TO HARMONISE OR NOT TO HARMONISE?

A COMMENT ON THE EUROPEAN COMMISSION'S

STUDY ON COMPANY TAXATION

Peter Birch Sørensen

The recent report by the European Commission on the future of company taxation in the European Union is a welcome contribution to the current debate on the need for EU coordination of corporate income taxes. It provides a wealth of factual information on the existing corporate tax systems and identifies the current tax obstacles to cross-border investment within the Union. It also contains numerous pragmatic proposals for piecemeal corporate tax reform as well as several interesting ideas for more comprehensive reforms.

The Commission study offers a large number of estimates of the current effective tax rates on domestic and international corporate investment in Europe. These estimates reveal substantial variation in effective corporate tax rates across EU member states. The study shows that most of this variation can be traced to differences in statutory corporate tax rates. Despite this finding, the report does not advocate a harmonisation or approximation of corporate tax rates. Instead, it argues for a consolidation of the corporate tax base for European multinational companies.

In this comment I will start out discussing the various approaches to a harmonisation of the corporate tax base in Europe. Following this, I will consider the issue of tax base versus tax rate harmonisation and discuss alternative routes towards an improved coordination of corporate tax systems in the EU.

Commission blueprints for tax base harmonisation

The aim of the Commission's proposals for tax base harmonisation is to provide multinational companies with a single consolidated tax base for all of their EU-wide profits. A consolidated tax base would have several advantages. First, it would eliminate the need for EU multinationals to deal with 15 different company tax systems within the EU. Second, it would eliminate the need to identify the 'correct' transfer prices for transactions between related entities within the same multinational group of companies. Both of these simplifications could significantly reduce the costs of tax compliance. Third, a consolidated tax base would automatically allow offset of losses in one member state against profits made in another member state, thereby securing greater neutrality in taxation. Fourth, a single tax base for all EU activities would eliminate unintended tax obstacles to cross-border mergers and acquisitions arising from the current lack of coordination of member state capital gains tax rules.

The Commission report discusses four different blueprints for achieving a single tax base for EU multinationals: 1) Home State Taxation, 2) A Consolidated Common Tax Base, 3) A European Union Corporate Income Tax administered at the EU level, and 4) A Compulsory Harmonised Tax Base. The first three systems would be an optional choice for EU multinational companies, whereas the fourth system would be mandatory for all corporations in the Union, including those with only domestic operations.

A common feature of the four systems is that they all eliminate the current practice of separate accounting based on the arm's length principle for individual entities within a multinational group. Instead, European multinationals will be allowed or required to calculate their EU-wide profits under a single, consolidated tax base. As a substitute for separate accounting, a common formula would then be used to apportion profits to member states for taxation. This profit allocation would reflect the multinational group's economic activity in each member state, as measured for instance by its sales, property or payroll in each country. All four systems assume that member states will maintain their right to choose their own tax rate on their apportioned share of the EU-wide profits of a multinational group of companies.

It is highly interesting that the well-known problems of transfer pricing and thin capitalization under separate accounting have now motivated the Commission to seriously consider the alternative of formula apportionment which has long been advocated by many academics. The use of formula apportionment raises a number of difficult issues such as the problems of defining a group of related companies to be subject to formula apportionment; specifying the factors in the formula, and separating the EU tax base from corporate income deriving from non-EU sources. These and other technical issues relating to profit allocation have been excellently described by Joann Weiner[1] and will not be pursued here. Below I will just briefly state the main advantages and disadvantages of the four different company tax systems, as I see them.

Home State Taxation

The system of *Home State Taxation* implies that EU multinationals would be allowed to calculate the consolidated profits on their EU-wide activities according to the tax code of their Home State, that is, the member state where their headquarters are located. A German-based multinational would calculate its EU profits on the basis of German tax rules; a multinational group headquartered in France would calculate its total taxable EU-wide profits in accordance with French tax law, etc. From the perspective of national policy makers, the main advantage of Home State Taxation is that it does not require any harmonisation. All that is needed is that participating member states mutually recognize the company tax systems of the other countries participating in the system. For tax administrators the elimination of separate accounting should make life easier by eliminating the need to enforce complex transfer pricing rules for transactions within the EU. From the perspective of the business community, one attractive feature of Home State Taxation is that the system is optional: no company will be forced to switch to the system, but those that make the switch are likely to experience lower tax compliance costs, since they will no longer have to adhere to the different and sometimes conflicting national rules for the setting of transfer prices. Switching to a consolidated tax base will also enable companies to offset losses on operations in one member state against profits made in another member state, and corporate restructuring within a consolidated group will meet with fewer tax obstacles.

