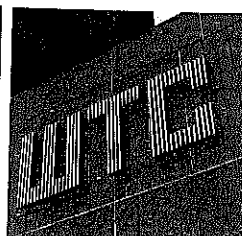
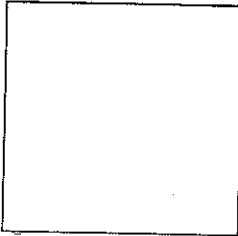
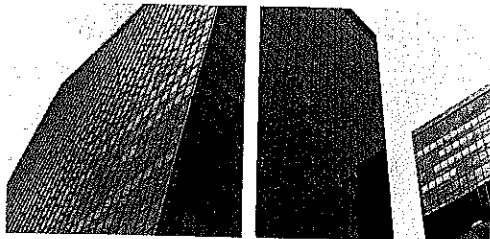


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The Assignment of Corporate Tax Competences in the European Community

The goal of the present article is to review the main economic questions to be addressed in the harmonization debate relative to the taxation of enterprises outside the financial services sector. The company tax requirements arising from the completion of the internal market are looked at first. It will be argued that more supranational involvement may be needed than was originally envisaged. Subsequently, the operational implications of the subsidiarity principle for corporate taxation in EMU are explored. The case for a comprehensive harmonization turns out not to be clear-cut at present. In the conclusion it is sketched concisely how, if and when the need is clearly established, a suitable common European corporate tax regime may look.

I. Introduction

Since the middle of the eighties, following the launching of the so-called 1992-program, the economic integration process in the European Community has once again a fair wind. With the internal market objective basically secured and public and private agents examining its concrete implications for them, the Community is now preparing itself for a new, in fact final, quantum leap in the economic integration process: the establishment of an Economic and Monetary Union (EMU), on which the intergovernmental negotiations started on 14 December 1990.

The fundamental microeconomic rationale underlying the efforts to create both the internal market and EMU is that by overcoming the market fragmentation arising from remaining non-tariff barriers and the existence of different national currencies the Community economy

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will be able to make considerable gains in allocative efficiency and hence reach higher welfare levels.

The removal of these sources of fragmentation – often termed “negative integration” – is, however, generally not enough to achieve Community-wide optimal resource allocation. Competition, the driving force behind this optimizing process, can be distorted due to market imperfections (collusion of firms, market externalities) but also because of distinct national state aid and tax regimes, including the social security system. “Positive integration” by way of common policies or of the harmonization through EC law of national rules may be in order to provide a minimum level playing field for firms located in different Member States.

This concern lies at the root of the EC’s competition policy. One of the precepts of this policy (ex art. 92,1 of the Treaty of Rome) is that barring well-defined circumstances, firm-, region-, or sector-specific subsidies or fiscal incentives are prohibited inasmuch as they affect trade between Member States.

Pending the national implementation before 1 January 1992 of the important Council decisions of 23 July 1990 relative to several aspects of the fiscal treatment of companies operating in more than one Member State, which will be dealt with extensively in part II of this article, art. 92 of the Treaty banning specific fiscal incentives is essentially the sole “*acquis communautaire*” in the area of corporate taxation. The national *general* corporate tax regime is not subject to any constraints as the various harmonizing proposals put forward by the Commission in the last twenty years always failed to obtain the necessary unanimous approval of the Member States.

This state of affairs is deemed in many policy circles and academic writings as falling clearly short of what is required for a well-functioning single market. Legislative measures at supranational level are urged such that, as a minimum, Member States deploy a uniform tax treatment of transnational profit flows; some go further and advocate a comprehensive harmonization of national tax rates, bases and systems and favour a single European corporate tax regime whose proceeds could be shared among the Member States (and the Community) according to predetermined distribution keys. The demands of these “Euro-harmonizers” do not only reflect a concern about economic efficiency. As the national economies grow more integrated the cross-border mobility of the corporate tax base is likely to

go up as well. Some Member States fear this may set in motion a mutual outbidding, “fiscal dumping” process toward ever lower corporate tax pressure, eroding the tax intake at a time when several Member States are undertaking strenuous efforts to rectify their public finance imbalances.

The opponents to the “Euro-harmonizers” in the Community’s emerging corporate tax debate advance considerations – often drawn from the fiscal federalism literature – in favour of the status quo. Stressing the virtues of national fiscal sovereignty, one of their fundamental propositions is that competition should not be limited to private agents alone but should also pertain to governments. To the extent that corporate taxes are a significant factor in determining firms’ location decision, enterprises will tend to move to those jurisdictions offering the best “value for money”. This way market forces can do the job of bringing about whatever tax convergence is needed.

It is apparent from these opposite views that the question of whether and how to harmonize corporate taxation in the European Community is complex. In a decentralized system of multi-tier government like the European Community great value should be attached to a high degree of fiscal sovereignty and to the concern for interjurisdictional equity, i.e. a “fair” allocation between the Member States of corporate tax revenue. But on the other hand, the efficiency rationale behind economic integration in general makes it also compelling to establish a corporate tax regime that minimizes distortions with regard to where in the Community to invest, what to invest in and how to finance it. In addition, any proposed reform at Community level should be judged on its managerial merits: the tax collection procedure should not be too heavy administratively, it should not be highly vulnerable to tax evasion, nor should it cause serious compliance costs on the part of companies.

