IV – Business Tax Harmonisation in the New Europe

Introduction

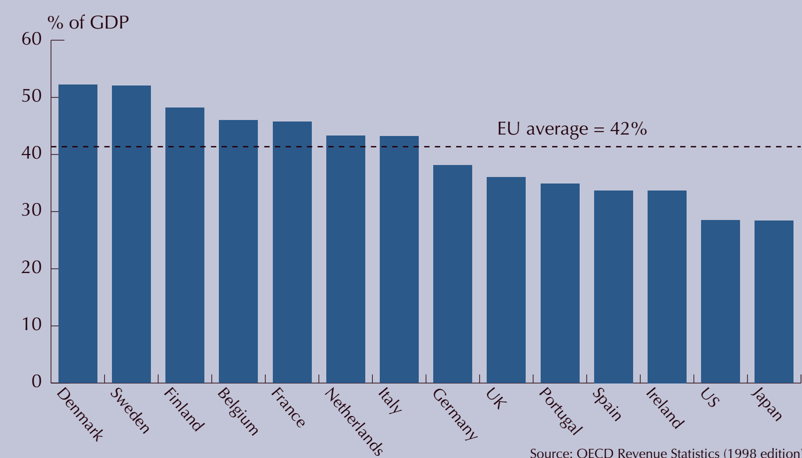
In the past year, there has been growing political debate in Europe about corporate tax harmonisation as a number of European finance ministers and European Commissioners have called for either full harmonisation of corporate taxation or at least an end to 'harmful tax competition'. A number of European politicians have expressed their belief that tax harmonisation is a logical progression from creating a single market with a single currency and integrated capital markets. Despite the resignation earlier this year of the then German Finance Minister, Mr Lafontaine, who was a leading advocate of this view, tax harmonisation remains on the EU agenda. The Commission's proposal for a 20% minimum tax on savings is another step down this road, although this could yet be vetoed or amended by the UK and Luxembourg.

In this special article, we first summarise the factual background to the debate and then consider the possible future drivers of business tax harmonisation in the New Europe. We then outline briefly the implications this could have for European companies. We focus on corporate taxation, but also comment below on differences in employer and employee social security contributions, which also have an important impact on business competitiveness[1]. We aim to provide a broad overview of the key issues from an economic perspective, rather than a detailed technical treatment of the many complex tax issues that arise in this area, for which specialist tax advice should be sought as appropriate.

Background to the debate

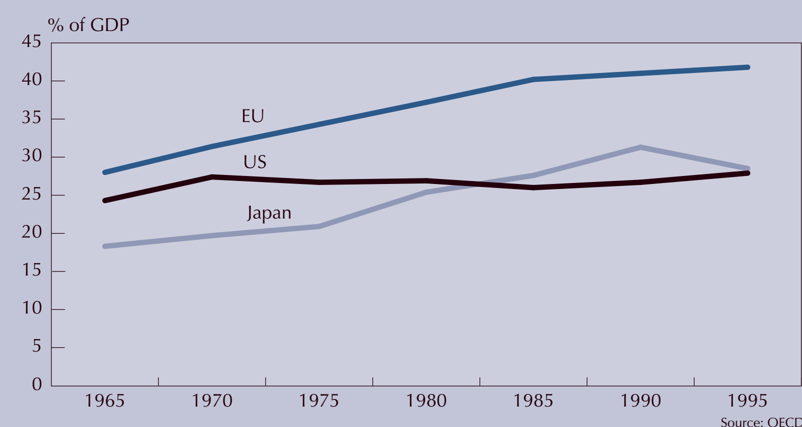
Figure 4.1 shows OECD estimates of how the overall tax[2] burden (as a % of GDP) varied across the EU in 1996, the latest year for which comprehensive data are available, and compares this to the US and Japan. We can see that:

