined them against the above criteria to see if they should be classified as harmful.

rather than being confined simply to special regimes. See European Commission (1997).

International tax co-ordination initiatives

The measures considered were divided into five categories: intra-group services; financial services and offshore companies; other sector-specific measures; regional incentives; and other measures. The UK measures on the list included, amongst others, rollover relief on the sale of ships, special tax measures for the film industry, enterprise zones and enhanced depreciation allowances for small and medium-sized enterprises (SMEs). This gives an indication of the types of issues the group addressed, although the Code does not specify exactly how the five criteria listed above would be used to ascertain whether or not the ‘potentially harmful’ were in fact judged harmful under the Code.

The Working Group concluded that 66 of the measures are in fact harmful, although those decisions have not all been unanimous.³⁸ Most of the harmful measures affect financial services, offshore companies and services provided within multinational groups — that is, they concentrate on those tax measures that are unlikely to affect the location of real economic activity but do affect the location of financial functions.

A group of measures aimed at the shipping industry caused division over whether they should be cited as harmful, highlighting the tension between imposing uniformity on tax rates and allowing different tax rates for more mobile activities. As an industry clearly competing in a global market, with countries outside the EU that also offer special incentives, these tax measures were seen as necessary to maintain some shipping activity within the EU.

The fact that measures on financial activities were included, while those relating to other types of activity

³⁸See, for example, paragraphs 45–51 (and accompanying footnotes) in Council of the European Union (1999).

Corporate tax harmonisation

were largely excluded, appears to indicate that the type of location that the Working Group is primarily concerned with is the location of taxable income rather than the location of real economic activity. This suggests that the main concern has been to prevent revenue erosion rather than to prevent the distortion of real economic activity. Indeed, one possible side-effect is that companies might no longer be able to use special tax regimes to arrange finance in ways that overcome other tax distortions to the location of their production activities, caused by a lack of capital export neutrality for example.

Under the Code, countries commit not to introduce new harmful measures (under a 'standstill' provision) and to examine their existing laws with a view to eliminating any harmful measures (the 'rollback' provision). Member States have committed to removing any harmful measures (or aspects of the measures that are judged harmful) by 1 January 2003. The Code is not legally binding — Member States have made a voluntary commitment to abide by it. The creation of the Code and its first steps towards implementation indicate a genuine attempt to co-ordinate some aspects of business tax policy within the EU. Its impact and its future will depend upon whether that co-ordination is now translated into changes to legislation in individual countries.

The Code and the costs of non-harmonisation

It is interesting to consider whether the Code, assuming that at least some of the measures that have been characterised as 'harmful' are withdrawn, addresses the issues raised in Chapter 4. These were loss of government revenue, distortions to real economic activity, and administrative and compliance costs.

International tax co-ordination initiatives

Competition between countries over reductions in general tax rates is not explicitly addressed by the Code of Conduct, which may make it unlikely that government tax revenues will be substantially protected. If the existence of the Code and the adoption of the 'standstill' and 'rollback' provisions encourage individual countries to consider the wider effects of their competitive reductions in tax rates, then the downward trend in corporate tax rates could perhaps be slowed. On the other hand, since the Code removes one area of competition between countries, it might speed up the downward trend in general tax rates. As policymakers find their freedom to compete for mobile investments by introducing special tax regimes more restricted, they may respond by reducing their general corporate tax rates instead. Ireland's introduction of a uniform 12.5 per cent corporate income tax rate is certainly suggestive in this regard.

Income-shifting and tax-planning opportunities create a distinction between those companies that can exploit them and those that cannot. This reflects the fundamental fact that it is relatively difficult to tax mobile activities, for all the reasons outlined in Chapter 3, whether those activities are internet gambling or investments in multinational companies.

It is also important that the number of countries involved in the Code is restricted to the 15 countries currently within the EU. Opportunities for tax planning are clearly not restricted to member countries of the EU and their dependent territories. Perhaps the most that can be achieved is the substitution of one set of distorted financial flows for another, as taxable income shifts into regimes operated outside the EU. According to Hines (1999), 'greater enforcement is much like a tax that drives the tax base elsewhere'.

