Company Taxation in an Enlarged European Union

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The Oesterreichische Nationalbank (OeNB), the Austrian Institute of Economic Research (WIFO) and the University of Vienna organized a full-day workshop on "Capital Taxation after EU Enlargement," which was hosted by the OeNB on January 21, 2005.

Matthias Roche (Ernst&Young Frankfurt/Main) opened the first session with a comprehensive overview of company tax systems and effective taxation in the ten new EU Member States. Since the accession of the ten new members in May 2005, transnational corporations have had to cope with 25 different systems of capital income taxation in the EU, and another two systems will be added in 2007, when Bulgaria and Romania are expected to join the EU. The statutory tax rates in the new Member States are on average lower than in the EU-15. However, not only the statutory tax rates, but also the national provisions for computing the taxable base are relevant for determining the effective tax burden on enterprises. The rules on computing taxable income of all new members allow for the depreciation of buildings and the amortization of intangibles and tangible fixed assets, whereas setting up contingency reserves and loss carryback are prohibited. Roche used a model investment project based on assumptions about the sources of finance and types of assets to calculate the effective average tax rates (EATRs) for a German parent company which operates a subsidiary in each of the new Member States: At 19.99 percentage points, the spread between the highest EATR (Malta: 32.81%) and the most attractive EATR (Lithuania: 12.82%) is very wide; the EU average stands at 19.61%. Compared with the EU-15, the EATRs in all new Member States except Malta are significantly lower. Tax incentives, such as reduced corporate income tax (CIT) rates (offered e.g. by Cyprus and Malta) or CIT rebates in special economic zones (e.g. in Latvia and Lithuania) still play an important role in the new Member States. In his conclusions, Roche pointed out that the new Member States offer a highly attractive tax environment.

Christian Bellak (Vienna University of Economics and Business Administration) and *Markus Leibrecht (OeNB)* presented preliminary results of their research project "Taxation and FDI in Central and East European Countries" (carried out in cooperation with Roman Römisch of the Vienna Institute for International Economic Studies – WIIW), in which they investigate the implications of company taxation for foreign direct investment (FDI). According to Bellak and Leibrecht, methodological differences are, among other things, responsible for the highly divergent outcomes of past empirical analyses closing in on the influence of the effective corporate tax burden on FDI flows. In addition, the DI tax rate elasticity is significantly higher in "core countries" than in "periphery countries." To obtain valid empirical results on the interrelationship of these two factors, it is necessary to choose the appropriate computation method. First, multinational DI activity can be determined on the basis of financial measures (DI flows and stocks) or measures of real activity (corporate assets and investments in plant, property and equipment, gross product of affiliates, number of affiliates); many studies are based on DI flows since these data are more readily available. Second, the effective corporate tax burden can be measured with several indica-

tors (based on different methodological approaches): the statutory tax rate, backward looking effective tax rates and forward looking rates. EATRs impact on business location decisions; the relevant data for DI are bilateral EATRs, as they account for the tax provisions of the host country, international tax provisions (e.g. double taxation conventions) as well as the corporate tax provisions applicable in the home country of the parent company. The bilateral EATRs calculated by Bellak et al. for seven important home countries and five new EU members for the period 1996 to 2004 show that statutory tax rates are higher than domestic EATRs, the variabilities of statutory tax rates and domestic EATRs are within a similar range, and country rankings by statutory tax rates and domestic EATRs produce similar results. Bilateral EATRs are usually higher than the statutory CIT rates of the host country, which is also reflected in the country rankings by bilateral EATRs. Using the latter, instead of statutory tax rates, in the empirical determination of DI tax rate elasticity yields significantly higher (negative) tax elasticities for the five new EU Member States examined. The estimated tax rate elasticities are, however, likely to decrease when other business location factors (e.g. public infrastructure and agglomeration effects) are included.

In his summary of the pros and cons of the existing methodological approaches to computing the effective corporate tax burden, *Christian Beer (OeNB)* emphasized that individual tax burden indicators shed light on different aspects. According to him, the macro backward looking approach should be used to analyze the burden of different tax bases (e.g. capital and labor) or to measure changes of the tax burden over time. The micro backward looking approach – while inappropriate for isolating the influence of the different corporate taxation systems – can be used to compute the effective corporate tax burden on enterprises of different sizes and sectors. Beer maintains that the micro forward looking approach neglects key elements of the tax systems and is based on – often rather arbitrarily chosen – restrictive assumptions.