In the light of these various demands, the European Commission has installed in January 1991 a high-level committee of experts, chaired by the former Dutch finance minister Onno Ruding, that has been asked to submit a report in early 1992 on the Community aspects of corporate taxation after the completion of the internal market.

The present article does not pretend to be a precursor to this prospective report. Its more modest goal is to review in some depth the chief economic issues that need to be addressed in the harmonization

debate relative to the taxation of enterprises outside the financial services sector¹.

Taking the gradualist perspective of economic integration, the company tax requirements arising from the completion of the internal market are looked at first. It will be argued that more supranational involvement may be needed than was originally envisaged in the Commission's 1985 internal market White Paper. Part III explores the operational implications of the subsidiarity principle for corporate taxation in the Community's prospective EMU. Here the bottom line is that the case for a comprehensive harmonization of countries' general corporate tax regime is at present not clear-cut. Part IV offers some concluding remarks, sketching in a nutshell how, if and when the need is clearly established, a suitable common European corporate tax regime may look.

II. Corporate Taxes and the Internal Market

An internal market is characterized by the absence of restrictions to the free movement of inter alia capital and the elimination of economic discrimination on nationality grounds. The Commission's well-known 1985 White Paper on completing the internal market called therefore (para. 151) for the removal of all fiscal obstacles to cooperation between firms of different Member States. The importance of eliminating these international fiscal hindrances was underscored in the so-called "Cecchini" Report on the economics of 1992 highlighting the significance of the indirect welfare gains to be generated through EC-wide sectoral restructuring.

A. The White Paper measures

The White Paper identified three chief obstacles: the fiscal treatment of mergers involving companies from different Member States; the imposition of withholding taxes at the repatriation of foreign subsidiaries' profits; and the problem of double taxation following the unilateral adjustment by one Member State of the profits of so-called "associated enterprises". In order to remove the first two obstacles the Commission had submitted draft directives as far back as in 1969; the

1 Admittedly, the distinction between financial services companies and other firms is becoming more and more blurred as there is a growing tendency for large enterprises to develop in-house financial intermediation activities for various units of the group.

double taxation question formed the object of a proposal in 1976. The Commission's patience was eventually rewarded since on 23 July 1990 the ECOFIN-Council finally approved their latest version. The nature of the problems and the solutions given to them can be briefly summarized as follows.

Fiscal cost frequently proves to be a deterrent for companies from different Member States wanting to merge. This cost arises from the fact that the national authorities of the firm placing its assets into another foreign firm at the time of the merger tax the possibly considerable difference between the real and the book value of stocks, buildings etc. of the dissolving firm. Whereas most countries have rules to lighten the tax burden in the event of mergers between domestic companies, there are no uniform provisions across the Community when the merger company is of another nationality. The directive, which in the end not only concerns mergers but also divisions, transfers of assets and exchanges of shares and which will become effective in all Member States before 1 January 1992, provides for an alleviation of the fiscal burden by deferring the actual payment of the tax until such time as the capital gain in question is actually realized².

An overt discrimination on the basis of nationality of ownership is constituted by the withholding taxes most Member States levy exclusively on profits repatriated to foreign parent companies. The recently adopted Directive stipulates that profits distributed by a firm to its foreign parent shall be exempt from withholding tax if the latter company holds a minimum 25 per cent of the subsidiary's capital³. The abolition of withholding taxes by 1 January 1992 – Germany, Greece and Portugal having been granted a longer delay – may well lead to a significant improvement of economic efficiency in that apart from removing an important element of fiscal distortion impinging on cross-border investment, it will also render superfluous – at least as far as intra-EC business is concerned – many of the "fiscal engineering" schemes (like intermediary holding companies or foreign based companies) that are widely used to avoid taxes⁴. Such treaty-shopping

2 Council Directive on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States. Official Journal of the European Communities, 20 August 1990, L-225.

3 Council Directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States. Official Journal of the European Communities, 20 August 1990, L-225.

4 A good description of various tax avoidance set-ups can be found in Giovannini (1989), p. 358-362.

is wasteful in its own right as it absorbs skilled resources that could be put to more productive use and distorts the location of financial intermediaries.

When the corporate tax regime differs significantly from one Member State to another, subsidiaries of a multinational enterprise are considered separate entities for tax purposes, and the tax system relative to foreign subsidiaries' profits is source-based⁵, meaning that the latter are taxed according to the fiscal rules of the country where the activity takes place, enterprises operating in more than one country have an incentive to shift profits artificially from a high to a low tax Member State by so-called transfer pricing, i.e., by internal over- or underinvoicing or the judicious allocation of overhead costs. Fiscal authorities suspecting artificially low profits sometimes take unilateral action and raise the profits of the local member of a multinational group to redress what they see as an interjurisdictional inequity. However, when one country in its bid to obtain its "fair" share of taxable revenue adjusts profits upward but the profits of partners in the group are not reduced correspondingly in other countries, the group as a whole suffers double taxation. The Convention concluded by the Member States in July is designed to eliminate this source of double taxation⁶. Failing mutual agreement between the two (or more) fiscal authorities on profit revision, the Convention provides for the automatic establishment of an arbitration panel – called an "advisory commission" – which will deliver its opinion within half a year from the date on which the dispute was referred to it. The Member States are held to act in accordance with the panel's ruling.

