

TAX COMPETITION IN THE EU25

Prague, December 17-18, 2004

The lively debate on tax competition in the European Union illustrates a vast academic literature discussing the risk of a sub-optimal production of public goods (including inter-personal redistribution) in a world where capital is perfectly mobile whereas labour, especially low-skill labour is not. This risk is to be balanced against the gains from putting some pressure on national governments to raise public sector efficiency.

The issue of tax harmonisation was re-launched by the European Commission's proposal, in 2001, to move towards a harmonisation and a consolidation of corporate tax bases within the European Union, and more recently by EU enlargement to low-tax countries. The CEPII and its business Club felt that the existing theoretical as well as empirical literature on the subject was perhaps not enough used in the policy debate. This is the prime reason for bringing together high-level researchers working on these issues at both the academic and the policy-relevant levels. The conference took place in Prague on December 16-17, 2004, hosted by CERGE-EI. It was organised within the TAXBEN project held under the 6th Framework Programme of the European Commission, and received also support from CEPII's business club and from the *Institut CDC pour la Recherche*.

During the **first day** the results of the academic literature were examined around four different themes: the scope for tax competition, the impact of taxation on the location of firms, tax avoidance and the scope for tax harmonisation. Concerning tax competition (Session 1), Alexander Klemm (Institute for Fiscal Studies, London) presented comprehensive evidence on the rate-cutting, base-broadening reforms which have taken place since the mid 1980s, ending in relatively stable corporate tax revenues. Patrick Artus (IXIS, Paris) examined the scope for tax competition in the macroeconomic framework of a monetary union with endogenous production prices. He insisted on the fact that any harmonisation of taxes within the monetary union should account for the endogenous reaction of the central bank. The presentation by Clements Fuest (University of Cologne) questioned the impact on foreign firm ownership in the extent of tax competition. He concluded that foreign ownership may not prevent profit taxes from declining when economic integration rises. Finally, Jouko Ylä-Liedenpohja (University of Tampere) analysed the precise incentives provided by the corporate tax regime of Estonia.

In Session 2, Ruud de Mooij (CPB, The Hague) provided measures of the efficiency gain to be obtained from a reduction in the distortion stemming from corporate taxation. He also reviewed existing knowledge on the impact of corporate taxation on location choices, thin capitalisation and profit shifting. Amina Lahrèche-Révil (CEPII) further discussed the impact of corporate taxation on location choices. She evidenced the non-linear impact of taxation which, although significant, is not the main variable that impacts on foreign direct investment. Finally, Marius Brühlhart (University of Lausanne), based on Swiss local taxes, presented some empirical evidence that vertical externalities (eg between municipalities and cantons)

may well dominate horizontal ones (eg amongst municipalities of each cantons). At the European level, this would mean that tax competition between member states may not be very sharp, and also that a European corporate tax would risk raising the aggregate level of taxation in the EU.

In the early afternoon, Kari Alho (ETLA, Helsinki) presented the TAXBEN project (“Tax/benefit systems and growth potential in the EU”). This project brings together seven European institutes (including the CEPII) under the 6th framework programme of the DG Research, in cooperation with DGs Taxud and Employment. It aims at studying the attainment of sustainable growth in the EU in relation with the tax/benefit systems and with the requirement of preserving the environment. Ian Perry (DG Research) completed this presentation with a broader presentation of relevant projects currently carried out under the 6th framework programme.

In Session 3, Harry Grubert (CESifo, Munich) and Deborah Swenson (University of California) presented some empirical evidence on tax avoidance. Using a “natural tax experience” in the US, Deborah Swenson found some limited evidence of transfer pricing.

The last session of the day (Session 4) was devoted to tax harmonisation. One major risk of tax harmonisation is that it provides a gain from staying outside the co-ordinated group of countries. Andreas Haufler (University of Munich) contradicted the classical argument saying that a group of countries may have an interest in imposing a minimum tax rate if it is large enough to have an impact on the world capital return. He showed that the group of co-operative countries may actually loose from higher taxes if its internal integration is not strong enough to induce lower transaction costs for a firm located in the union versus outside the union. In this case, the outcome of co-operation may actually be a decrease (not an increase) in corporate taxation. A complementary view came from Sam Bucovetsky (University of York) showing theoretically that the most likely outcome of a bloc-formation game would be a very large bloc of co-operative countries, hence paving the way of a successful enhanced cooperation. Finally, Jacques Thisse (CORE, Université Catholique de Louvain) presented a paper showing the impact of the origin/destination principle on the location incentive.

