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Fiscal Policy Coordination in the Light of E.U. Enlargement

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1. The conceptual framework

In this paper we are concerned with direct taxes on capital income and company income. A recent assessment of tax competition by the World Bank, after acknowledging that fiscal competition may have a disciplining function on government spending, questions the theoretical models suggesting that tax competition might result in a race to the bottom. Thus, "although marginal corporate tax rates have fallen over the past decade, bases have often been broadened. As a result, corporate tax revenues have increased or remained steady on average, except in European transition economies, where the decrease of revenues was more from privatization than from economic integration" (World Bank 2004). Moreover, a study commissioned by the European Parliament observed that "tax competition has effectively "capped" the tendency for taxes to rise in relatively high-tax countries, and produced convergence within the EU" (European Parliament 2001, xiv). In a resolution of 18 June 1998 the European Parliament welcomed "beneficial tax competition among member States as a tool to increase the competitiveness of the European economy confronted with the challenges of globalisation". The new CEE member states are, nevertheless, accused of using low tax rates and preferential tax bases in order to attract foreign investment in key economic sectors. The question that arises is not so much whether these accusations are founded but, rather, whether the slow process of tax coordination is likely to be deadlocked following the recent EU enlargement.

For many years capital income tax and company income tax were considered by the EC (and the OECD) from the point of view of double taxation, rather than fiscal competition. Although the EC lacks explicit authority for the approximation of direct taxes, past initiatives have been based on the general provisions requiring una-

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nimity at the Council for the adoption of approximation directives. There was, furthermore, opposition to the granting of exemptions or opt-outs, because it was felt that countries exempted from harmonisation would function as tax havens. Although the 1985 White Book on the establishment of the Single European Market appealed to the member States to eliminate tax obstacles, harmonisation in the field of capital income tax and company income tax has proceeded very slowly. In the course of 1997 the Commission proposed a package of measures to handle harmful tax competition [COM (97) 495]. These were deemed too far-reaching and the Commission proposed a revised package [COM (97) 567] which included: a Code of conduct for business taxation; the elimination of distortions to the taxation of capital income (minimum withholding tax on bank interest); measures to eliminate withholding taxes on cross-border interest and royalty payments between companies. The central proposal of this package was the Code of conduct for business taxation which took the form of a Council Resolution adopted on 1 December 1997. The Code covers "those business tax measures which affect, or which may affect, the location of business activity in the Community in a significant way", also identified as "those tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than that which generally apply in the country in question". Thus, the Code aims at combating preferential tax treatment, some forms of which may constitute state aids and be liable to prosecution by the Commission. The Commission issued in the course of 1998 a communication on the application of state aid rules to measures relating to direct business taxation [SEC (1998) 1800] and has enforced the rules in individual cases. Interestingly, the view that some forms of preferential tax treatment may constitute state aids was upheld in the WTO context, where the Appellate Body determined in its decision of 14.2.2002 (case DS 108) that the US system of corporate tax was discriminatory and incompatible with the Agreement on Subsidies.

2. Capital income tax

The fundamental issue is whether low-tax jurisdictions should agree to repeal their privacy laws and surrender their fiscal sovereignty so that high-tax nations can more easily enforce their tax laws – including taxation of income earned outside their borders. The situation before the entry into force of the EU directive on the taxation of capital income, also known as savings directive has been, in a nutshell, that competition took place on the basis of comparative tax advantages, rather than on the basis of comparative costs of the financial intermediation industry. Thus, as pointed out by Kanavos (1997, 281), as a result of the distinction in fiscal treatment between residents and non-residents, the ongoing competitive process threatened to degenerate into a situation where each country acted as a tax haven for financial asset holders residing in the 14 other Member States, given the free movement of capital in the EU. In actual fact, Britain and Luxembourg were the prime beneficiaries of the system, because they combined the favourable tax treatment with an efficient financial intermediation industry. These two countries were concerned that harmonisation would lead to capital flight to non-EU countries.

After a long gestation period the EU adopted on 3 June 2003 directive 2003/48 on the taxation of income in the form of interest from savings. According to article 10 of the directive, entry into force is subject to the conclusion of bilateral agreements with Switzerland and the European micro-States. Switzerland refused to participate in the automatic exchange of information but agreed to apply a withholding tax on the aforementioned income of non-residents, at the rates agreed within the EU for countries maintaining bank secrecy, namely the UK, Austria and Luxembourg. Thus, the directive is scheduled to enter into force in the course of 2005.

As far as competition by non-European countries is concerned, it is worth noting that in 1998 the OECD issued a report and recommendations on "harmful tax competition" (OECD 1998) and, since then, has been pursuing efforts aimed at the elimination of tax havens. The success of these initiatives is, however, far from certain, in view of the ambiguous US position. The OECD, branding the threat of retaliation by affected member States, convinced some low-tax countries in Asia and the Caribbean to sign "commitment letters" indicating that they would take the aforementioned steps, but these countries stated that the letters were not binding unless all OECD nations agreed to abide by the same rules. Although the EU savings directive was adopted and the requirement of Swiss participation was achieved, several OECD nations, as well as tax havens in Asia and the Caribbean, would be exempt from any requirement to share information, meaning that the so-called level playing-field does not exist. Free market proponents observe that more and more nations are lowering tax rates and therefore pressure to attack low tax jurisdictions will abate. They expect that the number of nations interested in tax harmonisation will shrink and the process will collapse.

