POLICY BRIEFING

Corporate Tax Reform in the EU: Weighing Pros and Cons

Leon Bettendorf[1]
Michael Devereux
Albert van der Horst[1]
Simon Loretz

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Last week, the European Commission launched proposals to reform radically corporate income tax in the European Union (2011), with a system known as the Common Consolidated Corporate Tax base (CCCTB). The Commission aims to facilitate cross-border investment by multinational companies and to reduce cross-border profit shifting. Research by the Oxford University Centre for Business Taxation, in collaboration with CPB Netherlands Bureau for Economic Policy Analysis, suggests that this reform would have significant effects on individual member states, but only small effects in aggregate.

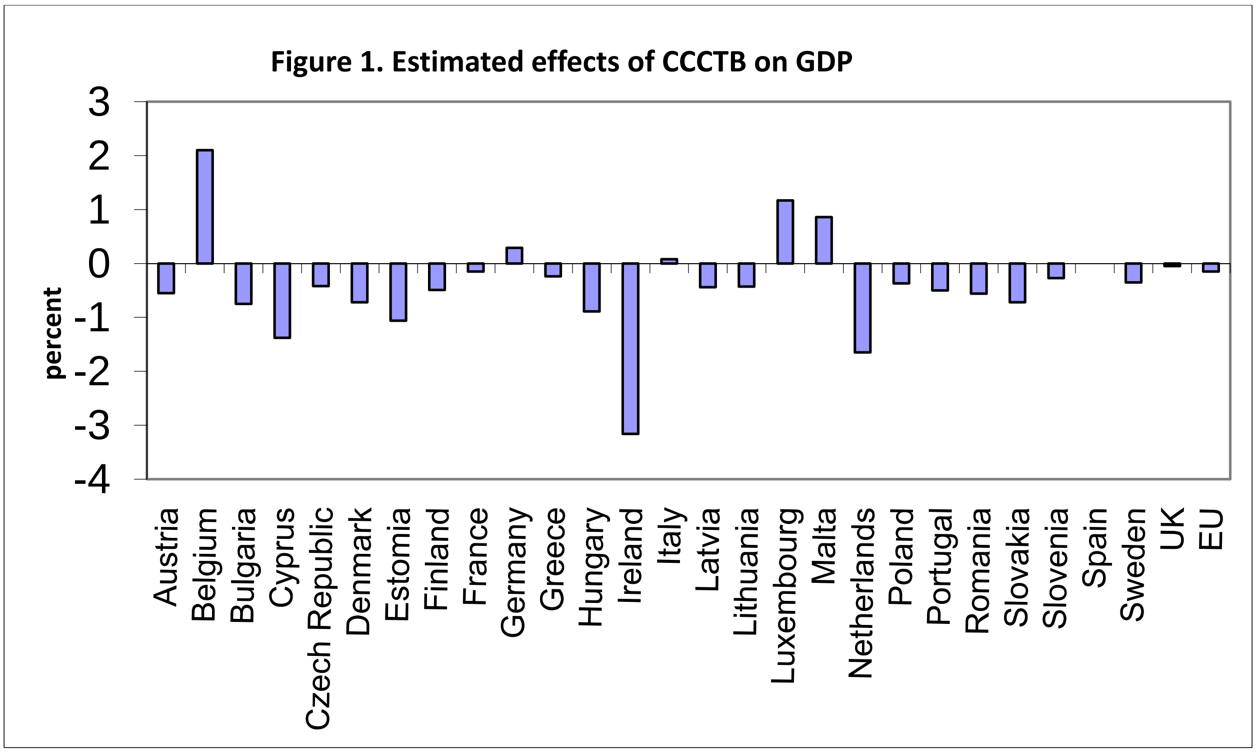
Under the current tax regime, multinationals file separate accounts for each country in which they operate. Under the CCCTB, each company would compute only its EU-wide consolidated profit, on a common definition of the tax base. This profit would be allocated to member states on the basis of an apportionment formula containing factors such as shares in employment, payroll, assets, and sales. Each member state would retain its autonomy to tax its allocated share of profits at its own tax rate.

We have investigated the economic effects of the CCCTB in a recent paper for *Economic Policy* (Bettendorf et al., 2010) and in an official impact assessment of the CCCTB (Bettendorf et al., 2011). In both studies, we apply a two-step approach. First, we use standardized balance sheet information from over 650,000 individual companies in the 27 EU member states to investigate the impact on tax revenues and effective rates at the company-level. Second, the investment and profit-shifting responses by firms, and the broader macroeconomic implications are simulated with an applied general

[1] CPB Netherlands Bureau for Economic Policy Analysis.

equilibrium model. This model for corporate taxation in the European Union also covers all 27 member states.

The effects of the reform would depend on the precise definition of the tax base, and other details of the reform. Figure 1 shows the estimated effects on GDP in each member state, and in the EU as whole, of a typical reform.[2] Two conclusions stand out. First, the average gains in terms of GDP - and also welfare - are negligible. For example, in the simulation of Figure 1, the average effect on GDP is -0.15 percent. Second, the economic effects vary widely across EU member states: in Figure 1 GDP rises by 2 percent in Belgium and falls by 3 percent in Ireland. But the details of the tax reform do matter in determining the effects in each country. We explain these effects by elaborating on five elements of the reform.



