ec TAX REVIEW 2005-1

Editorial

The past and the future of EU corporate tax

H. Onno Ruding, *Chairman of Centre for European Policy Studies (CEPS), and Former Minister of Finance of the Netherlands*

Efforts to reform the corporation tax in the EU have resulted in a prolonged impasse since 1990. Its cause is not to be found at the European Commission but in the requirement of unanimity for EU decisions on tax matters, together with the wide differences of view between the Member States whether progress in this area of harmonization and coordination is desirable and if so, how this should be done. These differences of view can be explained by priority to the national self-interest (in the short-run) and by politically diverging views on issues such as competition versus harmonization, federalism versus national sovereignty and high versus low tax burdens.

The Ruding Report (1992) on harmonization of the corporation tax in Europe had already urged consideration not only of aspects of harmonization of tax systems and tax rates but also the complex subject of the widely diverging national tax bases. It warned that rate harmonization without base harmonization lacks balance.

The European Commission, since 2003, rightly has given priority to base harmonization for two convincing reasons. First, a common consolidated tax base will make a substantial contribution to the necessary reduction of the administrative burden that now weighs heavily on many companies, particularly multinationals. It is caused by the many existing differences between the Member States. Secondly, a uniform corporate tax base promotes greater transparency of the real tax burden in the respective countries. This transparency is desirable in its own right but it also enables corporations to better compare the attractiveness (or lack thereof) of the various countries with respect to their effective tax burden (the combination of base and rate). This, in turn, is likely to stimulate competition between the countries in the level of their nominal rates. It may result in pressure on high rate countries to cut their rates to prevent a weakening of the 'climate' for inward foreign investments. Over time these developments could promote convergence of the EU corporate tax rates without any formal action by the EU toward harmonization.

I want to add two other arguments for base harmonization. First, the growing influence of the ECJ. Its recent decisions side with plaintiffs who claim that national tax laws discriminate against non-residents. They lead to sometimes substantial holes in national tax revenues and force the countries concerned *de facto* to amend their tax legislation and the content of their tax base. The implication is a form of harmonization via the back door. Secondly, the rapid European harmonization of the national accountancy standards for the financial reporting by public (listed) corporations. These new IAS/IFRS rules not only deserve support in their own right but also indirectly create a good argument for corporate tax harmonization. Rules for determining a company's profit for tax purposes and for reporting purposes are admittedly not necessarily identical. However, I find it an unconvincing and illogical position for governments which only recently agreed with uniform EU rules for accounting and reporting of commercial profit, to refuse on 'grounds of principle' to accept uniform EU rules for the calculation of taxable profit.

If the EU succeeds in a common corporate tax base I expect this base to be rather broad, although not so broad as to lead to wide protest against the resulting aggravation of the effective tax burden. On the other hand, too narrow a base would result in too heavy a decline of the tax burden because the drop in tax rates (in countries with relatively high rates) which is likely to follow a harmonization of the base.

We see a difficult and complex discussion in Europe on the desirability of more tax competition versus the level of national tax revenues deemed necessary by national governments. Although I recognize a tension between tax harmonization and tax competition, I disagree with those who see an absolute contradiction between the two. They can, to a certain extent, go hand in hand. This debate has to do with a difference in perception of what will happen in practice. One group (to which former Commissioner Bolkestein belongs) is afraid that this harmonization will lead to a high common EU (minimum) rate as preferred by France and Germany. They reject such outcome and are therefore unwilling to take action in the area of rate harmonization. Another group (to which I belong) also disagrees with the French-German policy goal but expects that the prevailing economic forces of globalization and international competition in the business world, combined with the policy preferences of many EU countries (particularly the ten new members), imply that base harmonization in practice will result in lower rather than higher rates and that EU rate harmonization will not lead to a high common minimum rate.

The arguments of opponents of corporate tax (rate) harmonization can be categorized in three components:

- the political objection (most strongly in the UK) that national sovereignty will be unacceptably weakened;
- the practical-economic objection (e.g. the outgoing Commission) that the freedom of competition will be affected and/or that harmonization will increase the tax rates or the tax burden;
- the practical-political objection that in the EU with 25 members the unanimity requirement blocks almost all tax decisions.