Figure 4.1 – OECD tax burdens



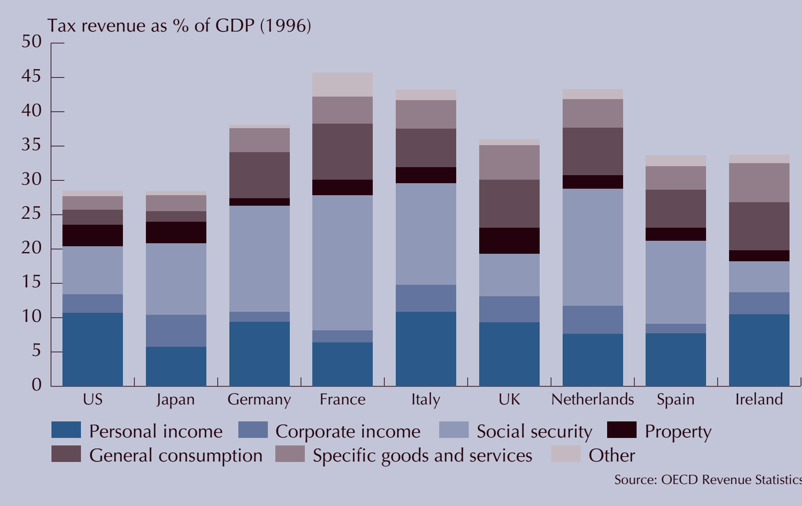
Source: OECD Revenue Statistics (1998 edition)

Figure 4.2 – Trends in EU, US and Japanese tax burdens



Source: OECD

Figure 4.3 – Breakdown of tax revenues



Source: OECD Revenue Statistics

[1] We do not consider indirect taxes such as VAT and excise duties here, although clearly there are also important issues surrounding ongoing or possible future EU harmonisation programmes in these areas. Similarly, we do not discuss personal tax regimes here, although EU harmonisation seems less likely in this area, with the important exception of the minimum savings tax rate already proposed.

[2] Taxes are defined by the OECD to be all "compulsory, unrequited payments to general government". Unrequited payments are those where benefits are not in proportion to payments and are defined as including all compulsory social security contributions.

Figure 4.4 – Social security contributions

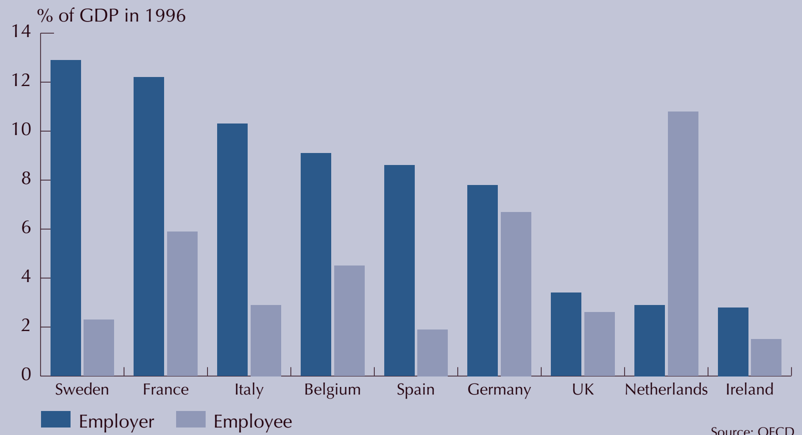


Figure 4.5 – Relative corporate tax burdens

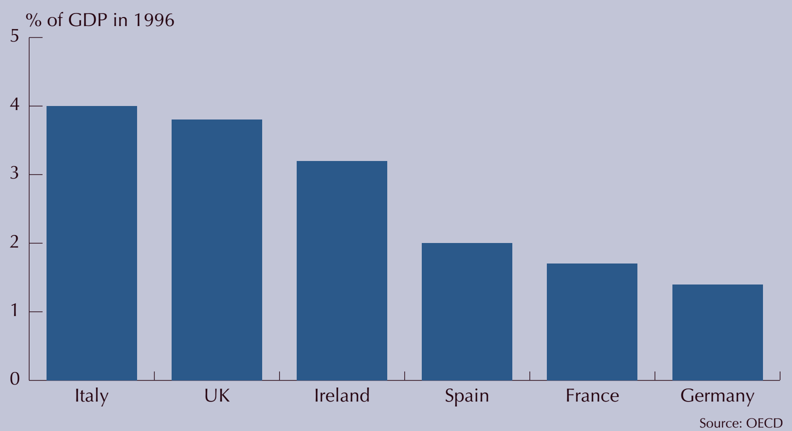
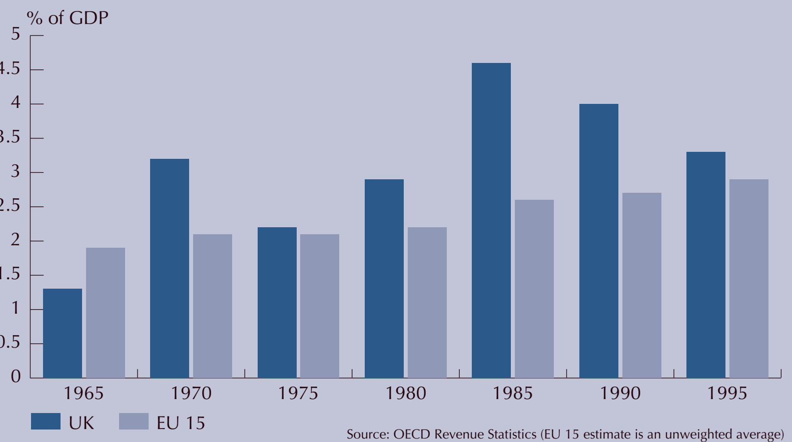


