EFFICIENT TAXATION OF MULTI-NATIONAL ENTERPRISES IN THE EUROPEAN UNION*

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Abstract

Current arrangements for multi-national company taxation in EU are plagued by severe conceptual and administrative problems, leading to high compliance costs, considerable uncertainty and ample room for abuse. Integration is amplifying these difficulties.

There are two possible approaches in designing an efficient trans-border corporate tax system for the European Union. The first is to consolidate the EU-wide operations of MNEs, using an agreed common base as the reference variable, and then to apportion this total tax base using some presumptive indicators of activity in each tax jurisdiction – hence, implicitly, of the likely benefits stemming from each location. The apportionment formula should respect requisites of neutrality between productive factors and forms of corporate financing.

A radically different approach is also available that offers considerable advantages in terms of efficiency, simplicity and decentralisation, including full administrative autonomy of national tax authorities. It entails abandoning corporate income as the relevant tax base and taxing at a moderate rate some agreed measure of business activity such as company value added, sales or employment. These are the variables usually considered in formula apportionment, but they would apply directly without having first to go through the complications of EU-wide consolidation based on a common-base definition. Reference to a broad base, with no exemptions or deductions, would allow to set low statutory rates.

JEL codes: H25, F15, F23, H87

1. Introduction

After ten years of neglect, there are good reasons to believe that the taxation of corporate income is rising again in the list of the EU policy priorities.

The EC Treaty makes no explicit reference to the harmonisation of direct taxation, but Article 94 opens the way for Community initiatives "for the approximation of such laws, regulations or administrative provisions of the member states as directly affect the establishment and functioning of the common market", which has provided the legal basis for existing directives in the field of direct taxation. Decisions require unanimity of votes in the Council.

As a rule, multi-national enterprises (MNEs) are taxed separately by the countries in which they operate on the basis of the income produced in each jurisdiction ("source" taxation)[1]. To this end, they must keep separate accounts for business units in each country ("separate accounting", SA) ascribing each item of expenses and revenues to each business unit on the basis – by universally accepted convention – of "arm's-length" pricing (ALP), that is of comparable or estimated prices for similar market transactions between unrelated companies.

While being in operation for several decades, the system has never worked satisfactorily since ALP is plagued by severe conceptual and application problems. Integration is amplifying these difficulties since intra-firm transactions take on increasing importance in the operations of MNEs, and financial market integration expands the opportunities for tax-planning in profit allocation and the debt-financing of capital spending.

Within the European Union, several steps were taken at the beginning of the nineties to reduce the tax obstacles to cross-border operations, including the Merger Directive (90/434), the Parent-Subsidiary Directive (90/435) and the Arbitration Convention on dispute resolution in transfer pricing (90/436). However, the problem of double taxation has not been resolved; cross-border operations give rise to substantial tax charges; in a number of cases there is a tax bias in favour of domestic investment; and cross-border offsetting of losses remains limited and uneven (European Commission 2001b). As a consequence, the EU rules appear only marginally better than the conventions and bilateral treaties that govern corporate tax matters internationally.

The advent of the euro and growing integration of goods, services and capital markets, are magnifying the costs and distortions of maintaining fifteen different tax systems. A recent EC Commission study (2001a) has provided fresh evidence on the size of these distortions, as reflected in very large divergences in rates of effective taxation (Table 1), differences in tax bases that multiply opportunities for evasion and abuse, and attendant loopholes and duplications of taxation.

[1] Often, the source principle is combined with a residence principle for at-least-partial taxation of income earned by foreign subsidiaries and branches of resident corporations.

Therefore, there are growing calls for an overhaul of the current rules on corporate taxation from EU companies and national tax authorities, not least in view of the stated goal of strengthening the global competitiveness of European companies and making the Union an attractive location for business.

Clearly, there is no perfect solution. The academic and expert debate has already identified a number of approaches that can be explored. Recently, considerable support has developed for some kind of common-base, consolidated taxation of corporate income at EU level, such as the Home State Taxation (HST) model proposed by Lodin and Gammie (2001) and the Optional Common Base Taxation (OCBT) discussed in a recent CEPS Report (CEPS 2001). Formula apportionment would then be used to allocate income among the different tax jurisdictions (cf. McLure-Weiner 2000).