The European Commission has sought to supplement the three White Paper measures by two new draft directives, submitted in November 1990. The purpose of the first is to establish a Community regime regarding the fiscal treatment of cross-border interest payments between firms by prohibiting the imposition of withholding taxes on the payment of interest or fees by a local subsidiary to a parent company based in another Member State. The second concerns the incorporation in the parent company's accounts of losses by branches or subsidiaries located in another Member State. In analogy with the fiscal

5 As distinct from the residence-based system according to which foreign subsidiaries' income is eventually subject to the corporate tax of the country where the parent company resides.

6 Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises. Official Journal of the European Communities, 20 August 1990, L-225.

rules contained in the draft European company statutes, the proposed directive provides for the possibility of loss "deduction-cum-reintegration": foreign subsidiary's losses can be consolidated at the level of the parent company but the associated deduction is reversed when the subsidiary returns to profit.

B. A possible need for additional supranational involvement

The three Council decisions, along with the two new proposals, form a major contribution to the elimination of cross-border fiscal hindrances to enterprises. However, it can be argued that the internal market calls for yet supplementary measures. The latter should serve two purposes: first, ensuring greater fiscal transparency and, second, the achievement of a more "systemic" solution to the problem of profit shifting and the broader question of the distribution between Member States of corporate taxes on multinational enterprises.

As to the first purpose, there is general agreement that in order to harvest its full economic benefits, the completion of the internal market needs to be complemented by a strengthening of competition policy. The reinforcement of state aid monitoring by the Commission would be considerably facilitated if the provision of fiscal incentives were more transparent. It would therefore be very appropriate to pass a directive stipulating that fiscal incentives can be granted only under the form of tax credits and/or advantageous corporate tax rates; in other words, that as a general rule of law a firm's taxable income is determined in an identical fashion for any enterprise located in a specific Member State.

As to the second, one may doubt whether the arbitration procedure introduced by the July Convention offers in the longer term an adequate response to profit-shifting practices by way of transfer pricing, even if the relative national regulations could be made more uniform.

Apart from the fact that the enforceability of their rulings will probably be weak, as the legal framework is an international convention and not a Community directive, such case-by-case panels, which are likely to apply the usual discretionary "arm's length" methods to assess the correct income earned in an individual Member State by a firm belonging to a multinational group, risk being overwhelmed by the rise in the number and complexity of cases referred to them.

A solution, to be durable, must remove the incentive for multijurisdictional firms to engage in transfer pricing, or thin capitalization for that matter⁷.

Essentially three different possibilities are on offer to this end but the "political" problem with each of them is that they involve a far-reaching harmonization of national corporate tax regimes and a correspondent loss of fiscal sovereignty in favour of greater competences at Community level.

This is evidently the case with the first solution, which would simply be to introduce a single European corporate tax regime. If all firms in the Community were subject to the same definition of taxable income and the same tax rate, the tax bill could not be reduced by shifting profits from one Member State to another. However, the transfer of competences from the national to the supranational level would be total.

The second method, used in the United States (and Canada) at the state level, is to resort to "European unitary taxation" by lumping all associated enterprises into a single unit for tax purposes. The unit's EC-wide income would then be apportioned to the Member States according to a predetermined formula. In the U.S. this formula grants typically equal weights to three components: payroll, property and sales, such that the tax bill T of multinational firm j in country i is determined as:

$$T_{ji} = t_i (A_s(S_{ji}/S_j) + A_l(L_{ji}/L_j) + A_k(K_{ji}/K_j))B_j$$

where t_i stands for state i 's tax rate, A_s , A_l , A_k are the apportionment weights attached respectively to sales, payroll and property, S_{ji}/S_j is the share of state i in total sales of firm j across all jurisdictions, L_{ji}/L_j and K_{ji}/K_j denoting the same ratio for payroll and property; B_j represents state i 's definition of firm j 's taxable income. Thus, a state in which a multijurisdictional enterprise sells, but does not produce nor reside would be entitled to part of the corporate taxes paid by that enterprise.

⁷ Thin capitalization relates to the practice of providing the bulk of foreign subsidiaries' working capital through loans from the parent company. This way foreign profits can be transferred to the parent company (as interest payments) without being subject to corporate taxes in the subsidiary country since interest payments are tax deductible. The thin capitalization question may grow in importance upon the adoption by the Council of the new proposal toward banning withholding taxes on cross-border interest payments.