Figure 4.6 – UK vs EU corporate tax burdens over time



- the average tax burden in the EU (42% of GDP) is significantly higher than in either the US or Japan (both around 28.5%);
- the EU average tax burden has risen steadily from just over 30% in 1970; the Japanese tax burden has also risen from a much lower level (around 20% in 1970) but the US tax burden has hardly changed over this period (see Figure 4.2);
- the tax burden varies considerably within the EU, from around 52% in Denmark and Sweden and 48% in Finland to around 34% in Portugal, Spain and Ireland; and
- among the largest EU countries, France had the highest tax burden in 1996 (46%), followed by Italy (43%), Germany (38%) and the UK (36%).

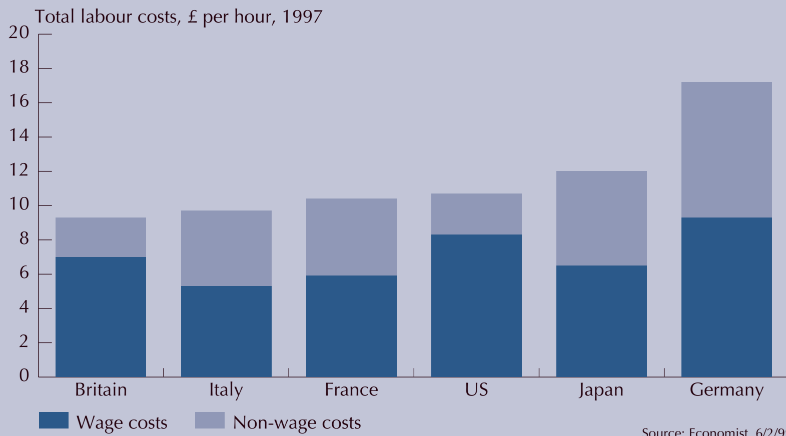
Breakdowns of these overall tax burdens by category of tax (see Figure 4.3) show that:

- the largest divergences between countries relate to social security contributions, which vary from 4.5% of GDP in Ireland and 6% in the UK to 15-20% of GDP in Italy, Germany, Sweden, Belgium, Austria, the Netherlands and France;
- further analysis shows that, with the exception of the Netherlands, higher employer social security contributions are the primary factor behind high overall tax burdens in the major mainland EU economies (see Figure 4.4);
- taxes on corporate profits make up a relatively small proportion of total tax revenues in all EU countries; the ranking of countries here (see Figure 4.5) is perhaps contrary to conventional wisdom which tends to be based only on headline tax rates; the UK and even Ireland had above average corporate profits tax burdens in 1996, while Germany and France were towards the bottom of the EU league table on this measure; and
- the relatively high UK corporate tax burden compared to France and Germany is not a new phenomenon but has in fact been evident since at least the early 1970s (see Figure 4.6).

The explanation for these latter two findings is that while, for example, the UK has a lower headline corporate tax rate than Germany or France, this is offset by a wider corporate tax base in the UK, with fewer deductions from corporate profits allowable against tax and less generous depreciation rates. Interestingly, recent research by the UK Institute of Fiscal Studies[3] has shown that it is

[3] M. Devereux and R. Griffith, Taxes and the Location of Production: Evidence from a Panel of US Multinationals, Journal of Public Economics, 68(3), 1998.

Figure 4.7 – Relative labour costs



Source: Economist, 6/2/99

the average effective tax rate, rather than the marginal tax rate, that influences the investment location decisions of US companies in the EU, although this is obviously only one of many factors affecting these decisions.

