Chapter 5
An Optional Common Consolidated Corporate Tax Base in the European Union

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5.1 Introduction

The governments of the EU Member States agreed in Lisbon to make the European economy the most competitive and dynamic knowledge-based economy in the world by 2010. Reforming the economies must therefore be a top priority. Taxes are one of the most important elements of economic policies and have therefore attracted considerable attention in recent years. A corporation doing business within the EU has to comply with up to 27 different tax systems, administrations and legal systems. This in itself is a considerable obstacle to economic growth and prosperity. Besides the compliance costs, the differences in effective tax rates across investment types and regions may lead to over- or underinvestment.

The lack of provisions for consolidation across borders often results in non-recognition of losses incurred by a subsidiary in one country in assessing the taxable profit of its parent in another country even if the subsidiary is fully owned by the parent company. There are also numerous situations in which double taxation occurs. Applying the arm's length principle in transfer pricing may still lead to conflicting tax claims from different Treasuries. Even though the dispute is between countries, the business entity often must pay taxes on the same income in more than one state.

The uncertainty of the tax outcome is obvious. Furthermore, countries continuously change their tax systems and their interpretation of the existing code. Businesses therefore have to make investment decisions with tax uncertainty added to the market risk they take. The effect of the tax uncertainty on investment has not been discussed much in the economic literature.

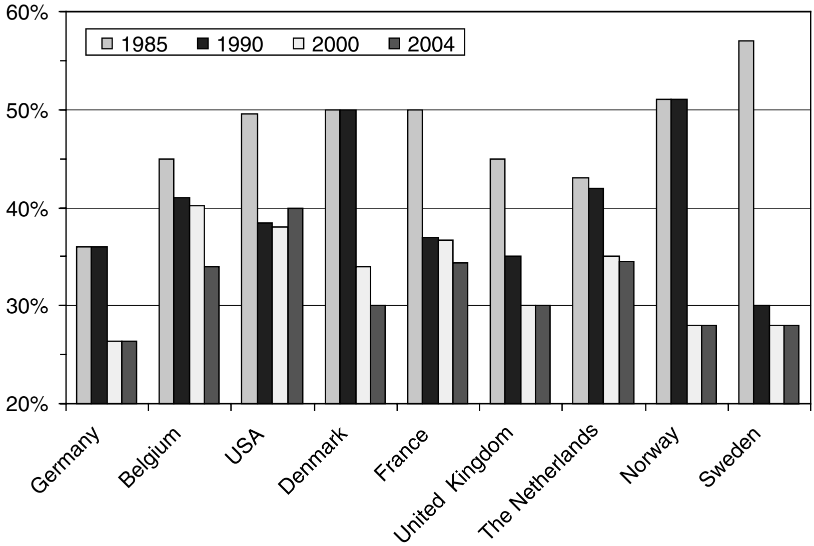
Nor has the way countries try to reduce the risk and the possible welfare gains from such policies. This paper addresses some of these issues. Under what circumstances can businesses benefit from a common corporate tax base in Europe? What benefits would be lost and what gains made if an optional common consolidated corporate tax base was introduced?

The paper is divided into seven sections. Section 5.2 gives some background information on the taxation of business activities in Europe. Section 5.3 looks into response measures taken by several countries in Eastern Europe. Section 5.4 reviews some of the challenges in the corporate tax area. Section 5.5 describes the

present work Member States in the European Union are involved in, constructing an optional common consolidated corporate tax base. Section 5.6 assesses the economic, legal and cultural barriers to such a tax regime. Finally, Sect. 5.7 summarises the report and makes some suggestions for the future direction of corporate tax policy in Europe.

5.2 Business Taxation in Europe

Most industrial countries have lowered their statutory corporate tax rates in the last two decades (see Fig. 5.1). The main reason behind this development has been their need to increase the number of viable investment projects after tax and thereby to promote job creation and economic growth. However, there has also been an element of tax competition. Competing for a given investment volume, however, would never suffice for governments. Since the tax revenue from corporate profits is a relatively small fraction of overall tax revenue, the lion's share of tax revenues from increased investment comes from the resulting jobs and consumption in the economy. It is from these sources that the government will receive most of the increase in tax revenue. With relatively high tax levels on labour income (payroll taxes, social security contributions and income taxes) and consumption, a reduction in corporate tax revenues may therefore easily be recouped from these tax revenue sources.



Source: Eurostat

Fig. 5.1. Statutory corporate tax rates