Under a unitary taxation scheme, the appeal of profit-shifting would be strongly diminished since the activities of the entire group are taxed together, rather than of each member separately. Unitary taxation looks *prima facie* an attractive solution for the Community as in principle it combines the discouragement of profit-shifting with a high degree of national tax autonomy. However, the experience in North America clearly suggests that if the Member States were to disagree on the use of a common apportionment formula, on common tax base rules and on an identical operational definition of what is meant by "associated enterprises", the scheme could give rise to serious distortions as well as proving very onerous to implement for national administrations and enterprises alike. But such a triple agreement would strongly erode national fiscal sovereignty, leaving Member States basically with the right to set their own corporate tax rates.

The third method to put paid to profit shifting practices is through the application of the "pure" residence principle. Under this system, the income of foreign subsidiaries is ultimately taxed exclusively according to the rules of the parent company country; full credit, implying the possibility of tax refunds, is given for corporate taxes paid in the source countries, but no deferral is granted regarding the taxation of non-repatriated profits. The effect of this treatment of transnational profit flows is that the EC-wide activities of multinational firms are all taxed following the rules of one country, that of the parent company. Consequently, profit shifting would not alleviate the fiscal burden. In spite of the absence of a visible supranational involvement the introduction of the "pure" residence principle is likely to meet with strong national resistances because besides being administratively rather complex, its concrete *modus operandi* would also be considerably different from the current corporate tax situation in the Community where seven Member States as a general rule exempt from corporate taxes foreign source dividend income, deferral is granted and foreign tax credits limited. Moreover, in order to ensure that capital exporting Member States did not end up in a net payment position as a result of reimbursements for taxes paid in source countries, a clearing mechanism involving source and residence Member States would have to be set up.

Any of the three options listed above offers a systemic response to transfer pricing or thin capitalization practices but it is important to note that none of them is adequate to solve the broader interjurisdictional equity question.

Member States are concerned about transfer pricing, not because it constitutes a serious source of physical investment distortions across the Community⁸, but because it denies them what they regard as their "fair" share of the corporate taxes paid by a multinational enterprise. If corporate taxes are seen as benefit taxes, i.e., the counterpart to the profit opportunities in the form of infrastructure, vocational training etc. provided to enterprises below cost by government, and transfer pricing were to lead a firm to pay taxes outside the country of production, one would be in the presence of a classical example of an externality, calling for remedial action. However, recent contributions to the literature⁹ have cast convincing doubts on the validity of the benefit tax view of corporate taxation and prompt the conclusion that it is by no means clear what a "fair" system is. As a corollary, there is no objective yardstick by which to distribute among the various Member States the total revenue collected on the basis of EC-wide activities, necessary to frustrate transfer pricing practices. None of the three responses to abusive profit shifting outlined above will prove viable if they are not complemented by what in the end are political agreements on how to allocate among Member States taxes paid by multijurisdictional firms. This crucial issue is explicit with unitary taxation in the determination of the apportionment formula. It is equally present, though implicitly, with the first solution – the distribution key for sharing the proceeds of the single corporate tax – and the third solution – the terms of the functioning of the clearing mechanism indispensable under full crediting.

III. Corporate Taxation in the Prospective EMU

It was argued in Part II that for the sake of the proper functioning of the internal market EC measures in the corporate tax domain are in order that eliminate discrimination on the basis of nationality, heighten transparency and provide a structural response to the problem of distributing between Member States corporate taxes due by multinational enterprises. Part III addresses the question whether embarking on the ultimate stage in the economic integration process,

⁸ The systematic pursuit of profit shifting would in fact be likely to raise the degree of corporate tax neutrality in the Community. By reporting a larger share of profits from operations throughout the EC in one and the same Member State, namely that with the lowest corporate tax, greater so-called capital export neutrality would emerge: the decision which Member State to invest in would be less influenced by differences in national corporate tax rules.

⁹ Devereux and Pearson (1989), Giovannini and Hines (1990).

viz. Economic and Monetary Union, calls for further corporate tax harmonization. More particularly, the query is asked whether EMU requires a uniformization of the Member States' corporate tax rates and base definitions.

Admittedly, the distinction between Parts II and III is somewhat artificial as the "internal market" and "economic union" stages of integration flow into each other. An economic union is an open-ended concept, such that its normative content is not precisely delineated. Building on an internal market, it seeks, inter alia, to enhance further resource allocation efficiency by way of harmonization or approximation of Member States' general legislation in the social and fiscal area where a strong economic case for common rules can be advanced. This case can strengthen or weaken through time as a result of structural economic developments – like the degree of cross-border factor mobility – or of evolving views on optimal market regulation.

A. The implications of subsidiarity

Taxation is one of the few areas where unanimity is still required for the passing of Community measures¹⁰. Acceptance by each Member State will be more easily won if a proposed tax measure respects the by now well-known principle of subsidiarity, stating that a higher level of government should only assume responsibilities that cannot be effectively taken care of by a lower level of government¹¹.

Subsidiarity is a decentralist paradigm with a number of important operational implications for the assignment of competences between the Community and the Member States¹². To start with, any Community involvement in economic policy should respect a degree of proportionality: it is only when independent national measures pose a serious problem for Community welfare that supranational rules should be put in place. Second, once significant externalities have been identified, it needs to be examined whether they can not be remedied sufficiently by ad hoc voluntary coordination between the Member States rather than by transferring competences to the higher Community level of government. Third, this transfer of competences is

¹⁰ The unanimity condition in fiscal matters may disappear following the Treaty revisions resulting from the intergovernmental conferences on EMU and Political Union.