The analysis shown in Figure 4.5 implies that, if there were to be complete harmonisation of EU corporate tax systems rather than just convergence of headline corporate tax rates, it is by no means clear that countries such as Germany and France would gain relative to countries such as the UK and Ireland. Indeed, the opposite could be the case. In Germany, for example, the tax reform package proposed by Mr Lafontaine earlier this year involved a reduction in the headline corporate tax rate on retained profits from 45% to 40%. This proposal provoked significant opposition from German business, however, because the lower tax rate would have been more than offset by a reduction in allowances, so widening the tax base and increasing the overall corporate tax burden.

Different circumstances would arise if there were to be any future move to harmonise social security regimes across the EU. In that event, businesses in countries such as the UK and Ireland might lose out. As illustrated in Figure 4.7, lower social security contributions play a major role in the lower total labour costs evident in the UK as compared to other major EU countries, notably Germany. The most important reason[4] for this relates to differences in state pension schemes, which are the largest single category of social security spending in most EU countries; state pension provision is much more generous in countries such as Germany, France and Italy than in the UK or Ireland. The corollary of this, however, is that either employers and employees in countries such as the UK have to make much larger contributions to private pension schemes, or these employees will be likely to receive significantly lower total pensions when they retire than their counterparts in mainland Europe.

The issue of pension reform is clearly a very important one but it is beyond the scope of this article. The general conclusion we would draw from our past work[5] on this topic, however, is that pension reform is likely be a gradual process working through national policy initiatives rather than being driven by EU directives. Rapid harmonisation of social security contribution regimes across the EU is thus unlikely. Furthermore, even if pension reform takes a similar direction in different EU member states, for example moving towards greater reliance on funded defined contribution schemes offered by competing private sector providers, any such reforms are likely to take many years to have their full effect.

Possible drivers of European business tax harmonisation

Having outlined the factual background to the debate, we next consider some of the possible drivers of change in this area, namely:

- the Single Market Programme and tax competition;
- the single currency;
- the EMU Stability Pact;
- national tax reform initiatives; and
- EU initiatives on corporate tax harmonisation.

There may, of course, be other factors that will be important influences on European tax policy, such as the challenge faced by national tax authorities in developing a fair and efficient method of taxing electronic business transactions, but such issues are beyond the scope of this article.

The Single Market Programme and tax competition

The Single Market Programme (SMP), which has been ongoing since 1986 but is still incomplete in many areas, included provision for increased harmonisation of indirect taxes on goods and services, in particular VAT. Progress has been relatively slow, with some significant differences remaining, but variations in VAT regimes have tended to decrease since the mid-1980s.

The SMP did not directly address differences in corporate tax regimes, but it has had important indirect effects. In particular, by encouraging greater cross-border investment both within and from outside the EU, the SMP has increased the potential advantages to national governments from engaging in 'tax competition' to attract a greater share of total EU inward investment.

Whether such tax competition is harmful is open to debate. The OECD[6] has highlighted the proliferation of what it describes as harmful preferential tax regimes and tax havens; these, the OECD argues, tend to distort financing and investment decisions and erode national tax bases. Much of the concern of the OECD, however, relates to tax havens in non-OECD countries that suffer from a lack of

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[4] Another reason is that countries such as Germany, France, Austria, Spain and the Netherlands follow the so-called 'Bismarck model' of social insurance whereby both contributions and benefits are paid out of a separate social security fund. In contrast, in the UK and Ireland, a significant part of social security spending is financed from general government revenues rather than a specific national insurance fund.

[5] Notably, our joint 1996 study with Professor David Miles of Merrill Lynch on Savings and Wealth Accumulation in Europe, the results of which were published in the June 1996 issue of our UK Economic Outlook publication. This study looked in some detail at the cost and sustainability of state pension schemes across Western Europe and the possible direction of future pension reform.

[6] Harmful Tax Competition: An Emerging Global Issue, OECD, 1998

legal and administrative transparency, rather than to EU corporate tax regimes.

The European Commission, however, most notably the former internal market commissioner, Mario Monti, clearly also believes tax competition within the EU poses some serious problems and has argued for national policies aimed at creating particularly low business tax regimes to be treated as a form of state aid. As pointed out in a recent CEPR commentary[7], however, state aids are of most concern when they give a major competitive advantage to a domestic firm with significant market power. This may be the case for specific corporate tax breaks that apply to a narrow group of companies, which is the focus of the current EU Working Group on harmful tax competition as discussed further below. It should not, however, be the case for general corporate tax rates that apply to all firms in a country.