Corporate tax harmonisation

Looking at the possible effects on real economic activity, if some of the special regimes to encourage location in a particular state are deemed harmful and withdrawn, then to the extent that these have affected location decisions in the past, there will be a reduction in the distortion to location decisions. Although underlying differences between tax systems will persist — for example, the significant differences in statutory tax rates — the variation of different effective tax rates faced by different types of companies should be reduced. This could reduce the extent to which some location decisions are affected by tax, but by no means all of them.

On the other hand, there may also be cases in which the distortionary effects of different tax rates in different countries have been reduced by the existence of favourable regimes for certain financial flows. Special financial regimes that allow companies to locate their real activities where they want to and to offset the tax distortions by tax planning may well have had this effect. Removing some of these special regimes could actually increase the distorting effects of differences in corporate tax rates on real location decisions.

The Code does not address the underlying obstacles to more efficient organisation of companies within Europe. Nor will it address the compliance and administrative costs of operating with 15 different tax systems.

The other elements of the package

As mentioned above, the package also contained proposals on the taxation of savings income and on the taxation of interest and royalty payments. These are combined in one ‘package’, but each addresses a very different type of issue.

International tax co-ordination initiatives

The proposal relating to the taxation of savings suggests that either a withholding tax of 20 per cent should be levied on payments of interest income to non-resident individuals or, if a country does not want to levy the withholding tax, information should be provided to the non-resident individual's home country that would allow a tax to be levied when the income was repatriated.³⁹ This measure is focused on concerns, particularly in Germany, that interest being earned by resident individuals in accounts overseas is escaping tax altogether, due to income not being declared. This is more an issue of tax evasion than tax competition — where individuals are not declaring taxable income to their revenue authorities — exacerbated by banking secrecy rules — which make it difficult for those authorities to overcome the lack of disclosure. Problems of tax evasion may be better addressed through increased disclosure rather than through withholding tax measures. This component of the EU package has proved to be the most controversial, but it is not our main concern here.

The final element of the package is a draft directive on the taxation of interest and royalty payments made between related companies. This addresses not a question of companies facing a lower tax rate because of special treatment but a question of payments of interest and royalties facing a higher overall tax charge as they are taxed in more than one jurisdiction. The EU has previously attempted to resolve this particular aspect of double taxation but without success (see Ruding Committee (1992)). The economic logic for bundling this measure into a package designed to tackle

³⁹The information-sharing alternative is referred to as a 'co-existence model'.

‘harmful’ tax competition is not at all clear, since the problem here is one of overtaxation, not undertaxation.

5.4 OECD Forum for Tackling Tax Competition

In parallel with the EU work, the OECD has established a ‘forum for tackling harmful tax competition’, to implement a set of guidelines outlined in a report of April 1998. Its focus is on both tax havens and harmful preferential tax regimes, but it initially appeared to cover only geographically mobile activities, such as financial and other business service activities. In fact, the measures that it recommends have potentially more wide-reaching consequences for corporate tax systems if they are adopted — in some contrast to the EU Code of Conduct, which did not initially restrict itself by the type of activity being carried out, but in its recommendations has focused largely on financial activities.

As with the EU initiative, the OECD does not suggest that a low general corporate income tax rate constitutes harmful tax competition. In fact, ‘the Report is careful not to suggest that there is some general minimum effective tax rate on income below which a country would be considered to be engaging in harmful tax practices’ (OECD, 1998). Potentially harmful situations might arise where the country is a tax haven and levies little or no tax on income, or where the country usually levies significant direct taxes on income but the system has preferential features that allow some types of income to be subject to little or no tax. Member countries participating in the Forum⁴⁰ also agreed to ‘standstill’ and ‘rollback’ provisions similar to those agreed by the EU, although there is no legal framework

⁴⁰Luxemburg and Switzerland abstained from the report.

International tax co-ordination initiatives

for members of the OECD to be compelled to carry out those provisions.

The guidelines presented consist of a series of wide-ranging recommendations, some of which are aimed at encouraging countries to adopt rules that would tighten up their provisions against avoidance, such as CFC rules, foreign information reporting rules and transfer pricing rules (according to OECD principles), and to review access to banking information for tax purposes (to make it easier for tax authorities to gain access to information on taxpayers). In theory, if widely adopted and rigorously applied, this type of measure could reduce the mismatches between different tax systems and improve the level of communication between tax authorities.