¹¹ A profound discussion of the origins and the contents of the subsidiarity concept can be found in Wilke and Wallace (1990).

¹² For a general discussion of the vertical assignment of economic competences in the Community reference can be made to Van Rompuy, Abraham and Heremans (1990).

only justified if the gains it permits from removing the "market failure" are not offset by high administrative or compliance costs, or by "government failure", i.e., by the poor quality from an EC-wide efficiency point of view, of supranational policy superseding the previous national ones.

The general consequence of observing the subsidiarity principle for taxation is that Member States should be left free to tax as they deem fit except when national measures exert a significant negative spill-over effect on other Member States such that the overall outcome is suboptimal for the Community in its entirety. More specifically, it signifies that the case for harmonizing through EC law Member States' general corporate tax regimes should rest on the fulfilment of three conditions:

- it first has to be demonstrated that differences between Member States in *effective* corporate tax rates (a concept defined below) are sizable and important in influencing the competitive position of national producers or the decisions of enterprises as to the jurisdiction in which they should locate their operations and how to finance them;
- second, the argument needs to be made that the tax cuts, which the enhanced mobility of the corporate tax base could possibly give rise to, are necessarily disadvantageous for the Community as a whole and can only be prevented by binding constraints at EC level;
- finally, Community rules for the uniform treatment of transnational profit flows or a single EC corporate tax regime should be efficient in terms of low administrative or compliance costs and should not themselves cause distortions in the Community-wide allocation of resources that are worse than those arising from the national tax differences they replace.

In the remainder of this Part we shall briefly examine the extent to which the current situation in the Community relative to corporate taxation meets these three conditions, bearing in mind that any conclusion must be seen as tentative since several central issues have scarcely been investigated empirically. In any event, as they are cumulative, it is clear from the outset that these conditions form a high hurdle to surmount for those advocating comprehensive harmonization of national corporate tax rules.

B. Locational non-neutrality and its importance

Any form of corporate taxation except lump sum is liable to induce economic distortions (non-neutralities) because it can give rise to decisions about investments that would not have been taken in the absence of taxes. These distortions stem from the bias corporate taxes can introduce in the relationship between an investment project's economic return and its after tax remunerativeness for the enterprise or the individual shareholder. This bias usually also has an international dimension: the size of the tax wedge for one and the same investment project is liable to vary between Member States on account of national differences in the level of the statutory tax rate and the definition of the taxable base, depending chiefly on the rules on depreciation, the treatment of trading losses, capital gains and foreign source income, and the valuation of stocks. In the presence of such differences, two sorts of inefficiencies reducing economic welfare of the Community as a whole can arise¹³. When two enterprises operating in the same Member State are subject to a different tax treatment because the parent company happens to be located in another Member State, so-called capital import neutrality (CIN) is violated: European resources may not be put to best use as a less efficient producer may carry out a project because an intrinsically more efficient company is taxed more heavily. So-called capital export neutrality (CEN) is violated when the choice of Member State in which to invest is influenced by company tax rules. If a firm would prefer to invest in Member State A rather than in Member State B but after taking account of differences in corporate tax pressure it plumped for investment in B, a Community welfare loss would result since production does not occur at the lowest cost prior to taxes.

Evidently, both CIN and CEN would be respected with the introduction of a single European corporate tax regime. If the Community were to adopt a uniform treatment of transnational profit flows, either CIN or CEN could be attained. CIN would obtain when foreign subsidiaries' profits were exempted from taxes in the country of the parent company; alternatively, CEN would hold following the application of the pure residence principle referred to in Part II, providing for the consolidation of a multinational firm's EC-wide profits. Which sort of neutrality should be striven for most is not clear.

¹³ Keen (1990) asserts full neutrality can be reconciled with different national statutory tax rates by applying the so-called "net equity" method to parent and foreign subsidiary companies.

Table 1

Weighted average of required pre-tax rates of return necessary to earn a 5% post-tax