It is also possible to argue, as the OECD has itself done, that tax competition could have beneficial effects by forcing governments to be more disciplined in their public spending decisions. As noted above, tax competition also seems to have encouraged desirable corporate tax reforms which produce simpler and more efficient regimes with wider corporate tax bases (i.e. fewer allowances and exemptions) and lower marginal tax rates.

The single currency

In the public debate on these issues, EU tax harmonisation has often been linked to the introduction of the single currency. The implicit or explicit suggestion in some of the contributions to this debate is that the single currency necessarily implies the need for tax harmonisation. We would argue that this is true neither in theory nor in practice.

From a theoretical perspective, complete tax harmonisation across a group of countries would be inevitable only if companies were completely mobile and there were no other differentiating factors between these countries[8]. In fact, it is costly to relocate existing companies and tax is only one of many factors influencing investment location decisions. It is true that one of these other factors, exchange rate risk, is eliminated within a single currency zone, but there are still many other considerations that will influence location decisions which are often much more important than tax rates. Although the single currency could be a catalyst to change at the political level, the launch of the euro per se is therefore likely to have only a marginal direct impact on the degree of tax harmonisation.

This view is confirmed by practical experience in countries with federal structures such as the US and Canada; this shows that there is still considerable scope for state and local governments to vary corporate tax rates within a single currency zone.

In the US, for example, the standard federal corporate tax rate is 35% but state and local governments levy additional taxes that vary from under 1% to 12%, although these taxes are deductible in calculating federal tax liabilities. There is more uniformity around the definition of the corporate tax base in several US states, which have tended to converge on the federal tax base definition, but local differences still remain.

In Canada, the effective federal rate for manufacturing companies is 22.1%. The provincial rates paid on top of this vary from only 5% in Newfoundland to 17% in Manitoba and New Brunswick, giving a range for combined federal and provincial corporate tax rates for manufacturers from 27.1% to 39.1%. There is somewhat less variation in combined tax rates for non-manufacturing companies, which range from 38% to 46.1%, but other aspects of the corporate tax system, such as tax holidays and special lower rates for small businesses, also vary materially between provinces.

The main difference between EU and North American tax systems is the much greater proportion of revenues going to federal as opposed to local government in the US and Canada. The EU budget is tiny by comparison at only around 1% of EU GDP. If anything, the current focus of attention is on limiting rather than expanding this budget, although it remains to be seen how consistent this will be with progress on enlargement. There are, as far as we know, no current proposals for any part of corporate tax revenues to be paid directly to the EU rather than to national governments.

The EMU Stability Pact

If the single currency per se does not necessarily imply tax harmonisation, neither does the EMU Stability and Growth Pact. This imposes limits on budget deficits[9] not levels of tax and spending. It could be argued that, with political constraints on the total tax burden, there is some indirect limit on public spending implied by the Pact, but such political constraints on the maximum acceptable tax burden would apply with or without the Pact.

It is, however, conceivable that the Stability Pact could imply some indirect constraint on overall tax levels if public spending plans are pre-announced for several years ahead. This is not normally the case, although firm three-year departmental spending plans have been set out recently in the UK[10]. Even in these somewhat unusual circumstances, however, the constraint would only be on total tax revenues, not on any individual category such as corporate tax. National governments would still be free to determine the structure and mix of taxation, subject to overall revenue levels being adequate to fund pre-announced public spending plans without borrowing more than 3% of GDP. In practice, of course, there would almost certainly be scope to vary some proportion of public spending as well.

What the Stability Pact does do, at least potentially, is to limit the scope for national governments within the euro area to respond to economic shocks that affect different countries in different ways using counter-cyclical fiscal policy. Many economists regard this as an undesirable feature of the Stability

[7] T. Besley and P. Seabright, Discord over Harmony, European Economic Perspectives, No. 21, February 1999, Centre for Economic Policy Research, London.

[8] In this case, there might be a tendency for corporate tax rates to be driven down to zero. If, for example, EU politicians responded by trying to harmonise rates above zero in this case, investment would just move outside the EU unless there were major trade barriers against imports from outside the EU.

