# Tax competition, income tax coordination and fiscal sovereignty in the EU

***The case of corporate taxation***

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1ST EUROFRAME CONFERENCE

ON ECONOMIC POLICY ISSUES IN THE EUROPEAN UNION

**Université Paris Dauphine, 4 June 2004**

# Some recent facts

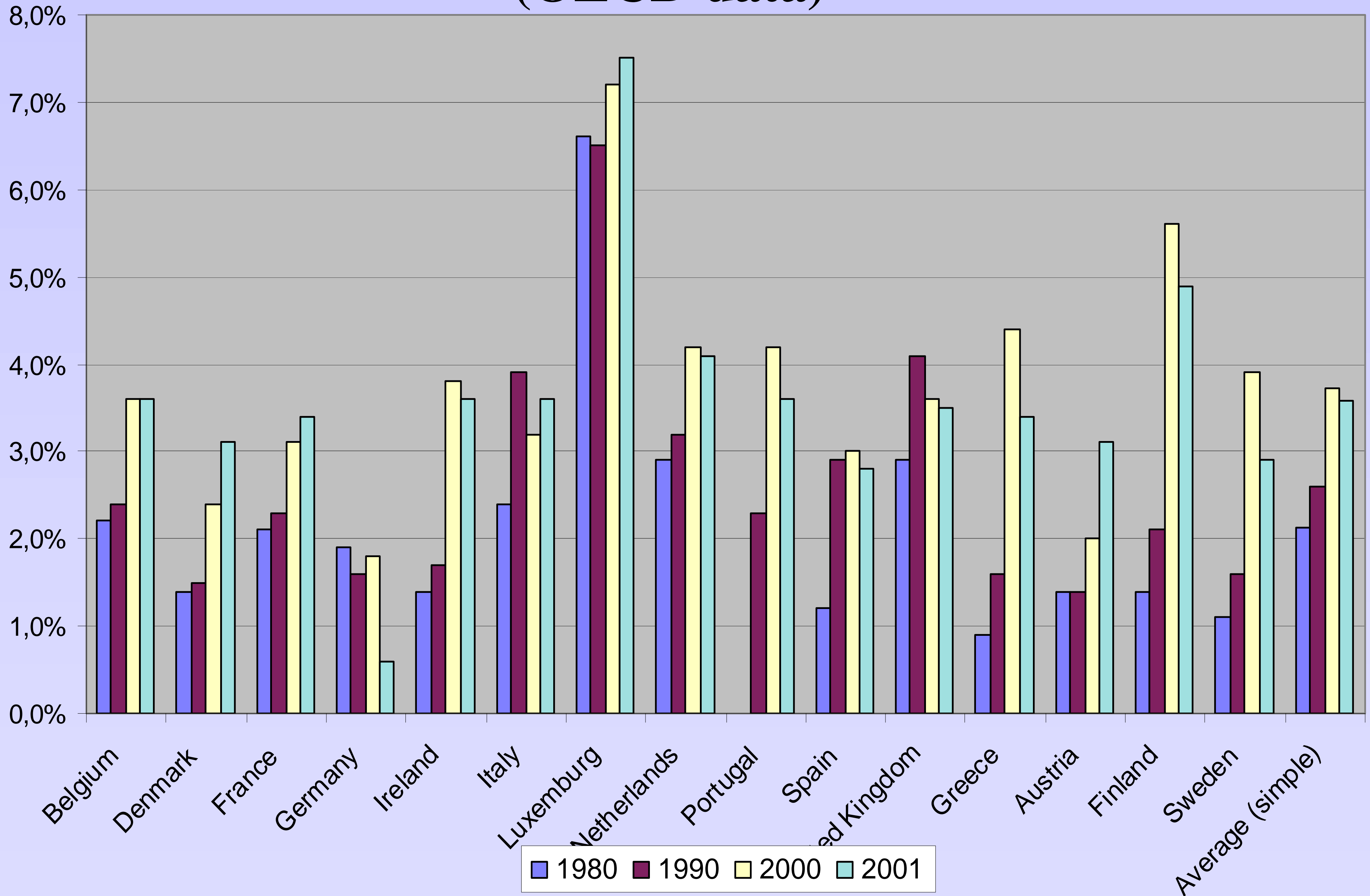
- Some major EU countries are increasingly worried about the effects of globalisation on their ability to raise the **desired amount of taxes**, in the **desired composition**.
- The issue is particularly relevant (and interesting) in the case of **corporate taxation**
- After the progress made to fight Harmful Tax Competition (Code of Conduct), some EU countries (Nl, Fr, G) are calling for **greater coordination**, and have recently supported the idea of **minimum corporate tax rates.**
- However, the **EU Commission** has reaffirmed that **no action** will be taken to coordinate national tax rates.