The **second day** was devoted to policy issues. It started with a view of taxation in the EU15 and in new member states. Then, the pros and cons of the EC proposal (concerning the harmonisation and consolidation of tax bases) were discussed. The day ended with a roundtable on tax coordination.

In Session 1, Henk Vording (University of Leiden) came back to the rate-cutting, base-broadening phenomenon which favours profitable firms (the effective average tax rate falls but not the effective marginal one). He proposed several explanations for such movements and questioned the future of corporate taxation. Then, Ludomir Lizal (CERGE-EI , Prague), Witold Orłowski (NOBE, Warsaw) and Olev Raju (University of Tartu) provided country views concerning three new members states: the Czech Republic, Poland and Estonia.

Session 2 started by a presentation of the EC proposal by Carola Maggiulli (DG Taxud). The European Commission has a somewhat specific approach to corporate taxation in the EU in that it aims at removing “tax barriers” within the Union, consistent with the completion of the internal market. This goal led to the two-tier proposal issued in 2001: targeted measures in the short run, a consolidation of tax bases in the long run. Carola Maggiulli also discussed the difficult question of apportionment formulas. Marcel Gérard (Fucam, University of Mons) then presented a set of simulations showing the different ways for a multinational group for avoiding corporate taxation. He showed how the consolidation of tax bases would remove such tax evasion, except when using a value-added apportionment formula. He also showed how host countries could benefit from consolidated bases, at the expense of tax heavens. He however pointed that the consolidation-plus-apportionment solution would bring little advantage compared to just cross-border loss offset, whereas apportionment could indeed boost tax competition if based on property.

The roundtable brought together Thiess Buettner (Munich University), Steve Bond (Institute for Fiscal Studies, London), Michaela Erbenova (Czech National Bank, Prague), Daniele Franco (Banca d’Italia, Rome), Witold Orłowski (NOBE, Warsaw) and Jean Pisani-Ferry (University Paris-Dauphine). Lionel Fontagné (CEPII) was the moderator.

Steve Bond insisted on the lack of political will as well as on the technical challenge and administrative unfeasibility on harmonisation. He advocated the replacement of corporate taxation by a residence-based taxes on dividends and destination-based taxes on consumption. Michaela Erbenova suspected tax cooperation (eg the Commission’s proposal) to be the first step towards tax harmonisation. She highlighted the strong differences in preferences across European countries, which justify differences in tax levels. She also mentioned the competition of non-EU countries, especially Asian countries, for the location of multinationals. She concluded that harmonisation would kill the search for optimal tax/spend combinations.

Daniele Franco brought a moderate view in the debate by highlighting the role of social contributions and VAT in determining the cost of labour, hence the attractiveness of each location. Thiess Buettner discussed the various ways high-tax member states could bargain with low-tax ones. He rejected both the tax/EU fund bargain which could end in higher taxation on average, in the same way as tax equalisation systems. He also rejected the minimum tax option which would need to be set as low as 12.5 or 15%. He ended advocating a European income corporate tax which would bring additional benefits at the EU level.

Jean Pisani-Ferry claimed that the case for tax co-operation relies mainly on the tax evasion problem. When admitting that general tax harmonisation is a non-starter and that general consolidation-plus-apportionment of tax bases is quite unlikely, one is left with the enhanced cooperation option. Jean Pisani-Ferry also noted that corporate taxation is not designed to finance the welfare state, hence the advocates of tax competition should not insist too much on differences in the extent of the welfare state across countries. Witold Orłowski admitted that a country such as Poland would have little to lose from a consolidation-plus-apportionment of tax bases, especially if such reform was to take place within the framework of an enhanced cooperation without Poland.