[9] Euroland countries face significant fines under the Stability Pact if their general government borrowing exceeds 3% of GDP in any year, unless this is a purely temporary deficit in reaction to a recession, defined as output falling by at least 0.75% in any one year.

[10] The UK is not, however, subject to the terms of the Pact given it has not yet joined the euro. It might be that the UK government would not have committed itself to forward spending plans in this way if it had been exposed to the risk of Stability Pact fines.

Pact, given that the alternative option of varying national interest rates no longer exists under EMU. One response to this might be to argue for a much larger central EU budget that could be used to fulfil this counter-cyclical role, funded from some kind of EU-wide tax base. Although this idea has been extensively discussed in the academic literature on EMU and fiscal federalism, however, it does not appear to be on the political agenda for the foreseeable future as noted above.

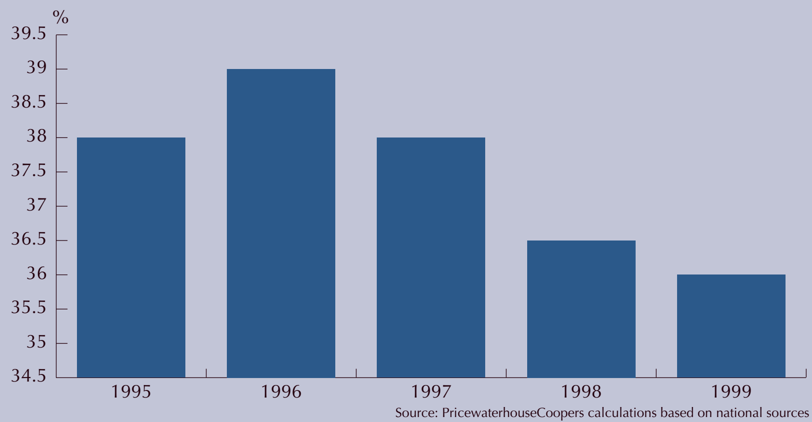
National tax reform initiatives

While the economic logic linking the single currency to tax harmonisation is not strong, there has been a clear trend for average EU corporate tax rates[11] to decline in recent years (see Figure 4.8). This has been associated with competition to attract inward investment and, perhaps, to persuade multi-national companies to declare profits in one country rather than another in certain cases.

Lower corporate tax rates have, however, also been associated with wider reform packages aimed at applying a lower marginal tax rate to a wider corporate tax base with fewer allowable deductions. This kind of reform, it can be argued, simplifies the tax system, reduces administrative costs and limits the scope for tax avoidance. As shown, for example, by UK experience after the corporate tax reforms of 1984, the eventual result could be a larger rather than a smaller corporate tax burden. It is not possible, however, to quantify this effect precisely given the difficulty of untangling the impact of tax reforms from other factors such as the economic cycle and structural trends in corporate profitability and the relative shares of labour and capital in national income.

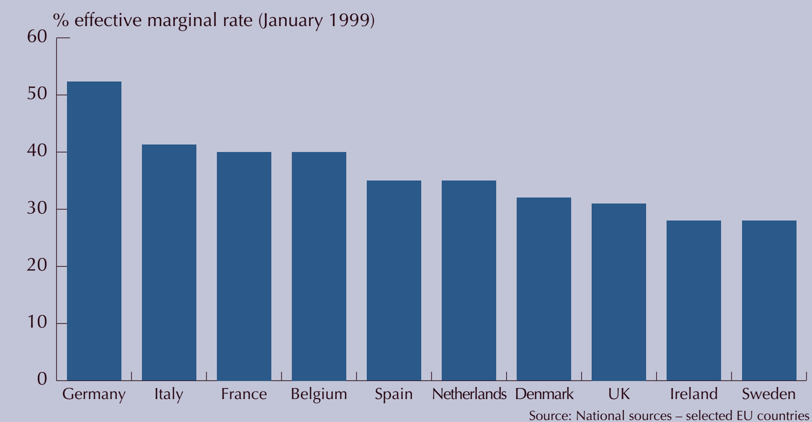
It seems likely, however, that the trend towards lower marginal corporate tax rates applied to a wider tax base will continue to be evident in many EU countries. This appears, for example, to be the current direction of tax reform in Germany. But there would be a long way to go before the EU would get close to a fully harmonised corporate tax system by implementing these national reform initiatives. This is illustrated by the wide range of effective marginal corporate tax rates across the EU, as shown in Figure 4.9.