We will argue that a radically different approach may also be considered that offers great advantages of efficiency, simplicity and decentralisation. It entails abandoning corporate income as the relevant tax base and taxing at a moderate rate some broad measure of business activity.

This paper is organised as follows. Section 2 recalls some principles for corporate taxation and Section 3 discusses desirable features of decentralised taxation systems. Section 4 summarises the current system of taxation of MNEs in the European Union. Sections 5 discusses the main solutions that have been advocated for overcoming the problems of SA/ALP and Section 6 outlines our approach for decentralised presumptive taxation of business units. Section 7 summarises our conclusions.

2. Taxing corporations

Economists have always been puzzled by the idea of a corporate income tax (CIT), which “does not quite fit into the conventional classification of taxes. They have been accustomed to thinking of a dichotomy between direct taxes on individuals ... and indirect taxes on merchandise ... The corporate tax fits into neither of these categories.” (Colm 1955, p. 88).

The main justification for collecting CIT has been a practical one: since most money earned and spent is channelled through corporations, there is strong administrative convenience in collecting revenues from corporations rather than individuals. Some efficiency arguments for taxing income at corporate level can also be made, but they are of lesser import in practice. For example, with CIT earnings can be taxed even when they are not distributed to shareholders, hence eliminating any bias in favour of retained earnings; similarly, retained earnings, dividends and capital gains can all be taxed at uniform rates (provided that the CIT rate is equal to the maximum rate on personal income).

However, the CIT has mainly been seen and applied as a “backstop” for personal income taxation (Bird 2002). In this view, corporate profits have been considered an integral part of shareholders’ income, and CIT as a sort of down payment on their future tax liabilities[2]. Integration of personal and corporate income taxation becomes especially difficult with cross-border income payments[3]; the different approaches adopted in this respect by the member states have been a source of controversy and conflicting tax claims on MNEs.

In general, there is no convincing justification for treating labour, and other personal income, and capital income alike.[4] Equity is violated because comprehensive income taxation discriminates against saving; efficiency suffers because capital accumulation is reduced and, as a consequence, tax revenues decline and the tax burden is partly shifted onto labour, with higher welfare costs than when labour is taxed directly (Gordon 2000). Capital allocation is also distorted because effective tax rates typically differ across assets and investors. Indeed, following the example of the Nordic countries, separate preferential taxation of the fruits of capital has been spreading worldwide (dual income taxation, or DIT). A major drawback of taxing corporations is that its burden will in all likelihood be shifted onto other economic actors, so that it is unclear who will actually pay for it (Bird 2002).

Once integration of personal and corporate income taxation is no longer sought, there is room for a different approach – the "benefit view" – of corporate income taxation that was once familiar to fiscal theorists but fell in disregard in the second half of the past century. For instance, Colm (1955) argued that the state should be seen as a "partner in production, side by side with capital and labour" (p. 53), with the task of promoting business efficiency through spending on education, research and infrastructure, and in general through the quality of its legal rules; accordingly, it could claim some of the fruits of business, commensurate with its contribution to creating favourable conditions for investing and working in the country.

More precisely, taxing corporations may serve the purposes of "internalising" environmental and other costs of economic activity not reflected in market prices; sharing the costs of providing a favourable legal, institutional and social environment for doing business; and reverting to the public sector some of the economic rents implicit in certain activities (Bird 2002).

A feature of efficient taxation relevant for our purposes relates to the distinction between effective and "normal" income, a distinction propounded over sixty years ago by Luigi Einaudi (1959) and applied to company taxation by Tanzi and Sadka (1993). The thrust of the approach is that, when effective income is taxed, an undesirable side

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[2] This is notably true in Europe, while the United States applies a "classical" system with no tax credit and double taxation of distributed earnings.