Investment in	Investment from													
	B	Dk	F	WG	G	Ire	I	Lux	Nl	P	S	UK	Jap	USA
B	5.83	6.34	6.53	6.36	6.36	7.17	7.24	6.56	6.71	6.71	6.66	6.61	6.78	6.66
Dk	8.35	7.02	7.24	7.64	9.36	7.84	9.42	7.53	7.38	8.01	7.96	7.28	7.83	7.63
F	6.26	5.67	5.75	5.69	6.75	6.81	7.09	6.03	6.17	6.59	6.32	6.08	6.68	6.12
WG	9.07	8.63	8.92	8.86	8.66	9.23	1.03	8.92	9.12	8.21	9.06	8.51	8.00	8.15
G	6.69	7.51	7.73	6.46	5.55	8.52	7.27	7.77	7.41	7.95	7.89	7.82	7.73	7.89
Ire	4.68	4.53	4.64	4.54	4.57	5.08	4.53	4.67	4.77	4.85	4.74	4.71	4.91	4.74
I	6.30	6.07	6.24	6.92	6.52	6.87	5.60	6.28	5.91	6.42	6.38	5.97	6.26	6.02
Lux	6.70	6.55	6.38	6.44	6.69	6.98	7.72	6.19	6.43	7.05	6.50	6.45	7.18	6.49
Nl	6.28	7.03	6.73	6.27	6.47	6.52	6.74	6.09	6.11	7.58	6.30	6.25	7.64	6.30
P	6.36	6.00	6.28	6.11	6.13	6.87	7.04	6.30	6.43	6.59	6.30	6.25	6.40	6.39
S	6.86	6.28	6.48	6.30	6.88	7.75	7.68	6.49	6.63	7.00	6.10	6.54	7.64	7.20
UK	5.71	7.24	6.11	5.91	6.64	6.60	6.93	5.63	5.75	7.02	6.20	6.12	7.83	6.35
Jap	8.38	7.59	7.85	7.61	8.43	8.55	9.08	8.68	8.01	8.87	7.96	7.90	8.24	7.96
USA	6.55	6.54	6.02	6.30	7.20	6.59	6.96	6.04	6.17	7.59	7.54	6.08	7.06	5.93

Table 2

Required pre-tax rates of return

	Own Country	Investing in:	Investing from:	Standard Deviation in:	Standard Deviation from:
Belgium	5.83	6.67	6.78	0.34	1.12
Denmark	7.02	7.96	6.61	0.70	0.95
France	5.75	6.33	6.70	0.43	1.00
Germany	8.86	8.83	6.35	0.55	0.98
Greece	5.55	7.59	6.97	0.73	1.20
Ireland	5.08	4.68	7.41	0.15	1.02
Italy	5.60	6.32	7.54	0.34	1.42
Luxembourg	6.19	6.74	6.69	0.39	1.13
Netherlands	6.11	6.63	6.68	0.49	1.03
Portugal	6.59	6.37	7.22	0.27	0.95
Spain	6.10	6.90	6.91	0.53	1.05
UK	6.12	6.46	6.65	0.62	0.94
Japan	8.24	8.22	7.07	0.44	0.86
USA	5.93	6.67	6.76	0.55	0.92
Average of column	6.35	6.88	6.88	0.47	1.04

Table 2 summarises the information Table 1 yields. Its first column gives the pre-corporate tax rate of return by a company investing at home; the second shows the arithmetic means of the p-values companies from the other thirteen countries face in investing in a particular country; the third column lists the average faced by a company from a particular country when investing in the other thirteen countries. Columns four and five report the standard deviations from the means given in columns two and three. The smaller the figure in column four, the better does the international corporate tax treatment in that country approach *capital import neutrality*. The same remark applies to column five as regards *capital export neutrality*.

cut. This question is an empirical one as it is contingent on whether the differences in efficiency between competing firms are larger than between countries in their capacity as production location.

King and Fullerton (1984) have devised an appropriate method to compute the size of corporate tax wedges. It permits to calculate what the pre-tax rate of return on an investment project needs to be to provide a predetermined return after tax. Devereux and Pearson (1989) have applied the King-Fullerton methodology to examine the differences in so-called *effective* tax rates with respect to transnational investment inside the EC (the US and Japan being included as well). The authors summarize the results of their computations for the manufacturing sector by means of two tables, reproduced below, reporting weighted averages of required pre-tax rates of return necessary to earn a 5 per cent post-corporate tax return. Table 1 is 14 x 14 matrix comprising all combinations of source (subsidiary) and resident (parent) countries¹⁴. For instance, the 6.34 of the first row, second column means that to earn a 5 per cent after tax return an investment by a Danish firm in Belgium through a wholly owned subsidiary needs to fetch a 6.34 per cent pre-tax return.

Table 2 presents the information contained in Table 1 in a more compact way. Its standard deviation columns show that the present corporate tax regime in the Community respects neither CIN nor CEN, the former being more closely approximated than the latter. Today's corporate tax situation relative to foreign direct investment is thus a potential source of welfare-reducing inefficiencies, a finding borne out by the calculations in de la Fuente and Gardner (1990)¹⁵. The first part of the first condition set by the application of the subsidiarity principle appears therefore to be fulfilled.

However, further analysis of King-Fullerton tax wedges brings out a number of interesting features. First, an important part (more than one

14 The weights used are thought to reflect actual investment patterns in Europe: 50 per cent equipment, 15 per cent commercial buildings, 35 per cent industrial buildings; 70 per cent of investment is financed (exclusively through the parent company) by retained earnings, 25 per cent by debt and 5 per cent by new equity. Inflation, an important determinant of the size of the tax wedge, was set at zero.