The concerns raised by the Forum concentrate closely upon the issues that concern revenue authorities in their task of collecting tax revenue. Due to the lack of mechanisms available for enforcing the recommendations, apart from ‘naming and shaming’ and the threat of essentially coercive measures such as the withdrawal (or denial) of financial aid or support, exclusion from other areas of international co-operation or domestic measures targeted at specific tax havens, the future of this initiative is somewhat uncertain.

CHAPTER 6

Future Issues

The report has so far concentrated on describing recent trends in corporate income taxes, the potential distortions that 15 different corporate tax systems within the European Union can create, and current initiatives that address some of the resulting issues. The presence of 15 imperfectly co-ordinated national corporate income taxes results in issues of tax competition, tax avoidance and distortions to the organisation of economic activity that go beyond the scope of these current policy initiatives. This chapter considers some more ambitious proposals for the future of corporate income taxes, from harmonisation of some aspects of the system (such as the tax rate and the tax base), through a European corporate income tax, to, alternatively, the gradual abolition of corporate income taxes within the EU.

One common element of these measures is that they seek to resolve the issues that arise between the corporate tax systems within the EU, but they do not address the similar issues that arise with tax systems beyond the Union. The difficulties arising between EU and non-EU countries would remain. The water's edge would be moved outwards to surround a larger group of countries, but it would not disappear.

Another common feature is that they would all require explicit political agreement — none of these developments is likely to occur without a great deal of political impetus behind it. Plans for expansion of the EU in the longer term are likely to affect the probability of agreement on taxation matters. The expansion of the

Union to include a more heterogeneous group of countries might make it more difficult to reach agreement, but the growth of the EU has also led to calls for greater use of qualified majority voting (see European Commission (2000)). A reduction in the number of areas where countries can use their vetoes to block new proposals could increase the likelihood of actions being taken on corporate income taxation at some point in the future.

The final feature relates to division of the resulting tax revenues. Underneath concerns about revenue erosion is the notion that tax systems should operate 'fairly' between different countries. But the concept of 'fairness' needs to be defined more explicitly in order to determine how to tax, for example, a British registered company owning a German subsidiary which sells its product in France and which is owned by Europeans of all nationalities. It is not obvious which governments should receive the tax revenue from those activities nor how should it be allocated between them. The difficulty in resolving this issue should not be underestimated.

6.1 Harmonise the Corporate Tax Base

One possible route for further co-ordination might be through the tax base. This would involve standardising the definition of taxable profits within the EU but keeping the 15 different corporate tax systems in place, with each country levying its own tax rate.

What would be needed to achieve a harmonised corporate tax base? There are several steps that would have to be taken to arrive at a harmonised definition of taxable profits, including

Corporate tax harmonisation

- (i) moving to a harmonised tax treatment of deductible items, such as depreciation, interest, goodwill, intangibles and other deductions;
- (ii) agreeing on the range of tax incentive measures allowed;
- (iii) agreeing on the treatment of income earned in other EU jurisdictions and on the treatment of dividends, interest and other payments between EU countries; and
- (iv) agreeing how tax rules with countries outside the EU would work.

Unless all of these steps could be achieved, there would be limited gains in terms of reducing the distortions outlined in Chapter 4. Countries could still compete over their overall tax rates. Harmonising the tax base would still leave scope for avoidance that exploited the differences in tax rates, such as manipulation of transfer prices. This suggests that it would also be necessary to achieve a common application of the OECD transfer pricing rules. The existing Arbitration Convention puts pressure on tax administrations to co-operate but does not address the basic problem of finding appropriate arm's length methodologies to cover increasingly integrated businesses.

A harmonised base would lead to fewer mismatches between EU countries, but of course the existing problems would still arise for transactions between the EU and the rest of the world. The location of production would remain affected by differences in corporate tax rates, and organisational structures would still be influenced by the requirements of dealing with 15 different tax systems. Administrative and compliance costs might fall slightly, but even if all the corporate tax returns worked upon the same definition of taxable

profits, there would still potentially be 15 of them to calculate and administer.