[3] Comprehensive taxation of personal income requires worldwide taxation of residents' income, but this is already contravened by the differential treatment of domestic and foreign-source interest and dividend income as well as by extensive areas of preferential treatment (public debt, pensions, mortgages, etc).

[4] The Ramsey rule of optimal taxation prescribes that the rates of taxation of different productive factors (tax bases) should be inversely proportional to their elasticity of supply (Ramsey 1927). Deviations from this rule may be justified on grounds of equity ("equal treatment of equals" and ability-to-pay for individuals, and non-discrimination between businesses in similar conditions); Buchanan (1980, Chapter 2) has shown that, with self-interested government, imposing the constraint of uniform taxation of individuals also produces a desirable reduction in revenues from taxation and taxpayers' exploitation by the "Leviathan".

effect is that work and effort are discouraged. On the contrary, presumptive taxation of income – based on some measure of average, or “normal” productivity – rewards hard work and penalises laziness, since income above normal productivity is exempted from taxation, while below-normal productivity entails a proportionately higher tax burden.

These are general features of any system of presumptive taxation, even one that completely abandoned reference to income as the relevant tax base. Systems of presumptive taxation also offer the important advantage of simplicity in the identification of the tax base, insofar as they are built on easily measurable variables.

3. Features of an efficient federal system

The crux of the problem, in designing an efficient tax system for the European Union, is that our national tax systems were conceived and built for largely closed economies, while over the past fifty years cross-border flows of goods, services and capital, and the resulting incomes, have become major components of our economies.

An aspect of particular importance is the growing weight of MNEs in international transactions: according to United Nations estimates, their intra-firm transactions account for more than 40 per cent of international trade (Tanzi 2002). This is a reflection of their enhanced ability to organise their activities, and establish their business units in the most advantageous and productive locations, without losing the benefits of centralised strategies.

Thus, companies search for attractive locations for their capital investments and countries compete to attract them; and business location decisions depend on a number of factors, of which taxation is one (Gammie 1992). Indeed, empirical evidence on the domestic and foreign investments of US companies confirms that the elasticity of real capital flows in response to corporate taxation is positive but not very large (Tanzi 2002). As tax burdens are assessed as part and parcel of the overall desirability of each location, rather than in isolation, there is room for efficient differentiation of CIT rates, and tax competition between the member states of the Union that will improve the allocation of productive capital.

Since the classic paper by Tiebout (1956), the notion that the mobility of persons and firms between competing (local) government jurisdictions may contribute to better outcomes in the choice and quality of public goods has been prominent in economic thinking. Brennan and Buchanan (1980) saw this competition as an effective mechanism for preventing rent-seeking behaviour and the exploitation of tax-payers by local officials; in this view tax competition imposes a desirable discipline on decentralised governments that is missing with monolithic centralised government. The possible violations of efficiency as a consequence of fiscal externalities across jurisdictions have been recognised, but they have generally been considered quite small, hence of little consequence (although hard evidence in this regard is lacking; cf. Oates 2001).

Thus, there appears to be little ground for harmonising taxation policies for MNEs at EU level since tax competition for mobile capital can be expected to be beneficial directly and through its disciplinary effects on government behaviour.

This conclusion has been challenged on the grounds that tax competition would lead to excessively low taxation of capital – which is the mobile factor – and underprovision of public goods (Wilson 1999 provides a useful survey of these arguments). This argument is predicated on the assumptions that the level and composition of public spending are optimal, independently of revenues, and that governments are intent on maximising the welfare of their citizens.

On this, Tanzi and Schuknecht (2000), after careful analysis of the effects of public spending in industrial countries over the last century, reached the conclusion that "small governments did not produce less desirable social economic indicators than big governments" (p. 119), and that in general "much of what governments want to achieve through public spending could be achieved by levels of spending ranging from, say, 25 per cent and 35 per cent of GDP". Since public spending in the European Union is higher – in most cases much higher – large waste and rent seeking by public officials is likely, and the concerns about possible welfare losses stemming from a tightening of external constraints on national fiscal policies would appear misplaced.