15 This statement needs, however, to be accompanied by the general caveat following from the theory of the second best: in the presence of a variety of distortions, removing one does not necessarily augment economic welfare. Additionally, it should be remembered that taxes that look formally identical may diverge in practice. Differences in tax enforcement can also be a source of de facto unequal fiscal pressure.

third) of the observed non-neutrality is caused by the levying of withholding taxes (whose abolition was decided in July 1990). Second, a *partial* harmonization of Member States' general corporate tax regime – such as harmonization of the rates or some aspects of the base – would not be worth undertaking since it does very little, if anything, to bring nearer cross-border neutrality. Third, and perhaps most noteworthy in the present context, there exist significant corporate tax distortions within one and the same country. The tax wedge on an identical investment project can differ more within one Member State – for instance depending on the manner in which the project is financed – than between Member States. This finding impairs the case for EC corporate tax harmonization because it raises the question why, if countries are apparently capable of living with them inside their own borders, company tax distortions are intolerable in EMU.

It was stated at the beginning of part III that the application of the subsidiarity principle not only requires the demonstration that current effective tax rates vary across the Community. It also needs to be shown that firms in their decision where to locate their business respond strongly to the absence of CEN, or that intrinsically less efficient foreign firms undertake domestic investments for want of CIN.

As it proves relatively most violated, it is logical to focus on CEN and raise the question of its consequence. The answer is bound to be brief since at present systematic empirical analysis to this effect as regards the Community is not available. The evidence on the US (see, e.g., Wheaton (1983), Bartik (1985) and Papke (1989)), where admittedly tax differentials between States are clearly smaller than in the EC but where the tax elasticity of investment flows is bound to be higher in the absence of linguistic and cultural barriers, suggests that varying corporate fiscal pressure is by no means a major factor affecting location decisions. Above all wage rates and skills, local market growth, the presence of raw materials, telecom, transport and educational infrastructure determine the implantation of an enterprise. A country's general corporate tax regime seems to play a key role in influencing the mode of financing of a project (debt, retained earnings, or equity; finance raised by subsidiary or parent), but its importance for the choice of physical location is likely to be minor, even upon the completion of the internal market. In this context, a common misunderstanding needs to be dispelled: the capital movements liberalization ensuing from the 1992 programme does not concern foreign direct investment: barriers to the latter were removed in the early sixties. Consequently, the completion of the internal market will

raise cross-border investment only indirectly (though probably importantly so).

C. Tax competition?

Suppose that, notwithstanding the dearth of evidence, governments were able to make their country more attractive for inward investment by lowering the net fiscal burden, i.e., reducing the effective tax rate while keeping public services intact, or that Member States could provide their domestically incorporated firms with a competitive edge vis-à-vis foreign enterprises by cutting effective corporate taxes. Under these circumstances, a fiscal competition process could not be ruled out. Failing collective action by way of voluntary coordination or binding constraints set in common, Member States could end up with a lower corporate tax pressure than each would have wished in a context of internationally less mobile enterprises, vindicating the fears of those who currently warn against the danger of a competitive tax erosion process¹⁶.

However, several arguments can be advanced that call into question the likelihood of an eruption of cut-throat competition even if firms displayed a high sensitivity to the net fiscal burden. First of all, the incentives to engage in corporate tax cuts are not clear in today's situation as their effectiveness depends largely on how other Member States treat foreign source income. For example, lowering the net fiscal burden with a view to obtaining more direct investment from other Member States is futile when the latter operate a residence-based tax regime. Likewise, tax cuts by residence countries are also ineffective when the source country levies a high corporate tax. Second, the knowledge that other Member States may follow suit, thus undoing the initial advantage, could act as an important deterrent to starting and continuing the downward spiral. Third, even though corporate tax revenue is relatively unimportant – corporate taxes represent in the EC on average 2,8 per cent of GDP and 7,1 per cent of total tax revenue – such that a large reduction would not have large *direct* budgetary consequences, the *indirect* budgetary impact could be considerable as it puts downward pressure on personal income tax rates in order to

¹⁶ Adherents to the public choice school of thought may not see this as a negative outcome. They stress the importance of mobility of the tax base as a prime instrument to keep the national Leviathans in check.

reduce incentives facing taxpayers to shelter personal income in the corporate sector¹⁷.

From a macroeconomic point of view, one might even welcome the fact that corporate taxes are a significant determinant of a country as a business location. As a result of the completion of the internal market and the introduction of a single currency, many of the traditional policy instruments for coping with economic shocks will no longer be at the disposal of the Member States. In order to avoid the risk of the Community's economic system becoming "overdetermined" in EMU, countries' general budgetary autonomy, including taxation, should remain as unfettered as possible. As corporate tax modifications influence a country's "wage-rental" ratio, they may be very useful in promoting necessary adjustments in factor markets, much like wage or social security policies.

D. Potential economic drawbacks of a uniform tax regime

The economic advantages of establishing a single European corporate tax regime are clear: it would ensure locational neutrality and the avoidance of tax competition, and would render a comparative analysis of alternative business locations simpler and more transparent. Apart from the cost this implies in terms of abandoning policy autonomy, a comprehensive harmonization of corporate tax regimes in the Community may also exhibit, however, some potential economic dangers. A first concern is that the common regime's tax wedges are not necessarily less distorting than those currently affecting domestic investment in the various Member States. A single European corporate tax regime should not simply mirror what present national rules have broadly in common; its chief aim should be to keep induced economic inefficiencies to a minimum. Secondly, so long as the unanimity condition governs EC decision-making with respect to fiscal matters a very strong degree of rigidity is imparted to a common corporate tax regime once it has been adopted. If non-EC countries were to introduce radical reforms, such as the cash flow corporate tax, and they were to prove a success, the EC might have problems in following their example¹⁸.