Otto Farny (Vienna Chamber of Labor) pointed out that the micro forward looking approach to computing effective tax rates, which is based on model investment projects and the respective tax laws, disregards the fact that the difference between the notional and the actual tax burden may be significant (especially in the new EU Member States); the backward looking approach, on the other hand, uses the actual tax payments.

He furthermore criticized stylizing the corporate tax burden as the key determinant of business location and investment decisions and called for further empirical analyses of the influence of wage-based taxes and charges on DI.

Session 2 revolved around two central aspects of corporate and capital taxation.

In his presentation "(Why) Do we need corporate taxes," *Alfons Weichenrieder (University of Frankfurt)* questioned the need for corporate taxation and underscored the relevance of this issue for small open economies. Tax theory suggests that, under specific conditions, the optimal solution for small open economies would be not to tax capital income. Despite an international trend in recent years to lower CIT rates, the GDP share of CIT revenues

remained relatively stable owing to an increase in the number of incorporated enterprises and to tax base broadenings coupled with the tax rate reductions. International comparisons show that EATRs (which constitute an important factor in the competition of business locations) were lowered to a considerable extent during the last decades. Against this backdrop, it is interesting to examine whether the erosion of corporate taxes has any alarming economic or fiscal effects at all. Analyzing the arguments given in the corporate finance literature in favor of the separate taxation of incorporated companies, Weichenrieder arrived at the conclusion that neither the classic argument of a benefit tax, i.e. a "quasi fee" for the use of the public infrastructure, nor the argument of a fee for the privilege of the shareholders' limited liability (and limited risk) sufficiently justify the separate taxation of incorporated enterprises. The argument that CIT can be used as a way to tax foreigners in a system of liberalized capital transactions is only valid on condition that the home country has a tax credit system in place for taxes paid in the source country. If, on the other hand, CIT is regarded as a prepayment of the personal income tax (PIT), precautions have to be taken to avoid double taxation, e.g. by introducing a shareholder tax or applying a full imputation system of corporate taxes with respect to the shareholders' PIT (with the latter solution leading to approximative results). However, full imputation systems usually apply only to resident taxpayers and there is no imputation system for cross-border dividends arising from tax burdens. If PIT on capital income is desired, a positive CIT rate is essential according to Weichenrieder. In this scenario, CIT is supposed to function as a "backstop" to prevent shareholders from escaping capital income taxation via profit retention and to reduce the attraction of declaring labor income as capital income. However, if CIT is more favorable than PIT, taxpayers will try to save money via the corporate shelter, especially if capital gains are not subject to taxation during the retention period. Weichenrieder pointed out that the most important function of the corporate income tax is to make sure that the capital income of natural persons remains taxable at all. Empirical evidence suggests that a reduction of the CIT rate below the PIT rate level results in a tax-induced shift of savings from private households to enterprises.

Christian Keuschnigg (University of St. Gallen) focused on the interrelations of capital income taxation and long-term economic growth on the basis of his complex proposal for a capital taxation reform in Switzerland (in cooperation with Soren Bo Nielsen und M. D. Dietz). This approach essentially aims to eliminate tax-induced distortions of investment and saving decisions by combining a specific variant of the dual income tax (as implemented in northern Europe) with a change in the taxation of equity. In his proposal, Keuschnigg recommends reducing the double taxation of dividends while at the same time introducing effective taxation of capital gains with a view to reducing tax-induced distortions adversely affecting investment demand (and thus also the accumulation of capital) and tax-induced distortions concerning the choice of both organizational form and type of financing. In addition to the CIT reform, he advocates leveling

the tax burden on all types of capital income at the personal level by introducing a uniform proportional tax. He claims that this will in all probability not cause any tax-induced distortions to private investors' behavior and will furthermore result in comparable tax burdens on enterprises independent of their organizational form (equal treatment of equity and debt with respect to the CIT assessment base). In this scenario, only company rents and excess profits would be subject to taxation which constitutes a reduction of the average tax burden on enterprises and would, in turn, improve the competitive position of Switzerland as EATRs play a key role in multinational enterprises' choice of business locations. The comparatively low proportional capital income tax as proposed by Keuschnigg (which would cut the current tax burden on interest and dividend income approximately by half) is designed to mitigate the effects of the double taxation of savings. At the same time, a more effective taxation of capital income would eliminate a tax loophole that exists in almost all countries and makes retentions profitable (lock-in effect). If the tax rate is chosen accordingly, it will not encourage entrepreneurs to record labor income as capital income (tax arbitrage). According to Keuschnigg, the implementation of this reform proposal (computed on the basis of a calibrated growth model) would translate into permanent GDP growth by approximately 2% to 3%. The resulting drop in tax revenues could be canceled out with a higher VAT on the one hand, and with spending cuts or a temporarily higher debt ratio on the other hand. The first option would entail considerable short-term costs because of distortions to the labor market, and the second (debt-financed) option would somewhat dampen the implied long-term growth effects.