Although harmonising the tax base might be less visible than harmonising tax rates, the actual process of bringing all the bases into line with one another would in fact be much more difficult to achieve than simply changing the tax rates. Gradual changes towards a more consistent tax base are likely to occur over time — for example, through developments in accounting rules — independently of any initiatives that tax policymakers might take.

6.2 Harmonise Corporate Tax Rates

Although it seems an unlikely prospect, it is worth considering what might be achieved if, alternatively, the members of the EU harmonised their corporate tax rates to a single rate, or perhaps agreed to a range of tax rates, as suggested by the Ruding Committee (1992).⁴¹ Each country would levy the same (or a similar) rate of tax on corporate profits, but other aspects of the tax systems, such as the definition of taxable profits, deductions from the tax base, the treatment of cross-border payments and so on, would be left unharmonised.

This measure would remove the competitive pressure between EU countries over their statutory tax rates. This would reduce the amount of distortion arising from differences in tax rates, such as income shifting through manipulation of transfer prices, but would not eliminate all distortions or all opportunities for tax planning. Revenue could still be lost through companies taking advantage of differences in tax base definitions, and governments could continue to compete over reductions

⁴¹The case for limiting differences between corporate income tax rates is also considered in more detail in Slemrod (1995).

Corporate tax harmonisation

in the tax base (for example, through exemptions for certain activities).

Decisions over where to locate would also continue to be affected by these differences in the tax base.⁴² Equalising the tax rate would produce little improvement in organisational constraints, but some compliance costs might fall if, for example, there were fewer transfer pricing disputes as a result.

Once again, although tax rates would be harmonised within the EU, important differences would remain between the EU and the rest of world, so this approach could only reduce some of the distortions within Europe. It would require co-ordination over tax rates which currently span a wide range (see Table 2.1 and the discussion in Chapter 2), although practically this would be much more straightforward than harmonising the corporate income tax base.

6.3 A European Union Corporate Income Tax

One step beyond individually harmonising the tax rate or the tax base would be to harmonise both, but retaining 15 separate systems in the individual countries within the EU. In effect, each country would impose an identical corporate income tax. If that is a possibility, perhaps the more interesting option is to consider the next step — agreement on the imposition of a European Union corporate income tax (EUCIT) in some form. There are many possible ways in which a EUCIT could operate: as a replacement for individual corporate income taxes levied by each country; as the corporate income tax levied on companies that operate in several

⁴²Although Devereux and Griffith (1998) found that the effective average tax rate was important for location decisions, it should be noted that harmonisation of statutory corporate tax rates would not equalise these effective average tax rates.

jurisdictions, with national corporate income taxes retained for domestic companies; or in addition to the national corporate income taxes levied by individual countries.

Consider the first example, where the EUCIT takes the place of all the individual corporate taxes levied within the EU, raising a similar amount of revenue to that currently raised by the 15 Member States. It would be levied on a single measure of profits, taxed at a single rate, and could be administered centrally, with the revenue allocated between Member States according to a formula or agreed rule.⁴³ Agreements would have to be reached over the treatment of income flows between the EU and countries outside the EU, just as this already occurs, usually on a bilateral basis.

The Member States would not necessarily have to agree over the exact relationship between the corporate tax and their personal tax treatment of dividends, provided they agreed that any relief granted to their resident shareholders for corporate tax already paid at the level of the firm applies to the shareholder rather than the company. Different approaches could then be adopted in different countries, but it would be difficult for any country to tie the shareholder relief to tax paid on specific profits.

The adoption of an EU-wide corporate income tax, in place of national corporate taxes, would eliminate the opportunities for income-shifting activity within the EU, and of course would also eliminate corporate tax competition within the EU. Competitive pressures would still exist outside the EU — the water's edge has been shifted outwards but not to encompass the whole world. Corporate income tax differentials would no

⁴³This is intended to be only a brief description of how a EUCIT might be levied. For a more complete discussion, see, for example, Gammie (1998).

