Deadlocked European Tax Policy. Which Way Out of the Competition for the Lowest Taxes?

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The Hard Reality of Tax Competition

Why is there no uniform taxation of cross-border enterprises in the EU? Why do small and medium-sized businesses feel themselves at a disadvantage as compared to big companies and with regard to their opportunities for tax planning? Why is VAT constantly increasing for consumers? Why are corporate taxes constantly being reduced? And why does the top rate of income tax keep on falling in many EU member states? The answer to all these questions is relatively simple: tax competition between EU member states and with countries outside of the EU. Tax competition is, on the one hand, hard reality in the EU and exerts considerable pressure on national tax systems, while on the other hand it is used in a number of ways within many member states to make things as comfortable as possible for large corporations. In this way the discursive momentum of the debate on tax competition – which is closely linked with the rhetoric concerning locational competition[1] – is used to bring about tax cuts for corporate enterprises and the rich. Behind the highly technical tax policy debate, which is virtually impenetrable even for interested laypersons, interests are being served that have a decisive influence upon tax justice and the financing of welfare states.

The problems of international tax competition have long been known. Furthermore, in recent decades the perceptible consequences, particularly within the European Union, of increasing economic and political integration and the latest enlargement rounds have intensified dramatically. Although the European Commission has emphasized the need for action since the early 1960s, in 2008 once again an extensive initiative providing for the establishment of a Common Consolidated Corporate Tax Base (CCCTB) foundered. This failed attempt serves as the starting

1. That is, the competition among the member states to offer the most attractive industrial locations.

point for an FES research project on European corporate tax policy. The present analysis is related to this project, alongside a comprehensive experts' report (Rixen/Uhl 2007). Our evaluation of the respective interests and motives behind international tax competition builds upon the conclusions of this research project, in which a large number of tax experts from EU member states – from both academia and politics – participated.[2] These findings were supplemented by an analysis of the structural position of individual member states in terms of international tax competition. By this means we were able to systematize the respective interests in European tax policy and to point out the obstacles that stand in the way of harmonization of corporate taxation and how they might eventually be overcome. The focus of the analysis is on the socioeconomic factors that shape member states' perspectives and thereby influence their positions towards the coordination of national tax policies. We have made a conscious attempt to »translate« the highly technical tax debate into more accessible language.

The Dangerous Dynamics and Consequences of Tax Competition

Competition for investment, jobs, economic growth, and prosperity has intensified among the member states of the European Union (see also Kellermann/Zitzler 2007). This competition involves, among other things, tax systems, in pursuit of the logic of the lowest possible costs for enterprises – because in terms of this competition taxes are understood primarily as costs. In this perspective tax competition is in the first instance locational competition. In the competition for direct investment and production locations, states fear that they will be able to survive only by bringing their national corporate taxation in line with the falling trend. Empirical research indeed confirms the connection between corporate taxation and location decisions (Büttner/Ruf 2007; Oestreicher/Spengel 2003). However, one thing seems to be proven: taxes influence corporate decisions for a specific location only if conditions are otherwise similar. Consequently, enterprise relocations due to taxation have so far been limited.

Overall, international tax competition is more relevant in terms of financial accounting and tax administrations than for the location of real

2. All documents and other information can be found on the website of the tax project: http://www.fes.de/ipa/inhalt/unternehmenssteuer_e.htm.

assets. Internationally, nation states pursue a wide variety of taxation methods and tax strategies in an uncoordinated fashion. As a result, multinational companies are able to minimize their tax burden by adapting their corporate structure as it relates to taxation and by using legal »loopholes« in drafting contracts and accounting. Enterprises operating across borders engage in a kind of tax arbitrage by means of so-called »profit shifting« in their accounting. Profit shifting is possible, for example, through the manipulation of transfer prices in intra-company trade in primary and intermediate products. Another instrument of tax avoidance is adaptation of the financing structure. The issue of bogus intra-company credits makes it possible to avoid taxation because in different countries debt interest is deductible from tax liability to different extents (Weichenrieder 2007). Paper profits can in this way also be shifted to tax havens through the intermediation of holding and finance companies.

