FURTHER RESEARCH NEEDED ON COMPREHENSIVE APPROACHES

MARCEL GÉRARD*

Last October, the EU Commission released an important report on Companies' Taxation in Europe.[1] That document, expected for a long time already, was the core of a conference jointly set up by CESifo and Belgian FUCaM's Arpege[2], held in Mons, Belgium, on December 7–8. Though the core of the conference was the discussion of the report, its scope was actually broader and a selection of contributing papers will be published in a coming issue of *Ifo Studien*.

A new direction: moving to a consolidated tax base system

The Commission Report includes extensive empirical work, actually a computation of effective tax rates, dedicated to evaluate distortions implied by national tax systems, the identification of cross-border obstacles to the Internal Market and the design of mechanisms for tackling those company-tax obstacles.

Before briefly commenting on the directions suggested by the Commission, I'd like to stress two other points.

The new meaning of integration

First, the new directions suggested by the Commission, i.e. moving towards a consolidated tax base system, characterises an evolution of the way to conceive a tax system as well as of the economic environment of the tax system.

To be clear, a quarter of a century ago, when the Commission already formulated tax harmonisation proposals, it did so in a framework where the typical investor was an individual resident of the same jurisdiction as the company. Then the word "integration" was understood as integrating the domestic individual shareholder and the domestic company. In that framework the ideal system was no doubt imputation, a system adopted by many countries including France and Germany. In his 1977 book, *Public Policy and the Corporation,* Mervyn King writes that the EU "harmonisation proposals are concerned solely with the taxation of distributed profits, and consist of two recommendations. The first is that harmonisation should be under the imputation system with the basic rate of corporation tax lying within the range 45–55%. (...) The second of the EEC Commission's proposals is that 'the tax credit shall be neither lower than 45% nor higher than 55% of the amount of corporation tax at the normal rate on a sum representing the distributed dividend increased by such tax'".

In contrast, Fuest and Huber conclude their 2001 paper "Is corporate-personal tax integration in open economies counter-productive?" with the statement that "in an open economy, where the marginal shareholder is a foreigner, it is not desirable to offer double taxation relief for dividends paid by domestic firms to domestic shareholders". Indeed, the world has changed. The typical (marginal) investor is no longer a resident individual but a foreigner, and possibly a foreign company, investing in a worldwide, at least a European-wide, operating company. Thus the word "integration" now refers to a multinational group.

Such an observation helps us both to understand the recent change in the German tax system as well as the suggestion by the EU Commission of a new direction for tax policy.

Effective tax rates as a determinant of investment

Second, the extensive computation of effective tax rates conducted by the Commission deserves two comments. On the one hand, one can regret that the services of the Commission, presumably

* Professor of Economics and Taxation at FUCaM, Mons, Belgium, Marcel Gérard also teaches at the Ucl, Louvain-la-Neuve and the Ecole Supérieure des Sciences Fiscales, Brussels, and is affiliated with CESifo.

[1] Comm(2001) 582 final.

[2] FUCaM's Arpege is the Workshop for Economic Policy and Business Management of the Catholic Faculties of Mons, Belgium.

due to the mandate they had received, limited their empirical investigation to the levies directly operating on capital income, neglecting the levies on other factors, first of all on labour; indeed many companies' decisions are based on respective costs of factors and using one or another are no independent decisions. To be simple, you can in some way shift the burden of a capital income tax on the supplier of labour. On the other hand, and despite the fact that the Commission recognises that taxation is not the single determinant of investment, the importance of effective tax rates as an actual determinant of companies' decisions has not been tested or extensively discussed by the Commission; however, a growing literature is now developing on the empirical relevance of those measures, especially regarding foreign direct investment decisions. Two papers presented at the Mons Conference are good examples of such studies, i.e. de Mooij and Ederveen's "Tax and foreign direct investment: a synthesis of empirical research" and Buettner's "The impact of taxes and public spending on FDI: an empirical analysis of FDI-flows within Europe".

