TAX HARMONISATION IN THE EU: PERSPECTIVES FOR MULTINATIONAL COMPANIES AND MEMBER STATES

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This article is devoted to a contemporary problem of the corporate tax coordination in the European Union. Although tax rates have declined, revenues collected from corporate taxation are fairly stable. The ambiguous results from economic tax theory and the institutional settings have constrained strong EU policy action in the area of tax competition. There are welfare gains to be expected from tax coordination. Following its 2001 Communication, the European Commission is currently working with Member States on the definition of a common consolidated corporate tax base for European companies.

Key words: European Union, multinational companies, corporate taxation, tax coordination.

1. Introduction.

In the global economy the taxation of multinational companies has become a key challenge for tax designers. They are confronted with a two-fold reality. On the one hand, organization of the tax system has to secure the capacity for sovereign jurisdictions to levy taxes at rates and on bases determined by them, though possibly coordinated through a network of bilateral tax treaties or multilateral tax arrangements. On the other hand, multinational enterprises (MNEs), willing to settle branches or subsidiaries all over the world, complain against the complexity and diversity of tax systems, and simultaneously develop a capacity to reduce their tax liabilities through the more extensive use of sophisticated tax planning strategies. And indeed the present organization of international taxation, primarily based on a model proposed by the OECD and thereafter called Separate Accounting (SA), provides the various jurisdictions with, apparently, the power to make sovereign decisions on taxation, but, however, it has at least two undesirable outcomes: first, it forces the companies willing to operate in many jurisdictions to learn as many tax codes, and second, it allows those companies to undertake various tax shifting strategies in order to minimize their tax liabilities.

Those undesirable outcomes are especially present in the European Union. Therefore in 2001 the European Commission has proposed to consolidate the corporate tax base as a solution to these problems and a step forward in the functioning of the Internal Market. The basic idea is to create the common consolidated corporate tax base (CCCTB) in order to enhance competitiveness, boost growth and promote the creation of jobs in the EU. The urgency of changes in the taxation system concerning multinational companies creates a great interest of the scientists to this theme.

A great contribution into the investigation of taxation problems in the European Union is made by the eminent scientists and economists such as: A. Horst, L. Bettendorf, H. Rojas-Romagosa, F. Zipfel, D. Franco, G. Nicodeme, M. Gerardy, W. Eggert, A. Haufler and others. Inspite of them the author investigates the peculiarities of MNEs’ taxation, particularly its development trends in the European Union, perspectives for multinational companies and the major challenges for tax authorities. The goal of the research is to analyze the prospects of the CCCTB for multinational enterprises and Member States of the EU.

Methods of scientific research implied in the article are such as: complex and system, graphical and statistical analyses, comparison method.


Statutory corporate tax rates in Europe have been falling since the early 1980’s. The average rate in the EU-15 has dropped from slightly below 50% in 1985 to about 30% in 2006. This decline has fuelled fears of a race-to-the-bottom due to tax competition, a process in which governments successively undercut each others tax rates in order to attract mobile tax bases. This could ultimately erode the corporate tax revenues and impose a threat to the financing of the European welfare states. Such fears for tax competition have been reinforced recently by the accession of ten new Member States. Indeed, these countries apply corporate tax rates that have gradually reached levels of more than 10%-points lower than in the EU-15 countries. Despite cuts in corporate tax rates, however, corporate tax revenues have maintained remarkably stable over the past decades – albeit heavily influenced by the economic cycle. The corporate tax revenues expressed as a percentage of the GDP have, in fact, increased from about 2% in 1980 to close to 3% in 2004. The discrepancy between falling tax rates and increasing tax revenues is generally seen as the consequence of a widening of the corporate tax bases.
Since the second half of the 1990s, corporate income tax rates in Europe have been cut forcefully. The tendency has continued also in 2006, as shown by a 0.8 percentage point drop in the EU-27 average. The cut was stronger in the Euro area, where rates remain nevertheless significantly higher. In 2007 the average corporate tax rate in the EU-27 was 24.5% (Fig. 1), while in the Euro area, comprising mostly old Member States, the average is four percentage points higher [7, p.34].