The primary effect of these tax avoidance strategies is the erosion of the tax base in countries with a highly developed (social) infrastructure and, consequently, a high tax burden. High-tax countries such as Germany are particularly affected by these tax avoidance methods and hemorrhage tax revenues as a result (Sinn 1997; Weichenrieder 2007).

The problematic consequences for tax policy consist in the transformation of the tax structure under the influence of competition, which seriously calls into question state sovereignty. States feel compelled to react to the behavior of enterprises. In order to be able to hold their ground in international competition as regards tax revenues and favorable location conditions, their corporate taxation policy follows the trend towards reducing tax rates and broadening tax bases (Ganghof/Genschel 2008; Rixen/Uhl 2007; Scharpf 1998). Since these tax cuts are financed by broadening the tax base, the net effect of revenue loss to central government is not as great as is often thought. More serious are the effects on the tax structure and so on burden sharing within a country: progressive income taxation comes under particular pressure because income tax and corporate tax are linked together by the legal room for maneuver offered by the drafting of contracts and the choice of legal form. The preservation of a progressive income tax with a corresponding top tax rate for high earners requires the maintenance of high corporate tax rates (Ganghof/Genschel 2008). If coherent income taxation is to be ensured low corporate taxes must be accompanied by a reduction in the personal income tax burden (the so-called »spillover« argument; Ganghof 2006) – the overall result is tax relief for higher earners and a corresponding

increase in the burden on other earners and consumers. The losers from tax competition are therefore middle and lower incomes, consumers and regionally-oriented small and medium-sized enterprises. As a result, tax competition, which mainly concerns corporate tax, has a subversive influence on the financial structure *within* welfare states and calls into question national traditions and intentions of tax equity (Kellermann/Rixen/Uhl 2007). Revenue-neutral reform to increase the attractiveness of a location therefore inevitably induces political conflicts over distribution as regards budget financing.

Deficiencies of the European Approach

The effects of tax competition are largely undisputed in the literature and in the political sphere. As an appropriate response to this, Europe-wide regulation of tax competition would represent a real alternative, even if it would not solve the problem of taxation with regard to third countries outside the EU. Among the arguments that can be marshaled in favor of European coordination of tax policy are efficient and neutral corporate taxation across Europe and the recovery of national scope of action with regard to fair income taxation. In this context for 2008 the European Commission announced the abovementioned draft directive on the creation of a Common Consolidated Corporate Tax Base (CCCTB). This CCCTB was to consist of three elements: (i) accounting standards, (ii) consolidation, and (iii) formula apportionment. According to the Commission's plans, individual enterprises would have the option of choosing between submitting to the CCCTB or to the existing national tax regime. A consolidated corporate tax base would offer the substantial advantage of enabling an internationally operating corporate group to be considered as a unit in regard to its business activities. As a result, automatic loss compensation would be possible in accordance with economic reality. Strategic manipulation of the tax balance sheet and the shifting of paper profits would thereby become obsolete and the distortion of corporate decision-making due to tax reasons would be avoided. A common European tax base would make it possible once more to link corporate taxation with an enterprise's real economic activity in a country. Taxes would be incurred where real profits are generated.

Two fundamental defects were noticed in the European Commission's CCCTB. On the one hand, it was argued that a binding tax base had to be introduced, because otherwise it would constitute just one more tax

system, alongside the 27 that already exist. As a result, this would not be a sustainable solution to the problems arising from the strategic tax avoidance practiced by multinational companies. On the other hand, such harmonization of the tax base would automatically have to be accompanied by a minimum corporate tax rate since in all probability tax competition would otherwise take the form of tax rates becoming involved in an intensified race to the bottom, due to the heightened transparency. Only a consolidated, mandatory corporate tax base with a minimum tax rate can provide a lasting solution to the problem of harmful European tax competition without triggering new distortions of competition for enterprises in the Single Market (Rixen/Uhl 2007).

So far, even »harmless« or enterprise-friendly plans such as the European Commission's CCCTB have foundered on the lack of consensus among the actors, in this case primarily the member states. According to EU treaty regulations, questions of direct taxation are subject to the unanimity rule in the relevant EU Council, and the Union is far from being unanimous on this issue. In what follows we shall therefore ask what factors predominantly influence the various interests involved and maintain the logjam in this policy area.

