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Europeanizing Corporate Taxation to Regain National Tax Policy Autonomy

As a reaction to the German corporate tax reform, the English and Dutch governments also announced tax reductions. This demonstrates once again that tax competition is a very serious constraint on national tax policies. All over Europe, politicians argue that tax competition compels them to reduce tax rates to maintain their locational advantages for international investment. While governments thus admit that they are pressured to lower taxes because of tax competition they insist, on the other hand, upon maintaining their national sovereignty in tax policy matters. Arguing that tax sovereignty is an essential part of their statehood, member states of the European Union have, in the past, always refuted any attempts to even partially harmonise direct taxes in Europe.

Member states' insistence on tax sovereignty is counter-productive because, although they formally have the exclusive legal competence over tax policy, in fact, their actual capacity to design their tax systems according to national political preferences has long been taken from them. Under conditions of an open economy, national political autonomy to organize a socially fair and efficient taxation system can only be regained if the states do not simply adapt themselves to tax competition individually, but by regulating tax competition collectively on the European level. To achieve this, it is necessary to harmonize certain aspects of European tax policy. A Europeanization of corporate taxation does not contradict national tax policy autonomy. To the contrary, it is a prerequisite for real national tax sovereignty.

The Structure of Tax Competition and its Harmful Consequences

Tax competition results, if states use tax instruments strategically to attract enterprises, direct investment, or other economic assets. Competition is driven by enterprises reacting to tax advantages offered by a jurisdiction. However, taxes are only one of many factors relevant for locational decisions of enterprises. It is known that factors such as market access, infrastructure, labor costs and the educational level have a stronger influence on the choice of location than taxes. A company does not relocate only because of tax burdens.

Unfortunately that does not mean that tax competition can be neglected as a problem. Enterprises do not have to move their "real" production sites abroad in order to save taxes. The present structure of international and European tax law allows transnational enterprises to book their losses in "high tax" countries and their profits in "low tax" countries or tax havens. This type of tax optimization can be achieved by various techniques, such as the (legal) manipulation of internal transfer pricing for preliminary or intermediate products or the skillful choice of finan-

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cial structures. Instead of moving the complete company, it suffices to open a so called "mailbox company" in a tax haven or "low tax" country and to allocate profits to this subsidiary using these techniques. Thus, in the tax context, states compete primarily for the assignment of profits, without the need for the associated real economic activity to be relocated. Because enterprises are not forced to relocate to achieve tax advantages, competition for real direct investment is only a secondary consideration.

Even if tax competition is primarily about shifting paper profits and losses, it does have a real effect. In all European states, nominal tax rates – which are decisive for enterprises in their decision to allocate profits – have been reduced over the last 15 to 20 years. At the same time the tax base has been broadened, so that only rather small revenue losses can observed. Far more important than revenue losses are the effects of tax competition on the structure of national tax systems. Broadening the tax base has lead to a reduction of the tax burden on highly profitable companies, while less profitable or "new" capital is more heavily taxed. Also, a shift of the tax burden on labor and towards indirect taxation can be observed. In practice, this means that large multinational enterprises enjoy tax relieves, whereas the burden on medium and small companies and employees increases.

The main problem, which has hardly played a role in political debates, however, is that tax competition can undermine the progression of personal income taxation. In order to make it impossible for taxpayers to "hide" their personal income in corporations and thus to enjoy a lower tax rate, tax policy makers are usually eager to keep the gap between top personal income tax rates and enterprise tax rates as small as possible (backstop function of the corporation tax). The reduction of enterprise taxes, brought about by tax competition, thus creates pressure on the progressiveness of personal income tax rates. Tax competition makes it much more difficult for states to keep a progressive income tax system that encourages redistribution. Thus, tax competition favors those who demand a reduction of enterprise or personal taxes for material or ideological reasons. For everyone else there are allegedly no other policy options.

European Tax Initiatives

This development has rather been encouraged than successfully corrected by the European Union. Within the framework of its internal market program, the EU has removed the barriers to the free movement of goods, services and capital. The so called removal of tax borders – as it has been achieved with indirect taxes through various harmonization measures since the 1960's – is part of this liberalization. In the area of direct taxes, especially the European Court of Justice has secured an implementation of "discrimination-free" tax laws. In recent years the Court has declared various national defense measures, such as the so-called "Controlled Foreign Corporation" legislation, which were supposed to make it more difficult for enterprises to shift profits offshore, to be (at least partially) incompatible with European Law. Thus, the EU has contributed to the intensification of tax competition.

Despite the negative consequences for member states' tax policies it has not yet been possible to effectively regulate tax competition at the European level. This is so because by no means are all states equally disadvantaged by tax competition. Indeed, small states can "win" the competition because in relation to their own relatively small inland tax base, they can attract a great deal of foreign tax base. The bottom line is that they can increase their tax revenue by reducing their rate of tax. In particular the new member states – encouraged by Ireland's example – look forward to the prospect of a successful "catching-up" in their economic development as a consequence of a consistent tax reduction policy. In consideration of the fact that in taxation matters only unanimous decisions can be taken, small states, and those opposing a European involvement in tax matters for ideological reasons such as Great Britain, can successfully block every attempt to even partially harmonize corporate taxation. In addition, since the 1990s, when the problem of tax competition became virulent, a positive evaluation of competition has become widely accepted. As long as it remains fair, the European Commission regards tax competition as being positive.