Corporate tax harmonisation

longer play a significant role in location decisions between different EU countries, and organisational constraints to international companies structuring their activities on an EU-wide basis would be significantly reduced. National administration of corporate taxes would largely become unnecessary, as one centralised administration took responsibility for collecting and distributing the revenue, which should reduce the overall compliance costs.

Of course, such a tax would require a very high level of co-ordination. A new layer of administration would have to be created, negotiated and agreed on by the 15 participants. A whole new set of tax relationships with third countries would have to be established at an EU level. Unless the tax revenue raised was regarded as a Union resource, the most difficult question would be how to apportion this revenue amongst the Member States. This could provide significant grounds for disagreement, although agreements are currently achieved over the payment and allocation of existing EU funds.

Given that completely replacing the individual corporate tax systems with one new system would be an enormous project, there are alternative options. The EUCIT could perhaps be applied only to multinational companies operating within Europe, rather than to all companies. This would introduce the complexity of deciding which companies should be taxed under the EUCIT and which under their domestic corporate income tax. In theory, it could allow the EU to charge a different (i.e. lower) rate of tax on the more mobile operations of multinational companies than on domestic companies, but this would potentially create an incentive for domestic companies to become (or appear to become) international. This approach could still offer reductions in compliance costs and organisational

constraints for international companies operating in the EU, so long as it was not imposed on top of significant national corporate income taxes.

The final option would levy the EUCIT on all companies but would allow individual countries to impose their own corporate income taxes in addition (akin to the local corporate income taxes that are currently imposed in some countries). The tax base of the individual country taxes would be based very closely upon the EUCIT tax base, possibly with some minor adjustments allowed to reflect the particular characteristics of individual countries. This would raise the possibility of countries beginning to compete with one another again, but, provided the bulk of the corporate tax collected was through the uniform EUCIT rate and the range of local country tax rates was not very broad, the distortions to location choices would be significantly lower than they are at present.

Of course, this last option is close to the situation prevailing in the US, where state corporate income taxes are based quite closely on the federal tax and where state tax rates range from zero to about 12 per cent. There is evidence that these local tax rates do affect the location of investment within the US (Hines, 1996), so under such a system some distortions would remain.

6.4 Home State Taxation

An alternative proposal, if countries could not agree on moving towards a single European corporate income tax, is Home State taxation.⁴⁴ This would require each participating country to recognise the corporate income tax of the other participants. Like EMU, not all of the

⁴⁴For details, see Gammie and Lodin (1999).

Corporate tax harmonisation

Member States need agree to adopt Home State taxation.

Under one version of Home State taxation, total EU-wide profits would be calculated using the tax base set out in the Home State. Profits would then be allocated between different countries according to the location of operations (using an agreed apportionment formula) and taxed at the respective country's corporate tax rate. Different tax bases would co-exist within the EU, but a particular company or group of companies would only calculate taxable profits under one country's rules.

An alternative version of Home State taxation would adopt both the tax base and the tax rate of the Home State to determine the tax paid on overall European activities. The resulting tax revenue (rather than taxable profits) would then be allocated between the countries in which the company or group operates.

Both of these options are reliant upon agreement over the exact way in which the tax bases or the tax revenues are allocated between different countries. The form of apportionment would need to reduce the opportunities to shift taxable profits between countries, i.e. it would need to be based on activities that were relatively easy to measure and relatively difficult to shift between locations using transfer pricing or other forms of tax planning. In the US, the formula commonly used to apportion profits to different states is based on three factors — property, payroll and sales — although not all states use the same weights on these factors. The proponents of Home State taxation have suggested adapting the VAT base to measure the value added in each jurisdiction, although this has yet to be tested to ascertain its suitability and robustness to manipulation.

What would the effects be? Depending on apportionment formula, this could reduce the amount of artificial income shifting that takes place within the EU.

Other effects depend on the form of Home State taxation considered. The first option — using national tax rates to tax the share of EU profits allocated to particular countries — would leave firms with incentives to locate real activities in low-tax-rate jurisdictions, as at present. The second option — using a single Home State tax rate to tax EU-wide profits — would remove these distortions, although in the longer term there could be a different kind of distortion as new companies choose to set up in Home States with low tax rates. In both cases, it would be harder simply to pass profits through low-tax regimes. Both versions of the Home State system should reduce constraints against organising company structures more efficiently, since companies would have only one tax base to consider, but it would still be necessary to assess activities on a country-by-country basis to apportion that base.