Source: Bettendorf et al, 2011, Table C.32

First, consider the effects of a common base in isolation (i.e. where companies are not permitted to consolidate profits and losses across countries). A common base would have both winners and losers,

[2] To be more specific, this reform includes a common base which is somewhat broader than the current EU-average; the common base only applies to multinational enterprises; a balanced apportionment formula is applied, with equal weights on assets, employment and production; and revenue losses are compensated by country-specific changes in statutory corporate tax rates.

reflecting differences in existing tax bases. For example, definitions of taxable profit range from Belgium and Estonia where they are only a small fraction of economic profits to countries such as Ireland and Spain that apply quite broad tax bases. The introduction of a European corporate tax base would benefit countries that narrow their tax base, like Ireland and Spain. This is explained by a reduction in the cost of capital that would expand investment, stimulate employment and lead to higher GDP. Conversely, companies in Belgium (with its Allowance for Corporate Equity) and Estonia (which currently only taxes profit distributions) would be harmed by the common base. Overall, we find that the common base would only slightly increase GDP (by 0.1 percent) and employment (by only 0.03 percent), and does not improve economic efficiency. But the variation across countries would be large, ranging from a GDP fall of 4.5% in Belgium to a gain of 1% in Spain.

In aggregate, European economies would only benefit if the spread of tax burdens is reduced by harmonizing the tax rate as well as the tax base. This would reduce the dispersion of effective tax rates and so reduce distortions in the allocation of mobile capital across countries. In this case, GDP would improve by 0.3% on average.

Second, consolidation of all profits and losses across counties would not solve the problem of profit shifting, but merely change its nature. Currently, multinational enterprises have incentives to report a larger share of their profits in member states with low tax rates. Tools for profit shifting include manipulation of transfer prices and locating more borrowing in high-tax countries. Consolidation of all taxable profits within the EU would render these types of profit shifting obsolete. However, formula apportionment, where the consolidated taxable profits are apportioned to each member state according to a measure of local activities, would still allow multinationals to exploit tax differences, new types of tax planning. Effectively, statutory corporate tax rates would become excises on the factors that appear in the apportionment formula. Companies would therefore have an incentive to locate these factors in low-tax countries. It therefore seems likely that formula apportionment would replace the current distortions in capital and profit allocations by a new distortion that depends on the formula factors. Again, harmonisation of statutory rates would be necessary to reduce tax planning.

Third, an agreement on the apportionment formula would be difficult to achieve as different member states benefit from different designs. The weights of the components in the formula determine the share of the EU-wide consolidated tax base of a multinational company that is apportioned to each member state. If the asset share is important, capital-intensive subsidiaries would be apportioned a large share of the tax base, implying that a large share of tax revenues would accrue to member states hosting these subsidiaries. On the other hand, relatively labour-intensive countries would benefit if employment is assigned a large weight in the formula. The sensitivity of the welfare effects to the policy design is illustrated by looking at extreme formulas. If apportionment were based only on employment shares, labour-intensive countries in Central and Eastern Europe would benefit more than the capital-intensive countries in Western Europe. The pattern would be reversed under a pure asset formula. The dispersion of effects complicates reaching an agreement on the CCCTB proposal.

Fourth, the introduction of loss consolidation could improve efficiency, but primarily through reducing taxation. Under the current tax regime, losses can generally only be offset against past and future profits in the same country. With loss consolidation, losses could immediately be offset against profits in another country, leading to tax relief and an efficiency gain. We estimate that loss consolidation would raise aggregate GDP and employment by 0.2 percent, but would reduce tax revenues by 0.3 percent of GDP. The simulations indicate that the gains in terms of employment and GDP would disappear if the revenue reduction were compensated by higher labour taxes or corporate taxes.

Fifth, one of the potential benefits of the CCCTB should be a reduction of compliance costs as multinationals would no longer have to determine transfer prices for complicated intra-company transactions within the EU. The European Commission (2001) estimated costs related to transfer pricing in multinational companies at 3% of revenues. However, it is difficult to determine the proportion of such costs that could be reduced by the introduction of the CCCTB. For instance, transfer pricing vis à vis third countries would remain since consolidation would be limited to the EU. Moreover, the introduction of formula apportionment would introduce new administrative costs: it is even possible that compliance costs could rise if the CCCTB were voluntary and coexisted with the current system of separate accounting. However, it is also possible that our analysis may underestimate the reduction in compliance costs if the new system were able to simplify significantly the corporate tax system for cross-border activities.

To conclude, it is unlikely that the introduction of the CCCTB would bring significant benefits to the EU in aggregate in terms of employment, GDP or efficiency, although some individual countries could benefit significantly. This conclusion depends on the fact that heterogeneity in tax rates would remain. If tax rates were also harmonized, tax planning would be minimized and capital export neutrality could be realised within the EU. Moreover, if the tax base included an allowance for corporate equity, which would tackle the uneven tax treatment of debt and equity financing, the economic benefits could be far greater.

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