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Editorial

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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.

The potential implications of significant regional differences in corporate tax burdens in the enlarged European Union for capital allocation have been dominating the tax policy debate in Austria for some time. After all, some of the New Member States have only recently announced or implemented sweeping company and income tax reforms that aim at making their regions more attractive for FDI and firms' location decisions in general. As a result there have been calls for further decreases in company tax rates also in the Old Member States. For instance, the considerable difference of the Austrian corporate income tax (CIT) rate compared to its neighboring countries, especially Hungary and the Slovak Republic, has already led to a significant cut of the CIT rate in Austria's most recent tax reform.

This workshop centered on several questions: Which implications do significant regional tax differentials have for foreign direct investment (FDI)? Should (and for what reasons) CIT be levied in the first place? Which efficiency problems are linked with capital taxation? Moreover, it was looked into the issue of the rapidly intensifying tax competition and the increased need for coordinating CIT and capital tax policies as well as generally into the future of company taxation in the enlarged European Union.

Peter Mooslechner (OeNB) emphasized in his introductory remarks that intended and unintended spillover effects have to be taken into account in designing tax reforms in small, open economies and that in an "open environment"

the problem of levying taxes on mobile tax bases in general hinges on the possibility of an induced tax base flight (positive externality to other countries) or a tax induced tax base import (negative externality to other countries). He pointed out that the focus of tax reforms has significantly changed over the decades. Whereas in the 1980s, efficiency, simplicity and equity considerations were the keywords of tax reform proposals the tax reforms have been aiming at reducing the tax burden since the 1990s, in particular for more profitable and mobile firm.

Karl Aiginger (WIFO) underlined in his opening address that company taxation is a topic of high relevance for growth and employment in general and in particular for financing the European model of the welfare state, and also for the goal to decrease the income and productivity gap between Old and New Member States. He stated that this workshop may be viewed as a follow-up to the international conference on "Tax Competition and Coordination of Tax Policy in the European Union" that was held in Vienna in 1998 under the Austrian EU presidency. As there are still problems and questions in the realm of capital taxation in the European context that have not been resolved seven years after that first conference and as the enlargement has increased the complexity of the competition-versus-coordination debate further research is essential.

Since the accession of the ten New Member States in May 2004, transnational corporations have to cope with 25 different systems of company taxation in the EU. Statutory tax rates in the New Member States are lower on average than in the EU-15. However, compared to the EU-15, not only statutory tax rates, but also effective average tax rates (EATR) are significantly lower in almost all New Member States. Tax incentives, such as reduced CIT rates or CIT rebates and tax holidays in special economic zones, still play an important role in the New Member States. Thus, they offer a highly attractive tax environment in general. In the first session, *Christian Bellak (Vienna University of Economics and Business Administration)*, *Markus Leibrecht (OeNB)* and *Roman Römisch (Vienna Institute of International Economic Studies (WIIW)* inquired into the implications of company taxation for FDI. The empirical literature is highly controversial on this topic. According to Bellak et al., methodological differences are, among other things, responsible for the highly divergent outcomes of past empirical analyses. Obtaining valid empirical results on the interrelationship of company taxation and FDI requires an adequate computation method. In their view, firms' location decisions are influenced by EATR. More exactly, it is the bilateral EATR that impacts on FDI, as they account for the CIT provisions of the host country as well as international tax rules and the CIT provisions applicable in the parent company's home country. The bilateral EATR calculated by them for seven important home countries and five New Member States for the period from 1996 to 2004 show that statutory CIT rates in general are higher than domestic EATR and that bilateral EATR are usually higher than the statutory CIT rates of the host country. Using bilateral EATR in the empirical determination of the FDI tax rate elasticity yields

significantly higher (negative) tax elasticities for the five New 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 considered.

In his comment of the pros and cons of the existing methodological approaches to computing the effective corporate tax burden, *Christian Beer (OeNB)* emphasized that the existing tax burden indicators shed light on different aspects. The macro-backward looking approach should be used to analyze the burden imposed on 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 company tax systems – can be used to compute the effective corporate tax burden on enterprises of different sizes and sectors. Beer maintained that the micro forward looking approach neglects key elements of the tax systems and is based on – often rather arbitrarily chosen – restrictive assumptions. In *Otto Farny's (Vienna Chamber of Labor)* view, 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 Member States); this problem is avoided by using the backward looking approach, which uses actual tax payments and may therefore point at the significance of tax avoidance. Furthermore, he criticized the fact of 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 FDI.

Session 2 revolved around two central aspects of corporate and capital taxation. *Alfons Weichenrieder (University of Frankfurt)* questioned in his presentation the need for corporate taxation and underscored the relevance of this issue for small open economies in particular, since tax theory seems to suggest that the best solution for them would be to abolish capital taxation altogether. He stated that despite an international trend in recent years to lower CIT rates, the GDP share of CIT revenues remained relatively stable; admittedly, owing to an increase in the number of incorporated enterprises and to the measures to broaden the tax base. However, international comparisons show that EATR were lowered to a considerable extent during the last decades. Analyzing the arguments given in the public finance literature in favor of the separate taxation of legal persons, Weichenrieder concluded 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. A further argument, namely that CIT can be used as a way to tax foreigners in a system of liberalized capital markets is only valid on the condition that taxes levied in the host country may be refunded in the home country of the multinational company. 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. Should PIT on capital income be desired, a positive CIT rate is essential according to Weichenrieder, as 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.