# Three questions

1. Are countries right in fearing **a loss of corporate tax revenue?**
2. What can we expect **in the future** as regards the level of **tax rates** and the evolution of **corporate tax revenue**, considering both the effects of **tax competition** and of the **EU tax policies** (EU Commission and Council initiatives, and European Court of Justice decisions)?
3. Is the request by some member states of greater coordination and particularly of a **minimum corporate tax (CT) rate** a sound policy, to preserve revenue and increase EU welfare?

# Corporate income taxes /GDP

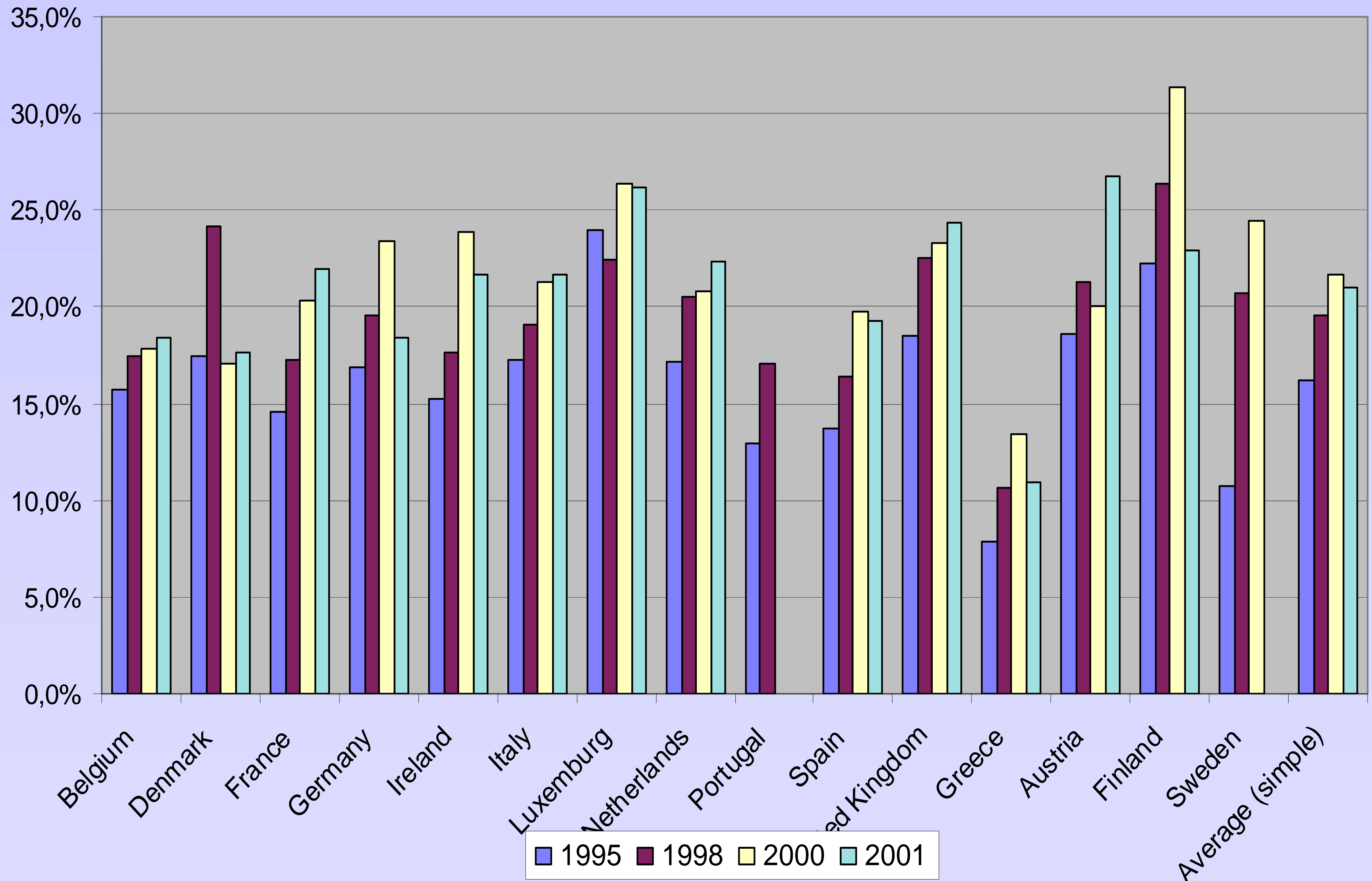
## (OECD data)