3. Company income tax

In contrast to progress made in combating preferential tax regimes, EU efforts aimed at the approximation of tax rates and tax bases have not borne results. The Ruding Committee report (1992) had recommended the introduction of a minimum rate of 30% and a maximum rate of 40%, bearing in mind that the Community average at that time was 35%. The Commission's views were recently expressed in a publication on "Company taxation in the internal market" (2002), based on the communication "Towards an internal market without tax obstacles" [COM (2001) 582], which in turn, supplements and builds on a Commission Services Study [SEC (2001) 1681].

According to the Commission's Services Study, as economic integration in the Internal market proceeded, taxation systems adapted to this process only very gradually. The pattern of international investments is therefore likely to be increasingly sensitive to cross-border differences in corporate tax rules, in an environment now characterised by the full mobility of capital. From the point of view of economic efficiency, tax systems should ideally be neutral in terms of economic choices. The choice of an investment, its financing and its location should in principle not be driven by tax considerations. The analysis by the Commission does not provide evidence of the impact of taxation on actual economic decisions, although empirical studies show that there is a correlation between taxation and location decisions.

The Commission's estimates of effective corporate tax rates builds on the methodology involving the calculation of the effective tax burden for a hypothetical future investment project in the manufacturing sector. It calculates effective tax rates at a given post-tax rate of return, whereas other studies compute the effective tax rate for a given pre-tax rate of return. The most important features of taxation systems such as the rates, major elements of the taxable bases and tax systems are included in the study. Finally, effective tax rates are calculated for marginal investment projects (where the post-tax rate of return just equals the alternative market interest rate) and infra-marginal investment projects (which earn extra profits).

With regard to domestic investments the Commission Services Study concludes that the different national nominal tax rates on profits can explain many of the differences in effective corporate tax rates. The Commission cites with approval the findings of a study by Baker Mackenzie which concluded that, in general, the composition of the tax base does not have a great impact on the effective tax burden and that the level of the tax rate is the truly important factor for the difference in the tax burden.

With regard to transnational investments the Commission Services Study observes that the effective tax burden of a subsidiary depends on where that subsidiary is located. Similarly, subsidiaries operating in a given country face different effective tax burdens depending on where the parent company is located. Moreover, outbound and inbound investments are more heavily taxed than otherwise identical domestic investments. To the extent, however, that companies are free to choose the most tax-favoured form of finance, then through international tax planning foreign multinationals operating in a host country are likely to face a lower effective tax burden than domestic companies.

The Commission Services Study concludes that that the most relevant tax component which provides an incentive to locate across the border and to choose a specific form of financing is the overall nominal tax rate – except in specific situations when a country applies for instance particularly favourable depreciation regimes. Interestingly, in its subsequent communication the Commission refrained from proposing the harmonisation of nominal tax rates, while also asserting that the scenario of a common tax base would "tend to increase the dispersion in effective tax rates if overall nominal tax rates are kept constant". The Commission added, however, that “in a dynamic context it is possible that the transparency associated with the harmonisation of the taxable base would induce a convergence of the statutory corporate tax rates, thus implying a reduction in the dispersion of effective tax rates”.

Although the harmonisation of nominal tax rates would go someway in reducing locational inefficiencies in the EU, priority was given to the harmonisation of savings tax, to the extent that competition in the area of portfolio investment does indeed take place on the basis of comparative tax advantages. At any rate, opposition to the harmonisation of company taxes has grown since the recent EU enlargement. The coalition of States opposed to tax harmonisation is actually larger than in the case of social policy harmonisation, because it includes the small Mediterranean member States. On the other hand, however, the pressures in favour of harmonisation are far more intense. France and Germany have made known that they would oppose the increase of the resources of the Community structural funds demanded by the CEE member States, as long as these countries reject harmonisation of company tax. These countries were accused of sucking jobs from France and Germany, an accusation that is not corroborated by evidence on investment flows. According to the annual report of UNCTAD for 2003 on foreign direct investment, “no large-scale diversion of FDI from the older EU members to CEE countries occurred during 2003”. Moreover, in absolute terms FDI in these countries slipped from a record high of 31 billion $ in 2002 to 21 billion $ in 2003, compared to a decline from 310 billion $ to 280 billion $ in Western Europe. Some CEE countries also argue that they have a lower tax rate (for example 19% in Poland) but also a broader tax base, and that the effective tax burden is as high as that of countries with 25% or 30% tax rates. Others argue that the most effective way to measure the corporate tax burden is to measure the ratio of corporate tax earnings to GDP. Thus, Poland’s corporate tax revenue amounted to 2% of GDP, whereas that of Germany amounted to 0,7% of GDP.

At this stage, the Commission is not likely to submit proposals for the harmonisation of tax rates. It might be possible, however, to make progress on a common tax base. Such a measure would enhance the transparency of national taxation systems and increase pressures for the harmonisation of tax rates, in accordance with the neo-functionalist expectation of “spill-over”. At last resort, it might be possible to overcome the unanimity requirement by making use of the mechanism of “enhanced cooperation” for the adoption of the relevant directives [COM (2003) 726, 24.11.2003]. This, however, makes more sense in respect of the common tax base than regarding the harmonisation of tax rates where the problem of “free riding” is likely to undermine the logic of harmonisation.

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