Structural Factors in the Tax Debate

National governments orient their choice of tax strategies primarily in terms of existing structural characteristics. The specific features of a given country make different tax policies desirable at least to some extent, as a rule geared towards maximizing national prosperity and its attractiveness as an investment location. This refers above all to a country's tax structure and the structure of the national economy. Based on our results, in the next section we attempt to draw up such a »map of interests« in the tax debate and discuss the issues arising.

A Multitude of National Tax Systems

Attitudes concerning the coordination of European tax policy are dependent among other things on differences in national socioeconomic structures and in the intentions embodied in tax systems. Analogous to national approaches to the welfare state, distinct tax policy traditions have emerged corresponding to the relevant type of public policy and the

requirements of the national economy, serving certain interests and being connected to particular notions of fairness and equity.[3]

Due to the high level of formalization of tax policy – its technical and legal complexity – the tax legislation process has strongly cumulative effects. This means that tax policy decisions are taken and amended, but rarely revoked or substituted (Rose 1984: 116f). Fundamental paradigm change is very much the exception in tax policy. As a result, there are significant differences in national tax structures in the EU as regards the financing of the national budget and the welfare system. The tax structure arises from the allocation of the burden of different forms of tax among tax payers. We can infer from the significance of single tax types the extent to which taxation is being used to pursue the aims of financing public expenditure, political governance, or redistribution. This enables us to draw up an order of preferences for the formulation of national tax strategy which can account for a country's rejection or acceptance of European tax competition.

The analysis of the tax system involves a comparison of the ratio of revenue of different tax types to GDP. This allows a division of EU member states into four groups:[4]

1. The first group, consisting of new member states, is characterized by the low tax revenues generated by personal income tax. In addition, these states show below average tax-to-GDP ratios. The top income tax rates, which serve to indicate how progressive a particular tax system is, are low by European comparison. Tax-based redistribution is of low priority and the welfare state is poorly developed. The tax systems of these states are directed primarily towards tax efficiency and international tax competitiveness. This points towards structural approval of the current state of international tax competition.

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3. For our typology of tax systems we first carried out a cluster analysis which included the ratio of revenue of corporate tax, personal income tax, social security contributions, and indirect taxes to GDP. We also looked at the top rates of income taxation as an indicator of how progressive a tax system is. We then broadened the quantitative classification by means of qualitative research methods in order to take due account of the expected national peculiarities. For this purpose we evaluated two regional conferences held in autumn 2007 within the context of the Friedrich-Ebert-Stiftung's tax project. The detailed development of the method (following Obinger/Wagschal 1998) can be found in Kammer (2008).
4. C1: BG, CY, CZ, EE, ES, GR, LV, LT, LU, NL, PL, PT, RO, SK; C2: DE, FR, HU, SI; C3: IE, MT, UK, C4: AT, BE, (DK), FI, IT, SE.

2. Characteristics of the second group, which includes France and Germany as examples of the continental European welfare state model, are a relatively high burden on earned income, mainly caused by above average social security contributions, and a below average share of revenue provided by corporate tax. The low corporate tax-to-GDP ratio can be explained, on the one hand, by the fact that in these economies the so-called »Mittelstand,« by and large consisting of small or family businesses, mostly organized as non-incorporated firms, is of particular importance. On the other hand, in these countries income and corporate tax rates are nominally high, which typically leads to a leaking away of mobile tax bases and losses in tax revenues due to profit shifting. Both these things mean that these states lose out in terms of tax competition. These countries, which are already strongly feeling the effects of tax competition, tend to be actively committed to far-reaching tax coordination and the restriction of tax arbitrage.
3. In contrast, in the third – predominantly »Anglo-Saxon« – cluster social security contributions play a subordinate role. The – in theory – proportional sharing of the burden of social contributions and the average ratios of the other kinds of taxes make it difficult to draw clear conclusions concerning the orientation of these states in terms of international tax competition. One important structural characteristic of this group, however, is the high level of differentiation and formalization of tax practices, as pointed up for example by British corporation tax law. The large number of special features would give rise to high unilateral compliance costs in the case of tax harmonization. Apart from that, going one's own way as regards tax policy has numerous tax competition advantages, as a result of which the countries oriented towards the »Anglo-Saxon« model tend to oppose European coordination initiatives.
4. The tax systems of the fourth cluster are characterized by particularly high revenues from personal income tax and a very high overall tax-to-GDP ratio. Alongside the Scandinavian countries[5] this group includes Belgium, Austria, and Italy. Tax-based redistribution plays a particularly strong role in these countries. The tax structure, the result of deliberate policy, is under strong pressure due to European tax