Moreover, tax revenues are not independent of tax rules and the resulting burdens. Lower tax rates on capital may well correspond to higher tax revenues, if investment flows in and employment rises. The success story of the Irish economy since the middle of the 1980s – with low rates of corporate income tax, substantial inward direct investment and high employment and income growth – confirms this view.[5]

A different issue concerns the possibility of profit shifting that is inherent in the existence, side by side, of tax jurisdictions with different tax system. What is at stake here is not the efficient allocation of capital, but the possibility for businesses to escape their tax liabilities by appropriately designing their internal transactions and capital structures so as to concentrate profits in low-tax jurisdictions and costs and losses in high-tax jurisdictions. In the same way, countries may be encouraged to offer preferential regimes, by changing their tax-base definitions, simply with a view to attracting financial capital and jobs from intermediation.

In general, such tax arbitrage is likely to be wasteful and inefficient. Wasteful because the internal financial transactions and capital structures of MNEs are distorted by the requirements of tax optimisation. Inefficient because locational advantages and public services do not lead to revenues accruing to the local authorities concerned, so that the continued availability of those benefits may be prejudiced.

In this regard, Keen (2001) considers that preferential regimes may serve a useful purpose, insofar as they restrict the impact of tax competition to the more mobile tax

[5] This central feature of taxation is often neglected by national officials who have tended to see negotiations on tax matters as a static zero-sum game of apportionment of a historically observed flow of tax revenues, and tax competition as diverting "their" receipts.

bases while leaving less mobile tax bases unaffected. “Given that countries do not cooperate in tax setting, it may be better not to cooperate over two tax rates than over one”, thus protecting countries’ ability to tax mobile bases more heavily. Ultimately, the strength of this argument rests empirically on the relative costs and benefits of preferential regimes versus transparent tax competition. In this regard, it appears significant that countries’ in the OECD and the EU have already agreed to discard certain preferential regimes (“harmful practices”)[6] and foster tax-rate competition.

The Ruding Report (1992) had already reached the conclusion that there was “an urgent need to approximate the rules for determining the tax base of member states in order to eliminate unacceptable distortions in competition”, with the attendant benefits of transparency and simplicity (p. 211).

In practice, considerable convergence in base definition has already occurred. The recent study by the European Commission (2001a) shows that tax bases are an important separate determinant of effective (direct) tax burdens on trans-national investment only in a minority of member states (especially Greece, Italy, Luxembourg, Spain and Sweden). In Ireland – long considered the villain of unfair tax competition – statutory and effective rates of corporate taxation are closely aligned (cf. their Chart on p. 6). Implementation of the Code of Conduct for business taxation approved by the Council of the Union (1998) may further reduce the remaining differences.

An additional factor that will foster convergence is the EU decision to adopt the IAS for the consolidated accounts of European MNEs as of 2005[7]. A critical issue in this regard will be the willingness to base the determination of taxable income on civil-law accounting principles, and to keep resort to tax-specific criteria to a minimum.

All in all, the distance to travel to achieve a common-base definition does not appear insurmountable, and the benefits for MNEs would be significant, and agreement on this remains a worthy goal for common policies at EU level, in context of continuing decentralised implementation of tax policies.

Two more requisites of an efficient decentralised system of MNES taxation in the EU concern neutrality and subsidiarity. Neutrality is desirable in the twofold meaning of “vertical” neutrality, whereby at the margin investment should not be affected by taxation, and locational or territorial neutrality, i.e. the absence of cross-border tax distortions.

One way to achieve the former would be to follow Einaudi and Tanzi-Sadka’s suggestion and adopt presumptive taxation of corporate income, either by taxing “normal” income or by resorting to presumptive indicators of business activity. In a decentralised setting, presumptive taxation also has the desirable feature that – since current income is not the determinant of current tax obligations – the scope for profit shifting is greatly reduced.

[6] Cf. European Commission (1997) and OECD (1998).
[7] Community Regulation 1606/2002.