Amongst countries cutting the corporate tax rate it is worth mentioning Bulgaria which, upon accession to the EU, cut the tax rate by one third and thus became the Union’s second country after Cyprus to levy a 10 % rate. Other countries cutting their corporate income tax rate substantially include the Netherlands (down 4.1 points to 25.5 %), Greece (minus four points to 25 %), Spain (minus 2. points to 32.5 %) and Slovenia (down two points to 23 %). Belgium, which levies a relatively high rate (34 %), has not cut its rate, but has introduced an allowance for notional interests (also known as allowance for corporate equity), which, compared to traditional tax systems, leads to significantly lighter taxation [7, p.7].

Other interesting developments, affecting not only corporate taxation, are the introduction of flat rate tax systems in several countries, e.g. Slovakia, which levies a 19 % flat rate tax on personal income, corporate income and consumption spending.

Although the downward trend has been quite general, corporate tax rates still vary substantially within the Union.

3. The background of tax harmonisation in the EU

The issue of tax harmonisation is nearly as old as the process of European integration. Confined initially to indirect taxation (over time, comprehensive harmonisation of value added tax has been achieved), direct taxes – in particular company taxation in the form of corporate income tax – have also appeared on the Member States’ fiscal agenda. The European Commission has launched several platforms for comprehensive harmonisation solutions in the past. Initial moves for more extensive harmonisation of company taxation were evident as early as 1962 with the Neumark Report. One proposal was for a uniform system of company taxation with split rates, providing for a minimum 15% rate of taxation on distributed profits.

Over the years the harmonisation of company taxation fluctuated in scope, i.e. in its range. In each case, the European Commission adopted a different tack. Up to 1990, moves towards harmonisation always sought to standardise corporate income tax almost entirely. Following the Guidelines on Company
Taxation (1990) and the Ruding Report (1992), which proposed a minimum EU-wide corporate tax rate of 30% [8], the focus shifted onto individual structural elements and the Commission abandoned its policy of comprehensive harmonisation. One outcome of this approach was the triple package consisting of the merger and parent-subsidiary Directives and the Arbitration Convention in which legally binding agreements on corporate taxation were set out for the first time.

The European Commission has reverted since 2001 to its original concept of comprehensive harmonisation. With presentation of the Bolkestein Report and two related Communications in 2001, the Commission once again gave priority to a comprehensive solution. But the guiding principle was always to remove obstacles to EU-wide economic activity. Originally, four models were discussed in the Bolkestein Report: home state taxation, an optional common consolidated tax base, a mandatory harmonised tax base, and the model of a European Union company income tax. Direct comparison of these models is possible only on a limited scale as they all represent a different harmonisation status, i.e. the individual Member States’ tax sovereignty is restricted in differing degrees by each model. Since 2001 – with presentation of the Communication COM (2001)58211 directly following the Bolkestein Report – the European Commission has pursued the CCCTB model [4]. Specific preliminary work began late in 2004 on a proposal for a Directive, which is scheduled for presentation by the end of 2008.

4. The role of CCCTB for multinational companies and EU Member States

Companies operating across the internal market are hampered by tax obstacles such as high compliance costs for cross-border operations, transfer pricing and the lack of cross-border loss compensation. These obstacles are inherent in the current system of Separate Accounting, where the corporate income of foreign subsidiaries of multinational enterprises is treated separately for tax purposes. Multinational companies use three main groups of tax planning strategies [2]:

- allocation and investment decisions;
- transfer pricing;
- financial detour strategies.

All these strategies could be used by MNEs if either tax rates or tax bases are not fully harmonised between participating jurisdictions.