The single measure regulating corporate tax competition in the past was the so called "Code of Conduct against Harmful Tax Practices". States declare themselves ready to renounce on particular tax practices, which target foreign capital and tax base but do not grant the same favorable treatment to domestic enterprises. Even if the Commission refers to it in the implementation of European State Aid Policies, the Code is not legally binding. Besides, it allows states to reduce taxes whenever they want, as long as they do not discriminate between domestic and foreign investors.

For some time now, the Commission has been pursuing another project, which would partially harmonize tax policies. By 2008, it wants to present a directive for a "Common Consolidated Corporation Tax Base" (CCCTB). The objective is to increase tax transparency and to make cross-border investments easier. In addition, many states hope that a CCCTB can also restrict corporations' possibilities for shifting paper profits. Current international tax law works on the principle of "separate entity accounting", i. e. the various parts of a multinational enterprise are taxed separately as if they were completely independent units. Precisely this nationally separate taxation enables enterprises to use the above-mentioned possibilities of shifting paper profits and losses. Under a system of a CCCTB the total and consolidated profit of all parts of an enterprise would be calculated according to unified rules and then be divided among the different locations in which it operates according to a fixed formula. The formula may be based on factors such as wages, turnover, or capital value at each location. A common consolidated base with a division by "formula apportionment" could indeed help to limit the possibilities for shifting "paper profits", if the factors in the formula are good indicators of real economic activity. To formulate it pointedly, it would then no longer be enough to open a "mailbox company" in a low tax country in order to enjoy tax advantages. As long as the local firm had no or only very limited wages, turnover, or capital value, only a minimal part or none of the total profit would be apportioned to the respective country.

However, the present status of deliberations, which until now have only been undertaken on the administrative level in a working group of the Commission, let it appear quite likely that a CCCTB will only be optional. Accordingly, enterprises could choose, whether they are taxed on the basis of separate entity accounting or on a consolidated basis. This freedom of choice would not only mean that the goal of simplifying tax assessment could not be achieved, but it also makes it very likely that the objective of preventing profit shifting would be missed. In addition, the Commission has declared that under no circumstances would it dictate tax rates to member states. In our view, this is a serious problem, because the introduction of a CCCTB alone cannot effectively regulate European tax competition.

For a Compulsory Common Consolidated Tax Base with a Minimum Tax Rate

Nonetheless, the European efforts to introduce a CCCTB offer a good starting point for a more far-reaching reform of European corporate taxation. Such a reform would forestall unfair tax competition, enable member states to regain their lost political autonomy to organize efficient and socially just tax systems and contribute to European solidarity.

We therefore propose a compulsory unified CCCTB accompanied by the introduction of a minimum tax rate. A unified basis of tax assessment combined with formula apportionment can limit the possibilities of profits and loss shifting if it is properly designed. Our proposal is that the CCCTB should be divided among member states according to a dual apportionment scheme with micro- and macro-economic components. The major part of the entire tax base should be divided between those countries where the enterprise has a base according to the micro-economic values of total wages, capital and turnover at the respective location. Different complications appear when deciding on the exact weight of the three mentioned factors, so that no simple solution, which is completely free of any problems, exists. For this reason – as experiences in Canada, where formula apportionment is used to allocate the tax base among the Provinces show – it may be sensible to select weights for different economic sectors according to different criteria.

This micro-economic formula apportionment should be supplemented by a macro-economic component that is based on regional Gross Domestic Product (GDP). The part of the entire base that is split according to the macro-economic apportionment system is assigned to all EU member states, whether or not the enterprise is located there. The division should be such that the region with the lowest GDP per capita receives the largest portion of this part of the tax base. The macro-economic key would explicitly address the issue of regional development and European solidarity. The allocation through a macro-factor helps those states benefiting from the current status quo of tax competition and expecting to serve their economic development by lowering taxes. The macro-component could make it easier for these states to agree to the harmonized common tax base.

It is, however, essential to supplement the introduction of CCCTB with the introduction of a minimum tax rate. Pure profit shifting would be made more difficult by a CCCTB together with formula apportionment, but that would not spell the end of tax competition. If it were no longer possible for an enterprise to minimize its taxes through profit shifting, then the remaining tax rate differentials would increase the attractiveness of real relocations. Precisely because tax competition in a system with a harmonized consolidated tax base would no longer allow profit shifting, it would increase the competition for real investment. In order to at least constrain such real tax competition, it is essential to introduce a compulsory minimum tax rate. It is difficult to specify what the exact minimum tax rate would need to be because the appropriate level depends on the definition of the tax base. If it is very broad, the tax rate can be lower than with a narrow tax base. Assuming the common tax base would be as broad as the current average of national tax bases, a rate of 30 % including any possible local corporate taxes would be appropriate.

A CCCTB must be compulsory for all legal forms of enterprises. Otherwise the possibilities for tax competition would simply be extended. Not only would 27 member state tax systems be in competition with each other, but there would also be a 28th system.

More Tax Autonomy through European Regulation

We understand the current European debate on a common consolidated tax base as an indication that among some governments there is recognition that they – and with them the European Union – have a clear tax policy problem, which cannot be solved by simple *laissezfaire*. Particularly the decisions of the European Court of Justice, that make unilateral defensive measures against unfair tax competition impossible, show the need for rules that do not offend European law.

But first, member states have to give up the myth of national tax sovereignty. It is impossible to have an internal market without tax borders, and at the same time keep effective national control over the design of tax policy. Europeanization is the prerequisite for regaining control over tax policy. Only a European solution can reinstall a democratic organization of tax policy, because the realm of taxation is anything other than a political vacuum. To the contrary, tax policy is central to issues of justice and distribution and thus basic democratic and social standards.

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