In his presentation, Keuschnigg also touched on the taxation of venture capital (VC)-funded startups. Challenging the current practice of subsidizing them, he claimed that levying taxes on startups might have a positive impact on their quality, i.e. net worth. The resulting tax receipts should be used to compensate for tax losses arising from the tax reduction on capital gains of VC-funded enterprises. Curbing not performance-related subsidies and favoring successful startups is supposed to contribute to a more active style of VC financing.

Anton Rainer (Austrian Federal Ministry of Finance) argued that the significance of corporate taxes, and especially their role in business location decisions, is generally overestimated. Besides, he questioned the results of Keuschnigg's study challenging the relevance of the assumptions implied by dynamic equilibrium models since such models underlying such (quantitative) analyses.

Alex Stomper (Vienna Institute for Advanced Studies) emphasized the impact of the perspective (corporate finance versus tax theory or macroeconomics) on the approach to analyzing the company tax issue. He, too, questions the practice of deducing findings from equilibrium models given their numerous simplifying assumptions (such as perfect competition) and because they fail to address several issues. He argues that Keuschnigg's proposal of levying taxes on VC-backed startups as an incentive (instead of subsidizing them) would discourage entrepreneurs and translate into fewer business startups. Introducing imperfect competition and

imperfect markets might have an impact on the results of model computations. Furthermore, there is no conclusive evidence to substantiate the assumption that a tax reform actually strengthens the equity base of nonincorporated firms, and Stomper voiced doubts about the wisdom of embarking on a comprehensive tax reform when its outcome is so uncertain. He pointed out that the analyses are based on highly simplified assumptions of the financing structure (pure debt or equity financing). In his view, it is most important to find out which financing alternatives are available to a certain type of company in imperfect capital markets and which financing structure serves it best, as well as to determine the impact of the various types of funding on investment decisions and the influence of tax provisions on the various financing alternatives.

The leading question for the third session was whether the tax policies in an economically integrated area should be coordinated or left to the discretion of national governments. In the EU, this question is particularly relevant for direct taxes since indirect taxes are, by and large, already harmonized.

Bernd Genser (University of Konstanz) outlined the achievements and failures of the EU in harmonizing corporate taxation. During the past four decades, the EU commissioned a series of reports on the harmonization of CIT, with the aim of leveling the playing field within the Common Market, abolishing discriminatory tax practices, and avoiding fiscal externalities. None of the blueprints included in these reports was ever implemented. Genser stressed that this must not be interpreted as a failure of coordination policies, since numerous issues tackled in these reports were actually incorporated into the relevant EU provisions, e.g. the Parent-Subsidiary Directive (1990), the Merger Directive (1990) and the Code of Conduct (1997). Nevertheless, several key issues have yet to be resolved. A case in point are the highly heterogeneous statutory and effective marginal and average CIT rates across Europe, which generates distortions in the allocation of capital and creates misplaced incentives for national governments to use their tax instruments in a strategic manner. Some of these problems are addressed in the Bolkestein Report of 2001, which proposes various approaches to harmonizing the CIT base for EU-wide operations of multinationals in combination with an allocation system for the distribution of the tax revenues among the EU Member States. While leaving tax autonomy to the national governments, the proposal aims at substantially reducing compliance costs, eliminating incentives for cross-border profit shifting, implementing capital export neutrality, and crowding out many incentives for unfair or strategic tax practices. However, as Genser pointed out, the Bolkestein proposals give rise to new problems: the Member States need to agree on a reasonable allocation key, the system might produce negative fiscal externalities, and the issue of non-EU activities has not been addressed at all. However, the Bolkestein proposals deserve credit for demonstrating that CIT harmonization is not necessarily accompanied by the loss of national tax autonomy; it allows for various ways of CIT/PIT integration along national tax traditions.

