16 Corporate Income Taxation and the Subsidiarity Principle

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16.1 Introduction

According to the political economy literature, the allocation of tasks between different levels of government should follow the basic principle of fiscal federalism (Musgrave 1959, Oates 1972). This principle also applies to “international unions” whereby some countries provide together certain public goods or policies. In particular, the assignment of responsibilities to the supranational level should reflect a trade-off between efficiency gains induced by delegation and the costs resulting from the implementation of a single policy between heterogeneous countries (Alesina et al. 2005 for a theoretical analysis; Alesina et al. 2005 for a more applied analysis). This theoretical framework is embodied in the European concept of subsidiarity since European governance is characterized by a complex system of overlapping jurisdictions whose design constantly requires improvements.

Because fiscal policy remains under the responsibility of the national decision makers, discussions on the potential application of the subsidiarity principle are restricted to the issue of coordination. Under these circumstances, coordination is needed if and only if decentralized decisions produce significant spillover effects. Nonetheless, this basic guideline is incomplete, as a large range of alternative arrangements is available. On

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the one hand, coordination could take the form of strong restrictions on national actions (in the most extreme cases, a one-size-fits-all harmonization policy). On the other hand, coordination could be softer and mostly informal. Furthermore, the assessment of interactions raises additional questions. When decentralized policies create large negative spillovers, strategic interactions between national policies have to be controlled, but this may be hindered by uncertainties in the measurement of these interactions and difficulties in determining their underlying nature. This is especially problematic as the characteristics of the spillover effects may also affect the form of coordination required.

Therefore, both a clear identification of the forms of coordination available as well as a good understanding of negative spillovers at stake is required. It may therefore come as no surprise that answers might differ according to the type of fiscal issue considered.

Focusing on corporate taxation, the conclusions of a functional subsidiarity test (Ederveen et al. 2008) could at first sight appear non-ambiguous. The liberalization of international capital flows, fostered by the completion of the Single Market, has dramatically increased pressure on European governments to compete for a highly mobile tax base. Not surprisingly, a race to the bottom has occurred: Figure 16.1 displays a striking downward trend in statutory corporate tax rates in the last twelve years in Europe.

![Fig. 16.1. Statutory corporate tax rates in the European Union between 1995-2006](source: Eurostat)