Although I share to a certain extent some of these concerns I want to present at least two important counter-arguments. First, it is not very credible to adhere to national sovereignty in extremis in areas where the current situation affects the proper functioning of the EU Single Market. For that reason, the EU (including UK) has rightly agreed on a far-reaching harmonization of the indirect taxes (Europe 1992). The same issue presents itself for some aspects of the corporate tax where companies face daily cases of clear distortion and discrimination, by way of higher taxation of companies from other Member States or cross-border transactions compared with domestic ones. The Treaty obligation to create the Internal Market confronts us with a number of still prevailing shortcomings; after the creation of the Single Currency. Many of the remaining imperfections of the Single Market can be found in the area of corporate taxation. Secondly, rejection of corporate tax rate harmonization for 'reasons of principle' is not very convincing when it comes from those who earlier had endorsed the harmonization of VAT rates. A plea by Bolkestein for a 'liberal Europe' and 'therefore' no corporate rate harmonization sounds shaky. It is important to note that the agreed harmonization of the VAT through approximation – a rather wide band with a maximum and a minimum rate – still allows for a substantial degree of national discretionary policy within this band and consequently a substantial degree of tax competition. However, the Internal Market cannot properly function with *huge* differences between national VAT rates. The same applies to the corporate tax rates.

Two recent proposals were – rightly in my view – rejected by many member countries and by the Commission. The first one concerns a French-German idea to harmonize the corporate tax base, under the condition that this will go hand in hand with a common minimum rate. I am afraid that the real goal of this initiative is not corporate tax harmonization in general, but rather the imposition of a high minimum rate, probably close to the current French or (higher) German level: so 30 or 35 per cent. This French-German proposal deserves rejection indeed: under the cloak of a pro-European approach they try to impose their own policy on all their partners, although the first component, base harmonization, deserves support. The second initiative is French only although Germany may sympathize: the Sarkozy initiative to force the new members in Eastern Europe implicitly to raise their very low corporate tax rates through an EU decision to make payments from the EU structural and regional funds subject to the condition that the recipient countries are no longer permitted to apply low rates. This effort to serve the national (French) interest by improving the competitive position of French companies and investments in France is not in line with current EU integration and enlargement policies and is unlikely to receive sufficient support.

In my judgment, based on the outcome of the Ecofin Council of September 2004, one can distinguish the positions as follows: first, countries who endorse a common corporate tax base, however without any link to EU action in the area of rates; secondly, countries who equally endorse a common tax base, under the condition of action on rates (a minimum rate) and thirdly, countries who at this stage do not support any initiative with respect to corporate taxation.

One must therefore conclude that the situation is politically and technically complicated and difficult; it will take a considerable amount of time to resolve all these obstacles. If one should nevertheless express a view on the most likely form of a final outcome, I submit the following. The primary action will comprise full harmonization of the national corporate tax bases. On that foundation the secondary action will concern the rates. One uniform common rate is unlikely and not even required but approximation is needed. This may happen spontaneously: convergence through changes in national rates based on decisions of the countries concerned, in light of competition considerations, or in a mandatory way, through EU harmonization directives. Preferably in the form of a band (see VAT), with a low minimum and a wide range.

The views about what is an acceptable and responsible minimum/maximum rate vary widely. At the time of the Ruding Committee in 1992, the corporate rates in all European countries were substantially higher than today; many countries, including Germany, France and Italy, were clearly above 40 per cent. The suggestion made by this Committee, a bandwidth of 30 to 40 per cent, should, therefore, be seen in the context of that time. Its purpose was an approximation of the rates, with a downward impact on the many high rate countries and no impact on the low rate members except Ireland. The situation today is quite different; one could consider a minimum of 20 per cent and a maximum of 30 per cent, perhaps 35 per cent. This kind of bandwidth would still permit a substantial degree of tax competition.