# Corporate income taxes/GDP

- Tax revenue from corporate income, as a percentage of GDP, **increased in the EU both over the 1980s and the 1990s, despite the progressive decline in the CT rates.**
- This observation is frequently used to support the idea that tax competition is not really a problem…
- Major **explanations**: a) increase in the tax base (tax reforms); b) increase in corporate profits; c) greater weight of the corporate sector in the economy; d) lower rates attracting tax base from abroad
- **In 2001 there is a clear sign of a reversal of this trend**

# Implicit tax rate on capital income

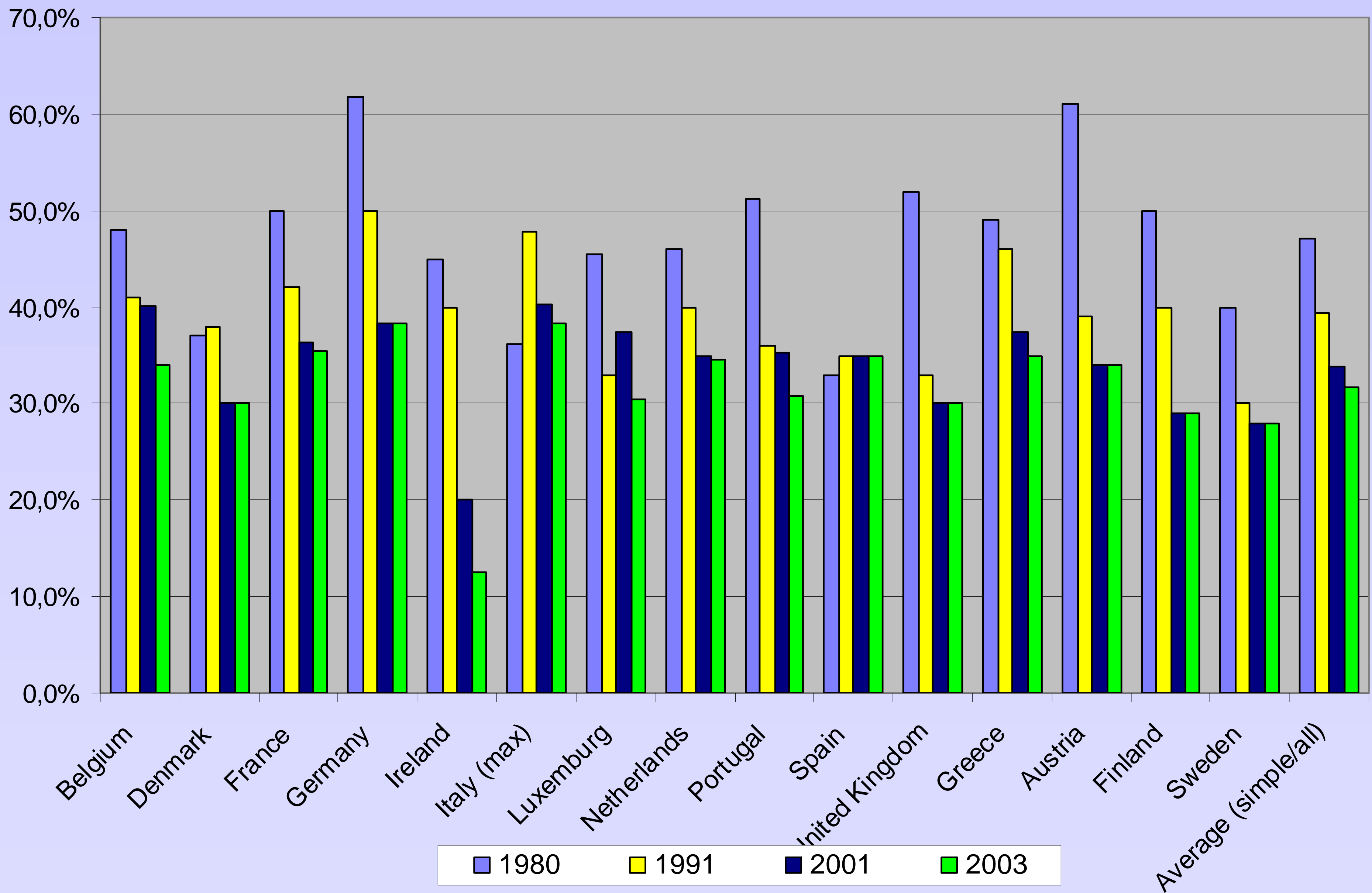


# Implicit tax rates (ITR) on capital income

- Period **1995-2001** (new Eurostat ESA95 series)
- Differently from past analysis, **ITR increases**
- The increase in the second half of the 1990s is significant, but again this does not allow to conclude that tax competition is not limiting the possibility of taxing capital income