At the same time the attractive flexibility of Home State Taxation is also the main weakness of the system, since the existing differences across national tax systems will continue to create distortions. Apart from the fact that national differences in statutory corporate tax rates will remain, members of

[1] J. M. Weiner (2001a), The European Union and Formula Apportionment: Caveat Emptor, *European Taxation*, vol. 10, October 2001, 380-388, and J.M. Weiner (2001b), Formula apportionment in the European Union: a dream come true or the EU's worst nightmare?, paper presented at the conference on *Corporate and Capital Income Taxation in the European Union: The EU Commission Report on Companies' Taxation and Beyond* at FUCAM in Mons, Belgium, December 7-8, 2001.

different multinational groups operating in any given EU country will be subject to different tax base rules if their parent companies are headquartered in different member states. In auditing the foreign affiliates of the domestic parent company, the tax authorities of the Home State will also depend on the assistance of foreign tax administrators who may not be familiar with the Home State tax code. Further, and perhaps more important, Home State Taxation will invite Member States to compete by offering generous tax base rules in order to attract corporate headqarters. Such competition would create negative revenue spillovers, since a more narrow tax base definition in any given Home State would apply not only to income from activity in the Home State, but to income earned throughout the EU area.

A Consolidated Common Tax Base

In contrast to Home State Taxation, the *Consolidated Common Tax Base* acknowledges the need for a harmonised set of rules defining the tax base for those companies opting for consolidation of their EU-wide profits. This will eliminate tax base competition for corporate headquarters and will create a more level playing field for European multinationals. Of course, the price to be paid for these advantages is the loss of national autonomy implied by tax base harmonisation. Moreover, the fact that the harmonised base would apply only to multinationals could create distortions between large and small firms operating within each Member State, since the small firms without international operations would still be subject to the domestic tax rules (unless they were allowed to opt for taxation according to the Consolidated Common Tax Base rules). It would also be a clear disadvantage that each national tax administration would have to deal with two different tax systems, that is, the new Consolidated Common Tax Base applying to multinationals, and the existing national tax rules relevant for domestic firms.

A European Union Company Tax

The same comments apply to the *European Union Company Tax* which is economically equivalent to the Consolidated Common Tax Base except that the latter system is supposed to be administered by national governments, whereas the European Union Company Tax is supposed to be administered at the EU level, with some or all of the revenue accruing directly to the EU.

A Compulsory Harmonised Corporation Tax Base

The fourth alternative in the Commission report is the so-called *Compulsory Harmonised Tax Base*. Under this system a single corporate tax base applies to *all* firms - domestic as well as international - in *all* member states. This will level the playing field between domestic and multinational firms and eliminate the need for national tax administrations to deal with two different tax systems. On the other hand, because it also harmonises the tax rules for small domestic firms, the Compulsory Harmonised Tax Base involves a greater loss of national tax autonomy.

Base harmonisation versus rate harmonisation

The large variation in the current tax treatment of European corporations is incompatible with the idea of a single market offering a level playing field for business competition. Because the level of corporation tax depends on the location of investment - and not on the shareholders' place of residence - the existing corporate tax differentials imply that corporate capital may flow to the countries offering the lowest effective tax rates, and not to the countries where capital can be most productively employed.

However, given the current differences in statutory corporate tax rates, a harmonisation of the corporate tax base might well lead to *larger* cross-country variations in effective tax rates, since a relatively high statutory tax rate is often compensated by relatively generous deductions from taxable profits. This is a serious weakness of the Commission's proposal to harmonise the corporate tax base without harmonising statutory tax rates. Indeed, the Commission's finding that effective tax rate differentials are mainly caused by differences in statutory tax rates would seem to suggest that rate harmonisation should take precedence over base harmonisation. On the other hand, if tax rates are harmonised, those member states who are forced to raise their statutory rates may try to reduce the effective tax burden by allowing more generous deductions for depreciation or by introducing special incentive schemes etc. This could mean that the intended approximation of effective tax rates would not be achieved. Moreover, in the absence of base harmonisation companies will still have to bear the high compliance costs implied by the co-existence of 15 different corporate tax systems in the EU. These are two good reasons why corporate tax coordination should not focus exclusively on rate approximation.