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. This proposal essentially aims at the elimination of 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. 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 that are adversely affecting investment decisions (and thus also the accumulation of capital) and tax-induced distortions concerning the choice of both organizational form and type of financing. 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. As only company rents and excess profits should be subject to taxation this would constitute a reduction of the average tax burden on enterprises and should, in turn, improve the competitiveness of a country as EATR play a key role in multinational enterprises' choice of business locations. 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, entrepreneurs will not be encouraged to record labor income as capital income (tax arbitrage). In his presentation, Keuschnigg also touched on the taxation of venture capital (VC)-funded startups. Challenging the current practice of subsidizing VC-funded startups, he claimed that levying taxes on startups combined with a tax break would raise their quality, i.e. their net worth. In his opinion, replacing a non-performance related capital subsidy by a performace related tax break would be welfare improving.

Anton Rainer (Austrian Federal Ministry of Finance) commented that the significance of corporate taxes, and especially their role in business location decisions, is generally overestimated. However, he concided that tax competition is important and is likely to lead to a race to the bottom with respect to capital taxes. He also agreed with the speakers that reducing the CIT might be a "profitable strategy" for small open economies. Besides, he generally wondered about the

relevance of (quantitative) analyses based on dynamic equilibrium models since such models rest upon numerous and restrictive implicit assumptions. *Alex Stomper (University of Vienna)* emphasized the impact of the perspective (corporate finance versus public finance) on the approach to analyzing the company tax issue. He argued that Keuschnigg's tax reform proposals could actually seriously hamper the supply of equity capital to start-ups and to those firms in general that are rarely in the position to issue equity, irrespective of the way equity financing is taxed. 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 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 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 already harmonized to a considerable extent. *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. However, 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 inefficient 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 harmonize 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: 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, as it allows for various ways of CIT/PIT integration along national tax traditions.

Lars P. 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 Member States. According to the Tiebout hypothesis, such a "voting by feet" would serve as an incentive to improve the efficiency of public services. Feld argues that this effect unfortunately is only of academic value since externalities between countries render decentralized tax policies inefficient. Moreover, public services are in many ways not comparable with "normal" goods. 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 will be limited by taxpayers' 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 compared the actual performance of decentralized and centralized tax policies and came to the insight that there is sufficient evidence to substantiate the hypothesis that fiscal competition enhances economic efficiency and that the assumption that decentralization will lead to a collapse of the welfare state and put an end to redistribution policies was not sustained. Also the impact of fiscal decentralization on economic growth is unclear. Finally, some evidence suggests that fiscal decentralization will increase 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. *Daniele Franco (Banca d'Italia)* warned of taking 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 for the time being. *Martin Zagler (Vienna University of Economics and Business Administration)* questioned whether tax competition is (or will ever be) compatible with the welfare state concept. Thus, tax coordination is predominantly an issue of distribution. This, however, means that tax coordination will only arise if countries have similar preferences over redistributive policies. He further argued that eliminating capital tax competition

does not necessarily preclude "tax competition", as competition could merely shift to "commodity tax competition".

In the last session *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. As levying taxes on economic rents is commonly accepted as justified, the answer to the remaining question, if (and to what extent) taxes should be levied on normal returns hinges on efficiency, equity and enforcement issues. Cnossen specified three relevant models apart from the existing capital income tax systems: the dual income tax model, the comprehensive business income tax model, and a net wealth tax. The existing capital income tax systems are characterized by the trend of levying higher taxes on labor income than on capital income and of tax discrimination against dividend payouts and in favor of debt financing. Cnossen recommended the introduction of a dual income tax system that includes comprehensive withholding taxes on interest income and the approximation of capital income tax rates. He voiced doubts about the current tax harmonization plans under discussion in the EU, especially with regard to the introduction of a common tax base and a harmonized European CIT. In his view, tax coordination is indispensable for effective capital income taxation, but he also underscored the importance of the subsidiarity principle.

In his comment, *Ewald Nowotny (Vienna University of Economics and Business Administration)* agreed with *Sijbren Cnossen* on the necessity for further tax coordination in Europe. He emphasized that the concept of comprehensive income taxation is advocated in theory only and that it is no longer very relevant in the EU as today taxes on labor income are generally (in part significantly) higher than those on capital income. He stated that taking into account that EU competition policy has been more sensitive towards direct subsidies than against tax transfers. This results in a clear incentive for Member States to substitute direct subsidies by tax incentives. He acknowledged the Nordic system of dual income taxation favored by Cnossen as an interesting solution, but he pointed out that Norway, Sweden and Finland have also effective wealth taxation systems. In his view, above all the distributional aspects have to be considered in economic policy assessments as tax competition applies particularly to the taxation of corporate profits and high labor incomes. According to Nowotny, the possibility for legal tax evasion and thus free-riding by big multinational companies creates massive allocative inefficiences as tax competition leads to distortions in the tax burden for international enterprises and local SMEs.

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 growth 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 is 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.