- **Also this indicator is sensitive to the cycle** (in addition it is **very difficult to calculate**… )
- **In 2001 there are signs of a reversal** of this increasing trend

# (Maximum) statutory corporate tax rates

## (including average local taxes)



# Statutory rates

- **Decreased significantly** over both the 1980s and the 1990s
- **The decline has not come to a stop yet**.
- **Between 2001 and 2003 eight EU countries reduced their rates; two more countries will soon follow** (Austria from 34% to 25%; Finland from 29% to 26%)
- There is empirical evidence that **tax competition has mainly taken the form of a reduction in the statutory rates** (there are also good economic reasons)
- During the 1980s the decline was mainly justified to increase **neutrality**; subsequently, the major (clearly expressed) target is **increasing the tax competitiveness** of the system (or restoring it, as a reaction of the tax policies undertaken by other countries).

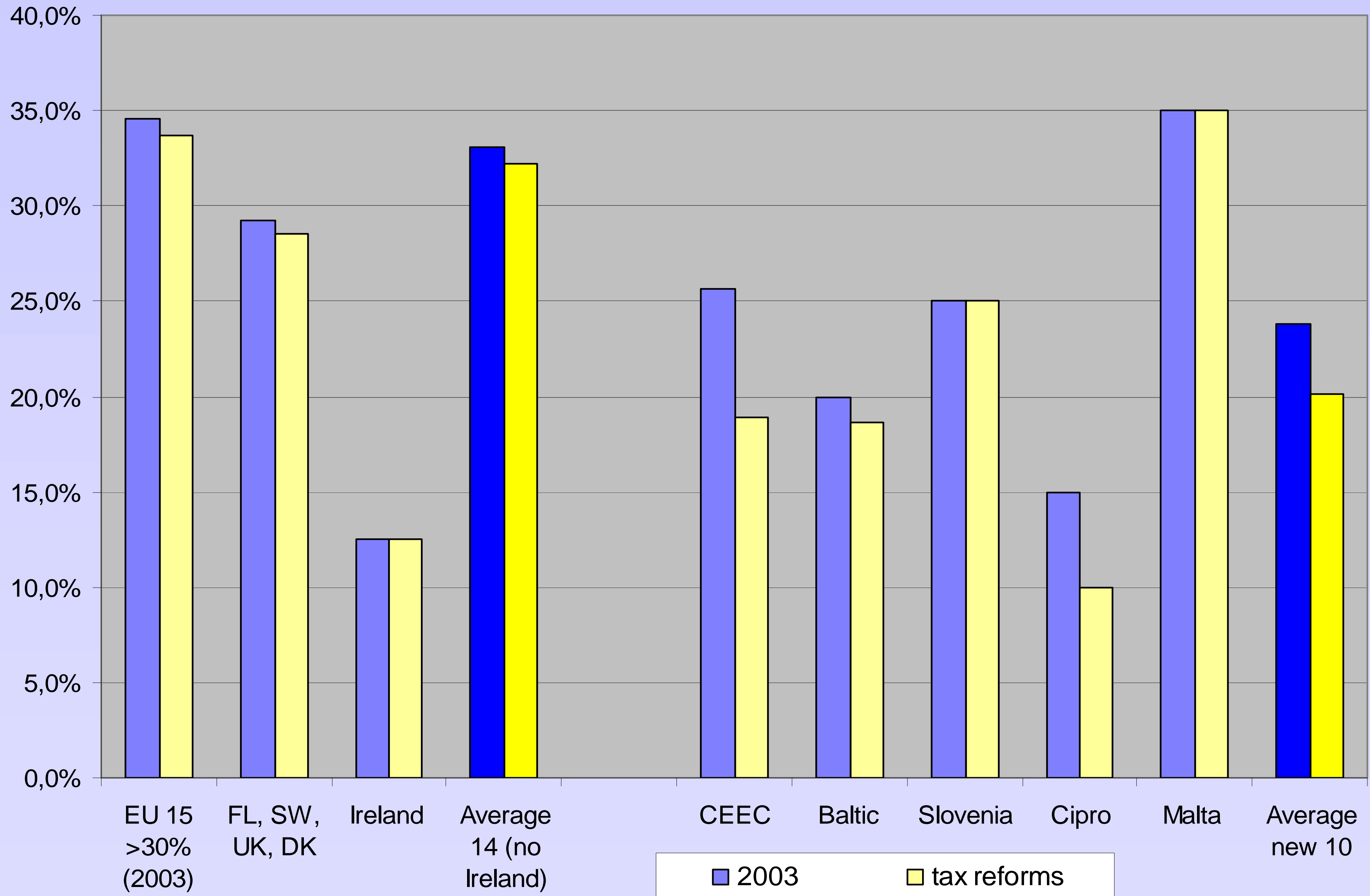
# Which perspectives for corporate tax rates and revenue?