17 Tanzi and Bovenberg (1989) state that a common trend of recent tax reforms has been to bring the marginal tax rate on personal income taxes more in line with the basis corporate income tax rate.

18 Had the 1975 proposal, setting a minimum of 45% and a maximum of 55% for the tax rates been adopted before, say, 1983, it is likely, given the unanimity requirement, that none of the Member States would have been able to bring its corporate tax rate below 45%, which several have done unilaterally since 1985, partly in response to occurrences in the rest of the world.

IV. Conclusion

The above considerations suggest that on the basis of the preconditions laid down by the subsidiarity principle, a *comprehensive* corporate tax harmonization is *in the present circumstances* rather hard to uphold. Member States may therefore be reluctant for both political and economic efficiency reasons to adopt far-reaching harmonization proposals. Paradoxically, however, government revenue, and in particular interjurisdictional equity concerns, may prompt them to do so, as was explained in Part II.

A "federal" remark on the long-term horizon brings this article to a close. Mature federations in the OECD (like Switzerland, Canada or the U.S.) show that an EMU is capable of functioning satisfactorily with a significant degree of fiscal diversity. But, in virtually all of them, the federal government plays a dominant role as regards company taxation, receiving half or more of total corporate tax proceeds.

In keeping with the open-ended nature of economic union, further progress in the economic interwovenness of Member States may sooner or later set the stage for predatory tax competition, calling for additional steps to a single European corporate tax regime. At that stage, corporate taxes could become a suitable candidate for the Community's own resources, which need to be extended anyway to enable the execution of the widening economic policy responsibilities of the Community in the context of EMU. One could even argue that corporate taxes would qualify better than VAT, as the common rather than the national market is the natural habitat for an increasing part of EC companies, more so than for individual consumers.

In a bid to couple the benefits of basic uniformity with the advantages of tax diversity, our personal preference would go to a regime where the definition of the tax base was identical across the Community and where the profits of enterprises operating in more than one Member State were distributed by way of a common, simple and easily verifiable apportionment formula. The Community would impose a minimum rate of, say, 20 per cent on EC-wide taxable income; individual Member States would be free to levy a national surcharge on that part of income allotted to them by the distribution key. Apart from being defensible in terms of interjurisdictional equity and efficiency, such a regime would also bring a managerial boon for enterprises since the whole of their EC activities could be reported by means of a single balance sheet.

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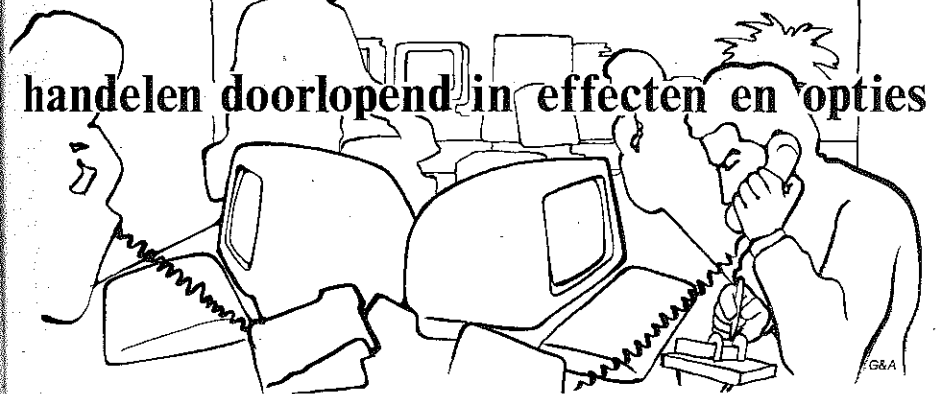
Samenvatting

De verdeling van bevoegdheden inzake vennootschapsbelasting in de Europese Gemeenschap

De bedoeling van dit artikel is de belangrijkste economische vragen van nabij te bekijken waarop moet worden ingegaan in de discussie omtrent de harmonisering van de belasting op ondernemingen buiten de financiële sector. De vereisten inzake vennootschapsbelasting voortvloeiend uit de voltooiing van de interne markt worden eerst onderzocht. Hier wordt de idee onderbouwd dat waarschijnlijk een grotere supranationale rol nodig is dan oorspronkelijk gedacht. Vervolgens worden de operationele gevolgen van het subsidiariteitsbeginsel verkend voor de vennootschapsbelasting in EMU. Een algehele harmonisering blijkt op dit ogenblik niet gemakkelijk te verdedigen. In het besluit wordt beknopt geschetst hoe, indien de noodzaak zich in de toekomst duidelijk zou stellen, een gepast gemeenschappelijk Europees vennootschapsbelastingregime er zou kunnen uitzien.

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