Base harmonisation with a minimum rate?

A system of Home State Taxation would allow EU member states to compete to attract corporate headquarters by lowering the rate as well as reducing the base of the corporation tax. A Common Consolidated Tax Base or a Compulsory Harmonised Tax Base would invite member states to lower their statutory tax rates to attract corporate activity (as measured by the property, payroll or sales entering the formula for apportionment of the tax base). Indeed, with a harmonised tax base a cut in the statutory tax rate would become a more transparent and unambiguous signal of a cut in the effective tax rate, and this might well intensify tax rate competition.

In recent years a growing number of observers and policy makers have come to see tax competition as a 'healthy' activity which puts downward pressure on excessive government spending and promotes efficiency in the public sector. I am sceptical of this optimistic view of tax competition. While tax competition may force some reduction of public spending, its main effect will be to shift the tax burden from the mobile factors such as capital to the less mobile factors such as labour which is already overburdened with taxes in most European countries[2]. Moreover, if the political process is imperfect, allowing room for rent seeking, as the proponents of tax competition typically argue, the cuts in public spending are likely to take place in areas where political resistance is the weakest rather than in those areas where the public sector is most inefficient. If rent seeking is the problem, the appropriate policy response is to reform the political and public sector institutions which give disproportionate power to special interest groups. Tax competition seems a very indirect and poorly targeted instrument for countering rent seeking.

[2] See P.B. Sørensen (2000), The case for international tax co-ordination reconsidered, *Economic Policy*, 31, October 2001, 431-472.

It is sometimes pointed out that corporate tax competition does not seem to be a problem since corporate tax revenues as a share of GDP have tended to be fairly stable over the last couple of decades. This argument overlooks two developments. First, the profit share of GDP tended to increase in many European countries during the 1980s and 1990s. On this basis corporate tax revenues ought to have increased. Second, corporate sector profits probably tend to account for an increasing share of total profits, since many industries dominated by proprietorships (e.g. agriculture) are in secular decline. Again this trend ought to increase the ratio of corporate taxes to GDP. The fact that this ratio has been roughly constant suggests that the average effective tax rate on mobile corporate capital does tend to fall over time. Indeed, the data suggest that corporate tax revenues relative to corporate sector profits have tended to decline in Europe since the early 1980s[3]. Unless policy makers want a systematic shift of the tax burden away from corporate capital, they should therefore take steps to neutralize the ongoing corporate tax competition in Europe. This could be done by combining the Commission's proposal for tax base harmonisation with a binding *minimum statutory corporate income tax rate.*

The case for such a minimum rate is that a member state which attracts capital from abroad by lowering its corporate tax rate will impose a negative spillover effect on the other member states, since the latter will experience a fall in economic activity and tax revenues due to a capital outflow. On the other hand, if a country decides to increase its corporate tax rate, it will induce an outflow of capital which will generate a positive spillover effect on other countries. Hence the case for a *harmonised* corporate tax rate is considerably weaker than the case for a *minimum* rate.

A harmonised corporation tax combined with residence-based personal taxation?

Under a system with a minimum rate companies doing business in high-tax countries could nevertheless claim to be at a disadvantage vis a vis their competitors in low-tax countries. Also, from a social perspective the European capital stock would still be inefficiently allocated as long as cross-country differences in source-based corporation taxes remain. This goes against the idea of a

---

[3] See p. 10 in E. Bretin and S. Guimbert (2001), Tax competition for firms: to cure or to care?, paper presented at the conference on *Corporate and Capital Income Taxation in the European Union: The EU Commission Report on Companies' Taxation and Beyond* at FUCAM in Mons, Belgium, December 7-8, 2001.

truly integrated single European market with a level playing field for all companies. Hence I believe that harmonisation of the rate as well as the base of the corporation tax should still be seen as a legitimate long term goal for the European Union.

