Editorial

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After the euro: corporation tax harmonization?

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It is understandable that in 1998 all political interest in both the member countries of the EU and the Commission's headquarters in Brussels will be focused on the final steps towards the EMU. However, if and when the Euro is in place on 1 January 1999, much of this attention must and will shift towards a subject where only meagre progress has been made in recent years: tax harmonization, particularly of corporate taxation. There are clear links between corporate taxation, the EMU and the single market.

I expect the political debate in 1999 to produce two different views, which reach different conclusions on the need for tax harmonization. On one side, there are those who argue that the EMU has reduced substantially the national room for manoeuvre after the elimination of interest rate policy and exchange rate policy as national instruments. Consequently, fiscal policy will be one of the very few remaining macro-economic policy tools that national governments - at least those that participate in the EMU - have left and should not give up. On the other side are those - the European Commission, several national politicians and many in the business, tax and academic world - for whom the EMU strengthens, rather than reduces, the need for tax harmonization.

I share the views of the latter group but want to focus the argument on what is really necessary. Commissioner Mario Monti - in the Commission's 'Discussion Paper on Taxation in the European Union' of March 1996 - made the point convincingly: 'It would appear contradictory to do nothing to remove tax distortions while trying to remove distortions related to misalignments of exchange rates'. After the Euro in 1999, this will be the main remaining area where the goal of the single internal market will not have been achieved. A successful EMU requires a high degree of policy coordination, on economic as well as political matters, and will unavoidably reduce remaining national autonomy, including on tax policies. It is unrealistic to assume differently.

Some opponents of tax harmonization support both the functioning of free markets and national sovereignty but are afraid that harmonization will lead to protection of the high-tax regimes prevailing in some member countries. However, that should not be the goal of tax harmonization. Rather, it should be one of avoiding 'tax competition', that is, reducing the rate or base of corporation tax in one or several countries, with the aim - admittedly or not - of attracting more direct investment, portfolio investment, treasury and finance company transactions from companies in other countries, both European and non-European. This tax competition may serve the initiating member country well but it will adversely affect tax revenues and employment in other Member States. If harmonization of corporate taxation leads to setting certain minimum rates, they should, therefore, not be fixed at the current level of the high-tax countries.

In other words, in principle, national corporation tax policies will continue to exist and may *de facto* entail a certain degree of tax competition, but one should block aggressive and deliberate tax competition, which leads to distortions and serious erosion of the tax revenues of other member countries. Tax competition is fine, as long as it does not frustrate the proper function of the single market in a significant way.

Forces in favour of the harmonization of corporate taxation after EMU can be grouped into four different categories:

- The need to remove a number of prevailing tax obstacles to the single market for capital, particularly discriminatory or double taxation of cross-border investment and capital flows.
- Recent developments in most member countries, which have led to a rising burden of taxes (and social premiums) on labour, and a lowering of (effective) taxation on capital, particularly internationally mobile forms of capital. This, in turn, compounds the already severe problems of structural unemployment.
- The fact that the fiscal erosion which results from unfair or harmful tax competition ('tax poaching') between EMU Member States in a single market without exchange rate uncertainties, is likely to grow in importance. It is my impression that several Member States - especially Germany, France, and Belgium - share concerns expressed by the 1996 OECD Ministerial Meeting and the 1997 G-7 Summit in Lyon concerning the adverse consequences of non-action in this field of tax competition. National sovereignty in the area of corporate taxation is undermined by the growing flexibility and mobility of international capital and by the tax action of other countries.
- The fact that the EMU and strict budget criteria of Maastricht (and after 1999, the stability pact) make it almost mandatory for EMU participants to avoid such a loss in national tax revenues.

This drive towards harmonization must, however, have a limited scope. It clearly should not aim at overall harmonization of corporate taxation as a harmonization *per se*, for the sake of harmonization as a principle. Neither should it lead to a substantial reduction of the *overall* tax burden of the corporate business world. Also, it should observe the important principle of subsidiarity in decisions from 'Brussels'. In other words, only *some* degree of harmonization is called for, in order to deal with the most blatant cases of distortion.