1. **Enlargement**

2. **EU policy initiatives**:
   - Code of Conduct (CdC)
   - Common consolidated tax base (CCTB)

3. **Court of Justice (ECJ) cases**

# 1. Corporate tax rates in the enlarged EU



# 1. Enlargement

- **New accession countries have lower CT rates** (figure shows maximum; e.g. Estonia 26%, but it is zero on retained earnings)
- Also **investment incentives** are widespread
- Despite the lower level of tax rates, the tax reforms enacted or proposed in these countries go in the direction of **further decreasing these rates**
- Enlargement has increased complexities and diversity and is putting a **greater pressure** on other EU countries to further reduce the corporate tax rate

# 2.1 EU initiatives: the Code of Conduct

- **Major aim**: to fight Harmful Tax Competition and **preserve tax revenue** (avoiding poaching on other countries' tax bases)
- But progress in the CdC (and state aid policies) is leading (by explicit recognition of policy makers) to a **surge in competition on the general tax system**.
- Clear examples are: the **reduction in tax rates** (**Ireland**, but also the **new accession countries**), and the **diffusion of the participation exemption** for inter-company dividends and capital gains
- Paradoxically, **tax revenue might decrease**… (and tax induced distortions increase)

# Participation exemption

| Countries | Dividends (inbound) | Shareholding | Capital gains |
|---|---|---|---|
| Austria | E | 10% (2004) | E |
| Belgium | E | 5% | E |
| Denmark | E | 20% | E (3 years) |
| Finland | Cr<br>(E) | (25%) | T |
| France | E | 5% | T |
| Germany | E | | E |
| Grece | E<br>(Cr) | | T |
| Ireland | E<br>(Cr) | | T |
| Italy 2003<br><br>Italy 2004 | Cr<br>(E)<br>E | (25%) | T<br><br>E |
| Luxemburg | E | 10% | E |
| Netherland | E | 5% | E |
| Portugal | E | 10% | T |
| Spain | E | 5% | E |
| Sweden | E | 10% | E |
| Regno Unito | E<br>(Cr) | | E (>10%) |

# Participation exemption

- The diffusion of PE regimes and the abolition of the tax credit on dividends is increasingly characterising the corporation tax as a **source tax**
- In turn, this might contribute to **enhancing competition on tax rates**

# 2.2 EU initiatives: the Common consolidated tax base (CCTB)

- Recent proposal for a **common consolidated tax base (CCTB)**, with **formula apportionment** (FA), (COM(2001), 582)
- **Major aims**: to reduce compliance costs, allow full cross border loss offset and remove transfer pricing problems
- In fact, **problems of transfer pricing would re-emerge if value added (at origin) was used as factor of apportionment**. Tax rate competition to attract profits (profit shifting) would not be removed
- If capital was included in the formula, there would be **tax rate competition to attract capital and multinationals**

# EU initiatives: CCTB

- In perspective, the success of this proposal would **increase tax competition on rates.**
- In the **USA** (adopting a similar system) there is strong tax competition on **weights in the formula** (towards sales only). It is suggested that in the EU weights should be fixed.
- **The setting of rates will remain the only tool available** (maybe along with some investment incentives, compatible with the Treaty and the definition of the common tax base)
- In the **USA the federal tax rate (35%) acts as a floor**, and the divergence between states' rate is much narrower (about 5 percentage point) than in the EU (about 40 pp.)