The European Commission has proposed to replace the current system of taxation of multinational companies by the taxation of a consolidated base, computed at the level of all the European entities of a multinational enterprise, and then distributed for taxation purposes among the various jurisdictions in which these entities operate, according to pre-established criteria [6]. The main idea of the CCCTB concept is to calculate the profits or losses of a corporate group that maintains subsidiaries and/or permanent establishments in more than one Member State on the basis of standardised rules. This would include the possibility of offsetting profits and losses to produce a consolidated overall result. The total profit calculated this way would then have to be allocated by means of an apportionment system (i.e. with reference to certain key variables) to the Member States in which the group is active.

The Member States could then apply their national tax rates to this allocation in order to calculate the tax due. Nominal tax rates would thus be the sole determinant of the tax liability. This approach replaces the hybrid system of source and residence principle described above with the source principle. Equally, the issue of tax credit method or exemption method no longer arises as profits and losses are combined into an overall result.

Finally, tax competition is intensified with common consolidated base taxation. Relatively open economies and those with low tax rates have stronger incentives to reduce their tax rate with a consolidated tax base than with Separate Accounting. Would formula apportionment be based on an internationally mobile production factor, like capital, tax competition might even result in a race to the bottom: for several Member States it is optimal to leave their proportioned share of the common tax base untaxed. Would apportionment be based on an internationally less mobile factor, like employment, tax rates are likely to be cut, but not to the bottom. In sum, the advantages of replacing Separate Accounting by consolidation turn out to be small for the EU as a whole [1].

Feld notes that there is evidence that fiscal competition induces higher efficiency in the provision of public goods and better economic performance. For these reasons he does not advocate tax coordination. However, one cannot assume that the budgetary problems created by tax competition will necessarily be modest also in the future. Primary public expenditure in the EU-15 has been about stable over the last 20 years at about 45 % of GDP. Without reforms, ageing would increase this ratio by about 5 % by the year 2040. Even assuming that spending will be curtailed by new reforms, it is very likely that there will be no much room to absorb sizeable revenue losses [3]. This implies that revenue losses in the taxes affected by competition might either increase deficits or require revenue increases in other
areas, such as indirect taxation.

- **New tax planning possibilities for MNEs** is caused by the formula apportionment. Tax planning is the ability of companies to minimise their tax obligations by shifting profits or economic activity across jurisdictions. Transfer pricing, the most common means of tax planning in the current system of separate accounting, will become meaningless with the consolidation of the tax base. With formula apportionment, the share of the tax base apportioned to each jurisdiction can be influenced by shifting economic activity from one jurisdiction to another. Even though real economic activity, like production or FDI, can be shifted less easily than paper profits to other Member States, so its economic impact is large.

- **Uneven playing field** is introduced if the common tax base is optional or if not all enterprises are allowed to participate. It results in a different treatment of MNEs and domestic enterprises, if the latter are excluded from the common base and still have to apply to the base of their home country. This creates an uneven playing field between enterprises and leads to a reduction of GDP, employment and welfare.

The gains from a reduction in compliance costs and the elimination of transfer pricing are offset by the efficiency losses from reallocation. Corporate tax revenues decline on average by about 2% due to the expansion of enterprises in Member States with low tax rates and/or narrow tax bases. Alternative means of financing have to be found in order to balance the government budget. The resulting gains in GDP and welfare are small, respectively 0.05% and 0.01% of GDP, which shows that the distortions introduced by the CCCTB offset the gains from consolidation. Some Member States gain, where others lose, from the consolidation and apportionment of the tax base.

1. Multinational companies in most Member States gain from consolidation and from the alternative route for tax planning (this gives them a competitive advantage over domestic enterprises, which do not benefit from tax base consolidation).

2. Governments in countries with a broad tax base lose from consolidation if the common tax base is defined at the current EU average. A broader definition of the tax base generates more corporate tax revenues, but distorts investments.

3. Welfare improves in Member States with large shares of multinational enterprises, below-average tax rates and/or broader-than-average tax bases. A low tax rate matters, because it makes Member States relatively attractive for multinationals. A broad tax base matters, because the common base is less distortive. And the openness of countries matter, because these countries are most sensitive to corporate tax reforms.