Figure 4.8 – Average EU corporate tax rates



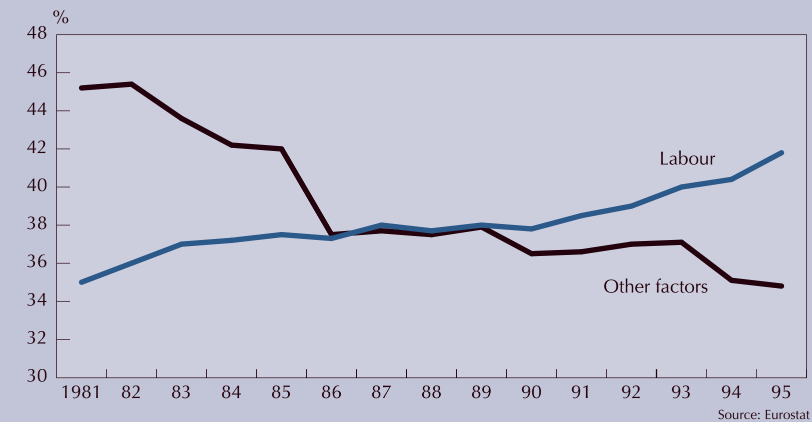
Source: PricewaterhouseCoopers calculations based on national sources

Figure 4.9 – EU corporate tax rates



Source: National sources – selected EU countries

Figure 4.10 – Implicit tax rates on labour and other factors of production in EU



Source: Eurostat

EU initiatives on corporate tax harmonisation

A final question to review is how, if at all, EU level initiatives might affect this process of corporate tax convergence. This has been an area of high profile debate within the EU in recent years, beginning with the informal meeting of ECOFIN ministers at Verona in April 1996, which set up a High Level Group to consider tax harmonisation issues. The European Commission has been pushing this agenda based on their view (see Figure 4.10) that the tax burden has shifted too far from capital to labour in recent years, to the detriment of employment. This argument is open to debate, since taxing profits more heavily could also damage employment

[11] Defined as the typical tax rates applied to corporate profits, combining federal and local tax rates where applicable. These tax rates do not, however, reflect differences in tax bases and so present only an incomplete picture of overall tax burdens.

prospects in the EU, but it has clearly had some influence in EU circles.

Following further discussions, the EU Council of Ministers reached agreement in December 1997 on a three point package[12]:

- a Code of Conduct for business taxation aimed at eliminating certain preferential tax regimes which currently exist within the EU; a large number of specific regimes[13] are being reviewed by a working group chaired by Dawn Primarolo (the UK Paymaster General) with a view to assessing whether they should be classed as 'harmful'; if they are, the intention is to remove them by 2003 (or as soon as possible thereafter); as yet, it is unclear what the outcome of this review will be or what the mechanism will be to enforce any suggested change on the EU member state concerned;

- measures to eliminate distortions in the taxation of capital income, which has culminated in a proposal for a 20% minimum tax on savings income that is currently being considered by EU finance ministers; and

- measures to eliminate withholding taxes on cross-border interest and royalty payments between countries (although we are not aware of any agreement on a specific proposal in this area to date).

There was also a Commission ruling in July 1998 that Ireland's 10% corporate tax rate for manufacturing companies and some internationally traded services constituted state aid. Ireland has agreed to phase this special rate out by the end of 2002, but has also received clearance from the Commission to reduce its overall corporate tax rate in stages to 12.5% by 2003, thus making the phasing out of the 10% rate of only marginal significance.

There have also been some important decisions on EU tax issues by the European Court of Justice (ECJ) dealing with alleged cases of discrimination between a member state's own residents and residents of other member states. This could lead to a greater effective degree of tax harmonisation but only in situations where the situations of residents and non-residents are comparable. Certainly, however, it seems that the impact of ECJ cases on domestic tax law (and the way this is interpreted by national tax authorities) is becoming more significant.

How fast tax harmonisation proceeds in the EU depends in part on whether there are any changes to the current requirement for unanimous voting on tax issues in the Council of Ministers. At present, this allows individual countries, such as the UK and Luxembourg in the case of the minimum savings tax, to use their veto to block or significantly amend any tax harmonisation proposals that would disadvantage their countries. If, as some European Commissioners have argued, tax issues were able to be decided by qualified majority voting, then more rapid progress might be expected on EU tax harmonisation. Countries such as the UK, however, are likely to oppose any such extension of qualified majority voting and, without such a change, progress on EU tax harmonisation is likely to remain relatively slow and piecemeal.