The day-to-day experience of the growing number of pan-European companies (both those headquartered in Europe and outside) demonstrates that important differences in tax systems, tax rates and tax bases still exist among Member States. These frequently lead to cases of distortion: discrimination and double taxation, particularly of cross-border transactions, investments and shareholdings. The business world will still face these unpleasant obstacles to the benefits of the single market in 1999, with the Euro in place.

I see the most urgent need for the following measures, all of which are in line with the recommendations of the 1992 Report from the Committee of Independent Experts on Company Taxation:

- eliminate withholding taxes on inter-company, cross-border payments of interest and royalties (the draft directive on this subject was regrettably withdrawn in 1994);
- facilitate the offsetting of losses and profits within a group of companies;
- widen the scope of the Parent-Subsidiary Directive to eliminate withholding taxes on dividends paid by subsidiaries to parents in other countries;
- remove discrimination in the taxing of dividends distributed to non-resident shareholders;
- allow companies more flexibility to allocate costs of headquarters for the purpose of tax deductibility;
- complete Europe's network of bilateral tax treaties;
- introduce 'advance rulings' in all Member States to avoid double taxation arising from transfer pricing disputes.

Commissioner Mario Monti has been working, actively but cautiously, since the beginning of 1996 on making progress in this area, by trying to overcome the serious hurdles of the EU requirement for unanimity in tax decisions, the emphasis on sovereignty by national tax administrations and the need to observe subsidiarity. His tools are those of seeking convergence through a working group of high-level taxation experts of the national governments, and proposals in the form of a voluntary, non-binding code of conduct for corporate taxation. The Council of Ministers adopted this Code of Conduct on 1 December 1997 and established the Code of Conduct Group (Business Taxation) on 9 March 1998.

To make such proposals more balanced and acceptable to individual Member States, he is proposing 'packages' of measures which contain some urgently needed corporate tax changes, plus proposals for the harmonization of one element of personal income taxation, namely that on savings, and in particular, the old idea of a harmonized minimum withholding tax on personal income derived from interest. Mario Monti is probably right that this 'package' approach offers the best chance to make political progress in this minefield of taxation.

The above-mentioned working group of national tax experts broadly agreed on criteria for judging what constitutes harmful tax competition, specifically: different treatment ('discrimination') for residents and non-residents, a lack of transparency in tax regimes, and failure to comply with OECD standards on transfer pricing by multinationals. These are valid criteria indeed.

If the rule of unanimity should block progress on tax decisions in the EU for many years to come, the question arises as to whether Member States might prefer to take steps toward tax harmonization among a smaller group of members only, either the participants in the EMU or members who agree on a specific measure. This approach can only be accomplished outside the EU treaties and its institutions, but would obviously not be binding, or enforceable, on other EU members (and not even on EMU participants!). In recent years, such ideas of a 'voluntary', 'flexible', or 'two-speed' way of coordination have cropped up regularly, but they have not, until now, received sufficient support. I am not in favour of such an approach; it goes against the spirit of the EU integration and, it would also be rather ineffective, if important members refused to participate. My preference is to replace unanimity on tax matters by qualified majority decisions. The extremely high degree of integration that goes with monetary union requires - as the next, but related step - a willingness to reduce national sovereignty over taxation as well.

Progress on corporation tax harmonization still leaves another related source of distortion untouched: the policies of national governments in the area of state aid to ailing local companies and subsidies to attract local investments by foreign companies. So, Member States should be pressured by the Commission to take (further) action towards reduction and coordination of national incentives that frequently take the form of tax facilities. There is need to apply the EU competition rules more actively.

After many years of no real progress, it is now the task of the Commission, together with the Member States, to revitalize the stalled process of tax harmonization, particularly corporate taxation. The EMU in 1999 is likely to mark the beginning of a period of growing pressure from the business community to take a number of urgent tax measures to perfect the single market.

I am delighted that the Commission (re)submitted, on 9 March 1998, a proposal for a directive to abolish withholding taxes levied on interest and royalty payments between associated companies (that is, with at least 25 per cent cross-shareholdings) in different Member States. This is the most urgently needed measure in the area of corporate taxation; fortunately, its scope is also wider than the withdrawn draft directive of 1990, which was limited to payments between parent companies and their subsidiaries.