# 3. ECJ decisions

- Increasing number of cases in direct (corporate) tax issues
- Major guiding principle: no **discrimination** between domestic and other EU member states' taxpayers
- Defence by member states based on the **fiscal cohesion** principle, the need to ensure effective **fiscal supervision** and **to prevent tax avoidance** are no more considered (in recent decisions) valid justification to discriminate
- The ECJ decisions aim at defending the basic principles of the Treaty (freedom of establishment) but also end up dismantling important aspects of the national tax systems, and **might be very costly in terms of revenue losses**

# ECJ decisions

- **Dividends**: Case C-35/98, *Verkooijen* (June 2000); Pending cases C-315/02, *Lenz*; C-319/02, *Manninen*. EC Communication (December 2003)
- **Thin capitalisation (TC)**: Case C-324/00 *Lankhorst-Hohorst,* (December 2002)

➢ *As a response countries are choosing the **less revenue costly** solution (not necessarily the most efficient and simpler)*

- ❖ Dividend: partial exemption
- ❖ Thin capitalisation: extension to domestic taxpayers

# ECJ pending cases

- **Cross border loss offset:** Pending case C-446/03: *Marks & Spencer*. Related *case Bosal case (C168/01, 18 September 2003)*
  - ➢ Some countries are already **extending the domestic system** of group taxation to foreign subsidiaries (traditionally only DK and in some cases Fr; now also Italy and soon Austria)
  - ➢ The **loss of revenue** implied by eventually extending loss offset to subsidiaries in other member states/countries will widely differ (depending on the type and generosity of domestic group taxation)

# ECJ future challenges

- **Controlled foreign companies (CFC) and transfer pricing**
  - The **ECJ decisions might increasingly restrict the ability of each member state to devise unilateral anti-avoidance measures to preserve tax revenue from tax rate competition**
  - In some cases (TC), the reaction by member state has been to extend to domestic residents the anti-avoidance measures, in order to preserve tax revenue
  - In perspective this might not be possible (e.g., in the case of CFC)
  - As a consequence, the **stimulus to compete through further reducing tax rates might increase**

# Conclusions:

## a) tax rate competition will continue

- There are several reasons for which one might expect that **tax competition on corporate tax rates will continue and even become fiercest**: enlargement, increase in EU integration, effects of some EU tax coordination policy, and of some ECJ cases
- In the future it will be **increasingly difficult** to finance tax rate cuts with a widening of the tax base **to preserve revenue**.
- The **concern about the shrinking of the corporate tax revenue is well grounded**

# Conclusions:
## b) tax rates and tax revenue might be too low

- In fact, for **some countries** the reduction in rates might not turn out in a reduction in revenue, if they will attract a wider share of foreign tax base and activities
- However, for the **Community as a whole** the corporate tax rates and the overall tax revenue might turn out to be **too low** (a "race to the bottom" is foreseeable in the future)
- The 12,5% of **Ireland**, and now the zero corporate tax rate of **Estonia**, are the benchmarks in this competition game. The CT might also disappear…
- The low Ireland rate had the major effect of attracting US multinational and tax base, **competition is now mainly within the EU** (attracting tax base and economic activities from other EU countries)

# Conclusions:
## c) do we need a common or minimum tax rates?

- **A unique, common tax rate is neither economically necessary, nor politically feasible**
- The proposal by some member state to introduce a **minimum tax rate** (or a lower and upper bound) should deserve careful attention
- The EU as a whole has to be internationally competitive, but a **limit** should be set to tax rate competition within the EU. A minimum CT rate could satisfactorily trade-off different conflicting needs (**efficiency and fiscal sovereignty**)
- The **existence of a corporation tax** is an important aspect of our tax systems: it is a backstop to personal taxes, it works as a benefit tax, it allows to tax location economic rents

# Conclusions:
## d) opening the debate on the issue is a priority

- The issue of tax coordination, and above all tax rate coordination, is very thorny (some countries fiercely oppose it), but **should be urgently faced**
- **Major obstacle**: smaller countries might loose (it depends also on whether tax rates are **strategic complements)**
- **To be feasible any proposal in this direction should consider the legitimate need of small peripheral countries to compensate for their location disadvantages, and find ways to compensate losers**