Implications for European companies

Where changes are planned in EU tax regimes, such as the proposed 20% minimum savings rate, or are under detailed review by the EU Working Group, companies will need to make appropriate arrangements to minimise any potential adverse impact on their businesses. In the many other areas where tax harmonisation seems likely to proceed slowly, if at all, companies operating in Europe will need, however, to continue to take careful account of differences in national tax regimes. These will impact on decisions as to where to locate and how to structure new and existing businesses to optimise their tax positions within the different EU fiscal regimes.

Tax differentials will become more important, however, if, as expected, the Single Market programme, the introduction of the euro and other drivers of change lead to an increase in cross-border trade and investment in Europe. The proportion of companies needing to manage their tax affairs on a pan-European basis will increase, with implications for both tax strategy and financial systems. This applies both to indigenous European companies and to inward investors from the US, Asia and elsewhere.

There will also be important implications for specific corporate functions. For example, treasury operations will need to focus on optimising their financing strategies so as to minimise the pre-tax cost of capital across Europe. Transfer pricing arrangements will also become increasingly important for companies operating on a pan-European basis and will be subject to increased review by tax authorities acting on a co-ordinated EU or global basis.

Issues relating to the taxation of cross-border electronic commerce will also become increasingly important for many European companies over the next few years although, like transfer pricing, this will be a global rather than just an EU issue.

Conclusions

Corporate tax harmonisation has moved up the political agenda in the EU in recent years but the popular debate on this issue has often been confused. Our analysis suggests the following key conclusions:

- the Single Market Programme has increased cross-border trade and investment within and into the EU, and so has added to the incentives for countries to make their business tax regimes as competitive as possible; it is, however, by no means clear that this has necessarily been harmful to the EU as a whole;

[12] It should be noted that current EU law already includes at least three Directives with important direct tax implications: the Mutual Assistance Directive, the Parent/Subsidiary Directive and the Merger Directive. Specialist tax advice should be sought on the implications of these Directives and of relevant ECJ cases.

[13] Areas under review include international holding companies generally, co-ordination centres in Belgium and Luxembourg, the Dublin docks area scheme in Ireland, holding companies and international financing companies in the Netherlands and a range of other regional and industry-specific schemes.

- while specific tax breaks for particular large companies may tend to distort competition in the same way as state aids, this is not likely to be the case just because a country has generally low corporate tax rates; at present, EU initiatives are focused on reviewing examples of these specific tax regimes to see if they have any harmful effects rather than on any broader corporate tax harmonisation agenda;

- corporate tax harmonisation is not an inevitable consequence of a single currency, either in theory or, as the experience of federal countries such as the US and Canada shows, in practice;

- the EMU Stability Pact does not imply any significant constraints on national tax policy and there appears to be no realistic chance at present of a significantly larger central EU budget being agreed that is funded from new EU-wide taxes;

- according to OECD estimates, overall corporate tax burdens, measured as total corporate tax revenues relative to GDP, are actually higher in supposedly 'low tax' countries such as the UK and Ireland than in some supposedly 'high tax' countries such as Germany and France; this reflects the wider range of allowances and narrower corporate tax base in the latter two countries, which outweigh the effect of a higher headline corporate tax rate;

- there has been a general trend over the past 10-15 years, both in Europe and globally, towards lower marginal corporate tax rates and wider corporate tax bases; we would expect this trend to continue, irrespective of any EU initiatives in this area; the effect will be to make tax systems simpler and more efficient but could just as easily increase as decrease the overall corporate tax burden;

- the key reason for lower total government revenue to GDP ratios in countries such as the UK and Ireland is their lower level of social security contributions, which in turn reflects their much less generous state pension systems; EU harmonisation in this area is unlikely in the foreseeable future because it will take decades for pension reforms to have their full effect and significant national differences are likely to remain in any event; and

- moves towards harmonised corporate tax systems seem likely to proceed more slowly than moves towards greater integration of European industries and markets and, hence, as more companies begin to operate on a truly pan-European basis, efficient tax planning will become even more important in maximising corporate value.