5. Denmark is the odd one out in terms of the classification of tax structures, being characterized by particularly high revenues from indirect taxes and personal income tax – social security contributions are practically negligible.

competition. These countries have reason to fear an outflow of mobile tax bases, revenue losses, and competitive disadvantages. So far, they have attempted to combat the consequences of international tax competition with unilateral compromise solutions. These states are thus applying a »dual income tax.«[6] This faith in national adaptation measures explains the merely cautious approval (primarily to be observed in Scandinavia) of coordination initiatives in European tax policy. Functionalist logic, however, marks out these states as clear advocates of coordination on the basis of their tax structure.

The method of income taxation and the level of progressiveness form the most serious lines of conflict between European tax systems. The new member states (Group 1) since the regime change starting at the beginning of the 1990s, no longer have comparable administrative capacities at their disposal. Moreover, financial institutions in these states are relatively weak. The greatest challenge these states are facing, therefore, concerns the strengthening of the administrative capture of all potential tax liabilities, the efficiency of the tax system, and the stabilization of tax revenues.[7] In order to increase tax efficiency, above all in Eastern Europe, simplified tax bases and flat tax systems are being introduced – tax-based redistribution is of secondary importance in this context. A similar conflict of interest between the new and old member states is suggested by a comparison of statutory corporate tax rates. These varied in 2007 between 10 percent in Bulgaria and Cyprus and almost 39 percent in Germany. A clear East-West gradient can be discerned here – EU-15: 29.5 percent; EU-27: 25.8 percent; NMS: 20.2 percent (COM 2007).

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6. Dual income tax, also known as the Nordic tax model, distinguishes between earned and capital income, which are subject to different tax rates. In Austria, Belgium, and Italy there are indirect forms of dual income tax. Capital income is subject to a low, mostly proportional tax rate (flat-rate taxation). Earned income, in contrast, is taxed at a higher rate and in a frankly progressive manner. The intention is to maintain progressive taxation of personal income according to the principle of ability to pay, without imposing too much of a burden on mobile capital as regards decisions on investment location.
7. Hungary, for example, is engaged in an arduous battle against a formidable black economy. Only around one third of potential tax payers are registered by the financial administration. As a result, two thirds of individuals and enterprises pay no tax at all.

A Multitude of National Economies

The analysis of the structural characteristics of European national economies also promises insights into the orientation of national tax policies. For this purpose the size of member states, the capital intensity of production in the national economy, and national wealth should be taken into account.

Small States – Large Influence

Empirical research has identified a significant correlation between the size of a country and the level of the corporate tax burden (Bucovetsky 1991; Wilson 1991; Ganghof/Genschel 2008). There is widespread agreement in the literature concerning the fact that smaller states, under otherwise similar conditions, opt for lower tax rates in competition for internationally mobile capital. Small states are in a position to realize a higher per capita benefit than larger states. In other words, uncooperative behavior in tax competition is the result of a strategy to acquire a structural advantage due to a narrow domestic tax base compared with that of larger countries. Reducing tax rates on mobile tax bases increases, in the case of capital taxation, net profits after tax, which enhances the attractiveness of a location. Small states benefit from tax competition in this respect because revenue losses due to tax rate reductions are (over)compensated by the inflow of mobile tax bases (Haufler/Wooton 1999). As a rule, certain sectors are given tax privileges in order to bring about a comparative advantage in competition among economies. Accordingly, small states tax corporate profits less than larger states. However, this mechanism has developed only since the mid 1980s, pointing to the greater influence of tax competition in the wake of integration within the framework of the European Single Market (Ganhof/Genschel 2008).