Comprehensive solution

In its attempt to pave the way for a further European Tax Policy, the Commission says that there are essentially two approaches which could be envisaged for tackling the company tax obstacles in the Internal Market – among them cross border loss-compensation and transfer pricing issues: targeted solutions which seek to remedy individual obstacles, and more comprehensive solutions which seek to address the underlying causes of the obstacles. The latter approach, the Commission says, since providing EU businesses with a single common consolidated tax base for their EU activities, would address most of the tax obstacles to cross-border economic activities that it has identified.

The report discusses the pros and cons of four ways of designing such a comprehensive system. The first two ways imply a consolidated base for all the European activities of a given multinational company: under the so called "Home State Taxation", the multinational company tax base is computed in accordance with the tax code of the company's home state, while under the "Common Consolidated Base Taxation" a European definition of the tax base is presented alongside with present national rules. In both cases, the tax base is then apportioned among the Member States and taxed at rates defined by each of those jurisdictions according to the subsidiary principle. The third way considers a "European Corporate Income Tax" which could be optional or compulsory for large multinationals, implying levying the tax at EU level and possibly attributing of part of the revenue directly to the Union. The last way is to set up a single harmonised tax base and system as a replacement for existing national systems.

The Commission itself, however, recognises that its findings are based on the current stage of the development of the research and that further work would be necessary to implement any of the comprehensive approaches.

A comprehensive tax system does not guarantee tax neutrality with respect to the location of parent or affiliates or other decisions

One can question what is really expected from the move to a comprehensive system and discuss the capacity of such a change to reach those expectations. Indeed, experience of other large federations shows that such a move is no guarantee of say, tax neutrality with respect to the location of either the parent entity or the affiliates.[3]

Should we expect the tax system to be neutral with respect to three decisions of the multinational, i.e. the decision of how to finance an investment, by issuing shares, issuing debt or using retained earnings, the decision of how to set up an affiliate, either as a subsidiary or as a branch or permanent establishment, and the decision of where to locate the affiliates or the parent entity? Such expectations can be reached under a separated tax base system as well as under a consolidated tax base system. Formal conditions can be derived quite easily,[4] which have in common the request of a full harmonisation of bases and rates. Keeping such a theoretical result as a benchmark, full harmonisation of tax rates and bases can be interpreted as an extensive approximation of tax rates and bases.

Especially, implementing the Comprehensive Business Income Tax proposed in 1992 by the U.S.

[3] See e.g. Goolsbee, A. and E. Maydew, 2000, "Coveting thy neighbor's manufacturing: the dilemma of state income apportionment", Journal of Public Economics, 75, pp. 125–143 and Weiner, J., 2001, "The European Union and formula apportionment: caveat emptor", European Taxation, 41, pp. 380–388.
[4] Ssee e.g. my forthcoming CESifo discussion paper "Interjurisdictional company taxation in Europe, the German reform and the new EU suggested direction".

Treasury – a system which combines separated tax base, tax exemption at recipient level and non-deductibility of interest payments[5] –, can be *a priori* as good a candidate as a consolidated tax base system. However, the superiority of a consolidated tax base approach regarding cross-border loss-compensation can be recognised.

Moreover, adopting a consolidated tax base with apportionment doesn't eliminate transfer pricing issues, nor other tax shifting strategies.[6] Indeed, suppose a production entity and a distribution entity, and that the apportionment is based on value added ; then the distribution of the tax base among the two jurisdictions can be modified by manipulating the wholesale price.

The point is that neutrality, in the meaning of the word mentioned above, requires that the decisions of the firm have no influence on their tax liabilities. In that respect it is not without interest to imagine, as an ultimate target, to set up a system where the corporate income tax is a European single system with tax revenues collected by the Union and distributed between the Union and the Member States according to criteria independent of firms' behaviour.

The final remark of the Commission Report is full of hope, however. Indeed, as already mentioned, the Commission recognises that its findings are based on the current stage of research and that further work would be necessary to implement any of the comprehensive approaches. Presumably it is an invitation to the academic community and other experts to join the Commission in that effort.

---

[5] See US Treasury Dept., 1992, "Report of the Department of Treasury on integration of the individual and corporate tax systems: taxing business income once".
[6] on that issue see a.o. Nielsen, S.B., P. Raimondos-Moeller and G. Schjelderup, 2001, Formula apportionment and transfer pricing under oligopolistic competition, CESifo Working Paper 491.