In the current era of euro-scepticism it may seem quite radical to propose a harmonisation of the rates as well as the base of corporation tax. However, it is crucial to keep in mind that the distribution of the tax burden across taxpayers depends on the *total* tax burden on income from capital. Apart from the corporation tax, this burden also includes personal taxes on income and wealth. An effective exchange of information among national tax administrations within the EU -as intended by the so-called Savings Directive which is currently being negotiated - would improve the ability of member states to enforce personal taxes on the interest and dividends paid out by the corporate sector, as well as personal taxes on capital gains on shares. In the current regime with hardly any exchange of information, the potential for capital flight to foreign bank accounts which cannot be monitored seriously constrains the ability of individual member states to impose taxes on income from mobile portfolio capital. By improving the ability of governments to tax foreign source income, information exchange will *strengthen* national tax autonomy, making it easier for each member state to choose its own preferred level of personal taxes on capital income. If they obtain more room of maneuver in the field of personal income taxation, EU member states should be more willing to give up autonomy in the area of corporate taxation to eliminate the many distortions to the single market created by the current corporate tax differentials.

The point is that the corporation tax is really just a withholding tax, serving as a prepayment of the final taxes on the capital income originating from the corporate sector. The final tax burden is determined by the personal taxes levied on interest, dividends and capital gains, and these taxes will remain under the control of member state governments even if the corporation tax were harmonised. If a member state finds that the harmonised corporation tax implies an inappropriately low level of tax on corporate-source equity income, it can rectify the situation by adding personal taxes on dividends and capital gains at the shareholder level. If it finds that the harmonised corporation tax is too high, it can use part of its apportioned corporate tax revenue to finance tax credits to shareholders.

Yet it must be recognized that the scope for residence-based taxes is limited by the possibility of capital flight from the EU area if important third countries refuse to cooperate on information exchange. This is a serious concern, although the OECD is making sustained efforts to induce the tax havens of the world to adopt a more cooperative attitude. Hopefully it is not too optimistic to expect that the tragic events of September 11 will pave the way for more international cooperation in the area of information exchange.

One should also keep in mind that The Best is often the worst enemy of The Good: complete corporate tax rate harmonisation may not be politically acceptable, so a call for complete harmonisation may block progress towards partial harmonisation. As long as corporate tax rates are kept fairly close in line, the remaining tax distortions to the location of corporate investment in Europe are likely to be small. Hence a reasonable compromise between economic efficiency and national tax autonomy might be to allow corporate tax rates to vary within a fairly narrow band, as proposed by the Ruding Committee back in 1992[4].

A pragmatic strategy for the short and medium term

At the present stage of European integration it is politically unrealistic to expect EU member states to agree to anything like the ambitious proposals for corporate tax coordination discussed above. In the short and medium term, a much more pragmatic strategy for coordination will have to be followed, as fully acknowledged by the European Commission. The Commission's proposals for targeted measures to eliminate particular tax obstacles to cross-border investment are a natural part of such a strategy.

I also agree with the Commission that the recent adoption of a statute for the 'European Company' ('Societas Europaea') offers an opportunity for experimenting with the development of a common consolidated tax base for this group of firms. The European Company statute harmonises several aspects of the company law of member states and allows the Societas Europaea's (S.E.'s) to submit their financial accounts to investors on a consolidated basis for all EU countries. However, in its present form the statute still requires an S.E. to keep separate tax accounts for each member state in which it operates. As argued by Sylvain Plasschaert[5], it would be natural to develop a single tax code or at least a single consolidated tax base for the S.E. to be applied to all of its EU-wide activities. Such a common tax code would make the S.E. statute much more attractive for companies and might serve as a focal point for member state corporate tax codes, thereby facilitating a gradual and spontaneous adaptation to a common set of corporate tax rules. But of course, if member states do not really want any approximation of corporate tax rules, they will be reluctant to allow the introduction of a single tax code for the European Company.

Perhaps things will have to get worse before they can get better: it may be that the costs and inequities stemming from the lack of coordination of national tax systems will have to become more dramatic before EU member states mobilize the political will to cooperate more closely on matters of tax policy.

Peter Birch Sørensen
Professor of Economics, University of Copenhagen
Director of Economic Policy Research Unit, Copenhagen
CESifo Co-ordinator in the area of Public Economics

[4] See the report from the Committee of Independent Experts on Company Taxation, European Commission, Brussels, 1992.

[5] S. Plasschaert (2001), The EU consolidated income tax revisited, paper presented at the conference on *Corporate and Capital Income Taxation in the European Union: The EU Commission Report on Companies' Taxation and Beyond* at FUCAM in Mons, Belgium, December 7-8, 2001.