Mobile Capital versus Capital Intensity

EU member states whose national economies show a high proportion of capital intensive production tend to be more strongly affected by tax competition because the definition of the corporate tax base can be decisive for profitability. Tax competition tends to increase the need to reduce tax rates, which as a rule goes hand in hand with a broadening of the tax base (so-called »tax cut cum base broadening« – cf. Carone et al. 2007;

Devereux/Sørensen 2005). Broadening of the tax base is achieved first of all by abolition of provisions. This involves a reduction of measures towards promoting targeted investment and branch-specific adjustments of the tax system; the relative profitability of real investments as against financial investments deteriorates (Oestreicher/Spengel 2003: 94f). Countries whose economic competitiveness derives significantly from capital intensive added value have a definite preference for favorable and extensive provisions. On the other hand, economies with a lower real capital intensity – for example, in which the financial or service sector is very strong – tend to prefer a relatively broad tax base with limited tax provisions because they seek to offer attractive location conditions for mobile capital through low tax rates (Jacobs et al. 2005).

Rich against Poor

There is a clear wealth gap between the EU-15 and the new member states from Central and Eastern Europe. We can expect states with low per capita incomes to make use of lower taxes also as a means of catching up with more advanced economies (Quaisser/Wegner 2004; Krajčír/Ódor 2005).[8] But states with high incomes also stoke up tax competition amongst one another from time to time. For member states with relatively high incomes and high social standards a more integration-friendly stance might be expected, however, since tax competition puts their financing systems under pressure. Nevertheless, for example on the Scandinavian side there is some caution concerning coordination efforts. This is because dual income tax represents an apparently elegant way of combining a high level of progressiveness in income tax with attractive locational conditions for capital investment – de facto this is due to the consolidation of tax competition and its problematic consequences. Support for a European solution to the tax problem can be expected from these states only if it guarantees extensive room to maneuver for national tax and welfare state models. Neither this group of states nor the states in the process of catching up can be expected to agree to fundamental regulation of tax competition.

8. This was also the case with the catch-up process of the Irish economy: the reduction of corporate taxes in Ireland to 10 percent in the 1980s was a significant component of economic policy, together with a stability-oriented monetary and exchange rate policy, strict budget consolidation, and wage moderation (Büttner 2006).

Analysis of tax systems and macroeconomic indicators suggests that the member states have different preferences concerning the level of coordination of European tax policy, not least due to varying structural conditions. Variables such as the type of tax system and welfare state play as important a role as economic characteristics. Add to that the high strategic interdependence in tax competition in respect of which even structurally similar states emerge as competitors providing attractive locational conditions.