Lars Feld (University of Marburg) discussed the issue of tax competition within the Common Market, where

companies can choose to locate mobile factors in the country offering the most attractive package of tax rules and public services. This fact invariably leads to competition among the EU Member States. According to the Tiebout hypothesis, such a "voting by feet" would serve as an incentive to improve the efficiency of public services. Unfortunately, Feld argues, this effect is of academic value only since externalities between the countries render decentralized tax policies inefficient. Moreover, public services are in many ways not comparable with "normal" goods (non-rivalry in consumption, decreasing average production costs, etc.). Even if a Tiebout world led to increased efficiency, it would still be incompatible with the large-scale redistribution policies of the European welfare states. All these aspects cast doubt on the viability or desirability of tax competition. On the other hand, tax competition may appear attractive from a political-economy perspective: the potential abusive behavior of politicians and governments (e.g. failing to implement welfare-enhancing policies, acting as selfish rent-seeking agents) will be limited by taxpayer mobility. Under the pressure of yardstick competition in an open economy, best-practice solutions and political reforms might be adopted more quickly and effectively. Hence, there is no conclusive evidence in favor of or against tax competition from a theoretical perspective. Therefore, Feld compares the actual performance of decentralized and centralized tax policies and summarizes his insights (gained by reviewing numerous empirical studies) as follows: there is sufficient evidence to substantiate that fiscal competition enhances economic efficiency; the assumption that decentralization will lead to a collapse of the welfare state and put an end to redistribution policies was not sustained. The impact of fiscal decentralization on economic growth is unclear. Finally, some – if still unsystematic – evidence suggests that fiscal decentralization will lead to more political innovation and higher citizen satisfaction. On the basis of these observations, Feld concluded that fiscal competition, if appropriately controlled by political procedures, has some advantages over harmonization.

The discussants basically agreed with Genser's and Feld's analyses but added some qualifications.

Martin Zagler (Vienna University of Economics and Business Administration) questioned whether tax competition is (or will ever be) compatible with the welfare state concept. He argued that harmonized taxes may simply shift intergovernmental competition to other areas, such as public expenditures.

Daniele Franco (Banca d'Italia) warned not to take political-economy arguments in favor of tax competition too seriously since democratic systems had a range of built-in mechanisms apart from tax competition to control government opportunism. He advocated a gradual approach to the design of new tax systems as the benefits and costs of neither tax competition nor tax coordination were certain or quantifiable at this point.

In his presentation "The Future of Capital Income Taxation in the European Union," *Sijbren Cnossen (University of Maastricht)* gave an overview of current tax practices and focused on the question if (and how) capital income should be taxed in the future. Levying taxes on economic rents is commonly accepted as justified. The question if (and to what extent) taxes

should be levied on normal yields hinges on efficiency, equity and enforcement issues. Cnossen specifies three relevant models apart from the existing capital income taxation systems: the dual income tax model, the comprehensive business income tax model and a net wealth tax. The existing CIT systems are characterized by the trend of levying higher taxes on labor income than on capital income and of tax discrimination against dividend payouts in favor of debt financing. Cnossen recommends the introduction of a dual income tax system that includes comprehensive withholding taxes on interest income and the approximation of capital income tax rates, but voices doubt over the tax harmonization plans currently under discussion in the EU, especially with regard to the introduction of a common tax base and a harmonized European corporate tax system. In his view, tax coordination is indispensable for effective capital income taxation, but he also underscores the importance of the subsidiarity principle. In conclusion, Cnossen argued that tax coordination has to be a bottom-up process that should be realized in a gradual and largely reversible manner.

Ewald Nowotny (Vienna University of Economics and Business Administration) observed that the concept of comprehensive income taxation is advocated in theory only; it is no longer very relevant in the EU: today, taxes on labor income are generally (in part significantly) higher than those on capital income. He acknowledges the Nordic system of dual income taxation favored by Cnossen as an interesting solution, but points out that Norway, Sweden and Finland have effective wealth taxation systems. Tax competition applies to the taxation of corporate profits, wealth and high labor incomes; these distributional aspects need to be considered in economic policy assessments. According to Nowotny, tax havens pose a real problem in this context. Tax competition leads to distortions in the tax burden for international enterprises and local SMEs as a result of the negative allocative effects.

The workshop "Capital Taxation after EU Enlargement" covered a broad range of topical issues; the accession of ten new Member States with ten different tax systems makes these issues all the more important for the future economic development within the EU and for the design of the EU's economic policies. Due to varying methodological approaches, however, the analysis of the 25 different CIT systems based on the effective tax burden failed to furnish final and conclusive data of their effects on FDI. Aligning a CIT reform (or a comprehensive capital taxation reform) with the aim of increasing the long-term economic growth potential was generally acknowledged as a highly complex challenge both from an economic and a social perspective. Even if it is not possible to prove conclusively whether tax competition or tax harmonization are more advantageous in the field of corporate taxation, a certain degree of tax coordination between EU countries seems indispensable. The bottom line of this intensive workshop was that more research work is clearly needed to create a firm basis for fiscal policy decisions at the EU level.