4. Consolidation intensifies competition in tax rates, which reflects the benefits from having a low tax rate. The switch by multinationals from favorable profit shifting (under separate accounting) to attracting production (with formula apportionment) implies that the gains from unilateral reductions in the tax rate increase. Simulations show that consolidation implies an optimal reduction in tax rates by individual Member States of 10 to 20 percentage points [2].

The final item is the question of the tax load on the shareholder in a corporation. This comes under the remit of income tax and is thus subject to policymaking by the individual Member States. Particularly important in this respect is how corporate income tax is integrated into income tax in general. Regulations on this differ from one Member State to the next. This issue – like the rate of taxation – will not be determined by a common set of rules within the framework of the CCCTB. Shareholders in a corporation make their capital available to that corporation and expect an adequate return. At big public companies, investment decisions may split into actual investment projects and the tax burden for the shareholders. But the situation is different for small and medium-sized businesses [4].

The largest distortions are introduced if apportionment is based on a single production factor, e.g. on employment or on capital. The incentives for reallocation are minimised if the apportionment formula resembles the distribution of corporate income of MNEs and is based on activities which cannot easily be affected by companies. However, even in this best case, formula apportionment generates an efficiency loss for the European Union. The reason why formula apportionment and its design matters a lot, is the large differences in tax rates in the European Union. These tax differentials trigger tax planning, by reallocation of production or sales to low-tax countries. This tax planning can be tempered, but not eliminated by a proper choice of the apportionment formula. Only the harmonisation of tax rates can undo the incentives for reallocation.

Ideally, designing a common consolidated corporate tax base offers the possibility to rethink about the way to tax multinational companies. It is important that the European Union reflects on sound economic principles such as neutrality across investors and sources of financing, equity across enterprises, simplicity, enforceability, stability of revenues. There is no obvious solution on how to alleviate all distortions and governments are faced with trade-offs in multiple dimensions. It is also necessary to examine
whether the absence of bilateral tax treaties between some Member States creates double taxation problems and whether the current systems discriminate between domestic and non-resident investors when dividends are paid [5]. This could potentially lead to an EU model tax convention or an EU multilateral treaty.

5. Conclusions

Policy actions in corporate taxation at the EU level are relatively infrequent. This reflects both an institutional design that promotes subsidiarity in tax matters and rather ambiguous results on both the existence and the likely effects of corporate tax competition in the European Union. The main benefits from replacing Separate Accounting by a consolidated corporate income tax base are the elimination of paper profit shifting, the introduction of automatic loss compensation for cross-border activities and the reduction of compliance costs. However, as consolidation introduces incentives for reallocation, the largest gains are only achieved when new distortions are minimised. First, the tax base should be defined the same for all companies, either domestic or multinational and irrespective of its origin. The participating countries should treat all enterprises equally by adopting a single, compulsory system. In this way, uneven competition between enterprises is reduced, such that most of the consolidation benefits are secured. Second, the apportionment formula is another crucial choice of the consolidation system. The design of the formula should limit the scope for harmful tax planning by MNEs. The welfare losses are the largest when employment gets a large weight in the formula, since the distorting effects of tax rate differentials are enforced by wage differentials in this case. Moreover, the strong reallocation effects also explain that tax competition is most fierce in this case. Both tax planning by multinational companies and tax competition by governments can be overcome by complementing consolidation with harmonisation of the tax rates. The welfare effects of consolidation will be unevenly distributed between Member States, given the diversity in the current systems of corporate income taxes and induced by the heterogeneous effects of consolidation and formula apportionment. When the largest distortions disappear the harmonisation is better for average welfare in the EU than the current situation with large tax differentials, but it does not exclude that alternative scenario’s allowing for variation in tax rates might be even better. These topics should not shadow the fact that, currently, the most important issue is to make the works on a common consolidated tax base a success.

References