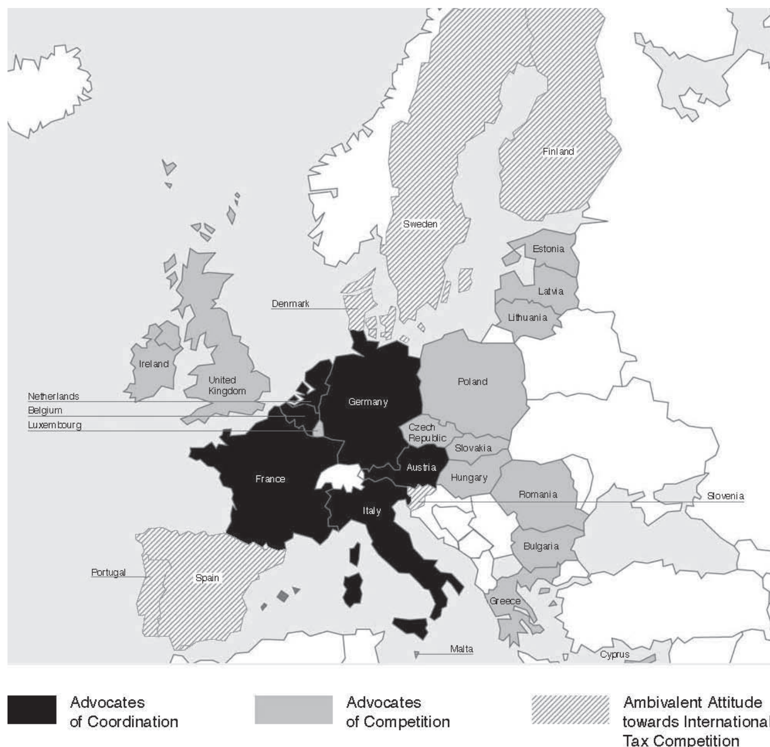
Map of European Tax Interests

Our results show that the principal advocates of more extensive European coordination of tax competition are the countries of core Europe. Support for the status quo comes above all from the »Anglo-Saxon« and Central and East European countries. The Iberian and the Scandinavian states have an ambivalent attitude to European tax competition and coordination initiatives. We can expect that Portugal and Spain, which are still engaged in economic development, would subordinate any proposal for the coordination of tax competition primarily to economic policy criteria. The experts we spoke to from these countries confirmed that among other things their position on the geographical periphery and their strong trade ties to South America are decisive as regards their dominant interests. In contrast, the social policy implications of coordination are decisive for the Scandinavian countries. Figure 1 based on the above extracted structural determinants is a map of interests concerning European corporate taxation.

Particularly among the advocates of competition the dominant opinion is that in the long term »real« tax competition will lead to the alignment of tax systems. It is also argued that alignment via these mechanisms would be more beneficial than »artificial« political harmonization. To that extent the European Commission's proposal of voluntary harmonization of tax bases (the CCCTB approach) and tax rate competition is looked on favorably. Against this background, a qualitative step in the direction of fiscal federalism, in the form of minimum tax rates, in the EU is not to be expected. The winners as regards the Commission initiative are the multinational companies, the majority of which came out in favor of the draft, since their tax compliance costs would be considerably reduced. Harmonization of corporation tax rates is naturally rejected by multinational companies because it would limit the possibility of tax arbitrage.

Figure 1

Map of Interests Concerning European Corporate Tax Policy



(own presentation)

A glance at the map shows clearly that neither the (necessary) unanimity nor a qualified majority are in prospect as regards tax issues at EU level. The efforts of the European Commission to frame the initiative of creating a CCCTB as a purely technical solution by emphasizing its voluntary nature and avoiding mandatory minimum tax rates could not conceal the underlying (perceived) political conflicts concerning distribution. To that extent, the focus for the time being should be on expediting a real public debate on the problems of European tax competition. Because the current standstill will sooner or later lead to the erosion of European welfarism.

Pragmatic Steps Forward

Against the background of the lack of consensus on the required integration in European tax policy, pragmatic reform measures could point the way out of the impasse. Concerning political objections to a common tax base, it would be worth pursuing a more modest aim, namely the introduction of so-called »country-by-country reporting.« The consolidated commercial-law accounts of multinational companies, which are oriented primarily towards stakeholders, make it difficult to discern what profits and losses were made in which countries. Intra-firm transactions are, to some extent, removed from the balance sheet. National financial administrations are therefore deprived of direct links; rather they are to be found in different tax balance sheets that are drawn up separately. The incentives and instruments for the »optimal« organization of the corporate tax structure derive from this. If, by contrast, the balance sheet presented profits and losses in individual countries it would be possible to compare this with the tax balance sheet, which shows only the taxable profit for individual countries.

Even if progress in the coordination of accounting regulations does not prepare the way for solving the political conflicts concerning European tax competition, by means of the mandatory coordination of tax policy, greater transparency would certainly be useful for an open debate on tax competition. More transparent and possibly stricter accounting regulations could lead to the exposure of aggressive tax planning – for example, by means of manipulated internal prices or excessive credit financing – and raise public awareness of the problem of tax avoidance. This could as a matter of course increase the political pressure for further reform of international tax law.

It is also conceivable that the proposals for the creation of a common corporate tax base will be taken up again within the framework of closer macroeconomic coordination within the group of advocates among EU member states. Coordinated tax policy would then become a further pillar in the existing cooperation, for example, in the Eurozone in the adjacent policy areas of fiscal and monetary policy. In general, what we can expect is that an increased functional need for a standardized tax base together with minimum tax rates will prevail on the basis of the existing cooperation between these countries in fiscal and monetary policy. Should such intensified macroeconomic coordination prove successful we might expect a bandwagon effect in terms of which other countries would adopt

the common standards in order to enjoy the benefits of cooperation. The example set by such a group of member states whose social systems and enterprises would benefit equally from intensified cooperation could lend new impetus to European integration concerning the creation of a European economic and social model.

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