The effects on administrative and compliance costs of running such a system depend upon the form adopted. Under the first version, companies need only comply with one country's rules to calculate profits but they must then be able to allocate those profits accurately between countries to pay the correct amount of tax. The second version is simpler as it would be possible for the Home State to account for the tax to other participating countries. Either way, Home State taxation would require closer co-operation between the tax authorities of the participating countries.

Home State taxation could be implemented without prior agreement over the precise detail of the tax base and exactly what tax rate should prevail, as would be required for the EUCIT. It would require fewer new structures in order to operate and might operate as a transitional stage towards the creation of a EUCIT.

6.5 Abolition of Corporate Income Taxes

A more radical option for the EU would be the abolition of corporate income taxes, with correspondingly greater reliance on other sources of revenue, such as taxes on labour income and consumption. Countries could agree either to reduce their corporate tax rates gradually or to move directly to a zero corporate tax rate.

If it is believed that the downward trend in corporate income tax rates will, in any case, continue and possibly accelerate, this approach would potentially give the EU at least a short-term advantage over the rest of the world of having made the first move. This is a crucial point — unless there is a reasonable expectation that tax rates will eventually be forced to zero through a process of globalisation and tax competition, it is unlikely that any country would agree to such a proposal — although if one group of countries did abolish their corporate taxes, the expectation of a world with no corporate taxes could become a self-fulfilling prophecy.

What problems would be resolved? In short, all of the corporate income tax distortions highlighted in Chapter 4 would be removed with respect to operations within the EU (or whatever group of countries agreed to do this). Those distortions with the rest of the world would still exist. The loss of corporate tax revenue would be approximately 3 per cent of the EU's national income, on average (see Figure 2.1), which would need to be found from elsewhere or otherwise spending plans would need to be reduced. The move could potentially attract a significant amount of new investment from outside the EU and raise the level of investment within the EU, although over time this effect would depend upon whether other countries followed the EU's lead and abolished their corporate income taxes.

What new problems could potentially arise from such a move? The lost revenue from corporate income taxes might not be the only revenue that is lost — if these corporate taxes play a significant role in ensuring the collection of some taxes, such as those on personal income or capital gains, the potential loss of revenue could be greater. The move could also undermine other countries' corporate tax systems, as the EU could then be used as a channel for avoiding tax, and its infrastructure and regulatory regime are likely to make it much more attractive than most existing tax havens.

There might be concerns about the distributional implications of such a move, since it can be perceived that companies ought to be taxed in order to tax their shareholders, who might on average be more affluent than those who do not own shares. This argument makes the mistake of assuming that it is the owners of companies who bear the effective incidence of existing corporate income taxes, which is not necessarily the case in open economies, as we discussed in Chapter 3. In addition, it is the overall progressivity of a tax system, taking into account all of the taxes paid and benefits received, that is important, rather than the progressivity of individual elements.

6.6 Summary

The future of corporate income tax systems within the EU depends crucially on whether the EU can be regarded as a large and relatively closed economy, which can co-ordinate over a corporate tax system levied at a rate of, say, 30 per cent and apportion the resulting tax revenue between its members by a mutually acceptable method. If the EU is itself closer to the case of a small, open economy in an increasingly global market-place, it might be more sensible to aim

Corporate tax harmonisation

for a managed reduction in corporate income tax rates which allows countries to work out how to replace the revenue previously raised from corporate taxation.

The possible expansion of the EU in coming years may suggest that it should be easier for the EU to act to maintain its own corporate income tax system as a large economic bloc. As the previous discussion indicates, however, there are few solutions to the issues we have discussed, beyond the federal solution of a single European Union corporate income tax. And, as with many other EU matters, the main issue may not be identifying a solution but finding a route to agreement on it and on its adoption. But even if the EU can act to maintain its own corporate income tax system, it still needs to worry about the interaction of that system with the rest of the world, which gives rise to all the potential issues we have discussed in this report. Overall, therefore, it is difficult to be optimistic that a satisfactory outcome will emerge in the short to medium term.

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