Location neutrality requires source taxation of corporate income. In its pure formulation, countries should exempt foreign-source dividend income and capital gains accruing to their residents from taxation, together with all resident companies' dividends and capital gains accruing abroad (Cnossen 1996).[8] Since the after-tax return to savings influences savers' intertemporal choices and the cost of capital, ideally business source countries and shareholders' residence countries should not impose additional taxes on dividends for personal income taxation purposes. Neutrality by forms of financing would also require the elimination of interest rate deductions at company level.

Subsidiarity boils down to freedom to set tax rates locally, in relation to an agreed definition of the tax base; and administrative autonomy, that is the ability of each tax authority to manage its own assessment and collection of MNEs taxes with minimum need for collaboration and assistance from other tax authorities (Cnossen 1996). Meeting the conditions set out above for location neutrality also goes quite far in facilitating administrative autonomy.

4. Taxation of MNEs in the European Union

Under current arrangements for MNE taxation, parent companies and their foreign branches (permanent establishments) and subsidiaries are normally treated as separate entities for tax purposes, based on SA. Income is allocated between the businesses in a group of related companies by applying ALP to intra-group transactions.

This system suffers from various shortcomings that, far from disappearing, are growing worse (Klemm 2001, McLure and Weiner 2000). Reference prices for intra-firm transactions are often neither available nor easily reckoned, notably for firm-specific products, services and use of intangibles. Internationally, the OECD has developed a set of "recognised" principles (last up-dated in 1995) that can be used by MNEs; however, the variety of acceptable approaches and their lack of precision leave ample room for divergent interpretations.

It is also interesting to note that two – out of five – recognised principles for ALP are in fact presumptive criteria ("transactional profit methods") for the allocation of profits; thus, a kind of formula apportionment, albeit case-by-case and transaction-by-transaction, is already a permitted approach in the European Union.

Conceptual difficulties are compounded by intractable monitoring problems, since each and every transaction has to be valued by companies and controlled by tax authorities. Of course, this is precisely where profit-shifting may arise. When tax authorities' opinions differ on what may be the acceptable treatment of a particular transaction, double taxation or tax-loopholes may be engendered.

[8] Both the German reform of 2000 and the ongoing Italian are in the direction of source taxation, abandoning the previous system of tax credits.

Double taxation and tax-loopholes may also result form the different combination of source and residence treatment of cross-border dividend and interest payments accruing to the parent company or shareholders. Loss offsetting is in general not allowed for subsidiaries, and only permitted within (varying) limits for branches. Deferral of taxation of profits of branches is normally not allowed whereas it is allowed for subsidiaries; conflicting tax claims may arise from control-foreign-companies (CFC) legislation enacted by several countries to counter the booking of profits in "tax heavens".

In sum, MNEs in the EU are confronted with huge compliance costs in trying to meet the requirements of fifteen different tax systems and considerable uncertainty as to the correct application of the rules; tax authorities are confronted with similarly intractable problems in verifying the proper application of ALP; conflicting claims on tax bases, double taxation and tax loopholes are rife.

5. Common consolidated taxation systems

Many of these shortcomings would be eliminated or greatly reduced by getting rid of SA/ALP altogether. One way to do this – while still retaining corporate income as the tax base – would be to determine the taxable income of MNEs resident in the EU on a consolidated basis, using an agreed definition of income, and then allocate this income to the separate business units by means of an appropriate "objective" formula. Each country would then tax the share of it pertinence as it wished.

Before discussing the various approaches that have been proposed in this regard, some comments are in order on formula apportionment (FA).

FA is a tool for the allocation of income generated by a company that operates in more than one jurisdiction, and does not involve the consolidation of the profits and losses of related companies. Rather, it basically is a "presumptive" alternative to SA/ALP that uses variables such as assets, sales and the number of workers to apportion corporate profits between business units; to function properly, it presupposes agreement across tax jurisdictions on the definition of business units and the taxable base (CEPS 2001).[9]

The contribution of each business unit to overall profits is assumed to be proportional to the factors included in the formula, with two consequences: first, estimated profit shares for each business unit may deviate significantly from the actual distribution; and, second, inclusion of a variable in the formula is equivalent to taxing that factor of production. On both accounts, perverse incentives, distortions and efficiency losses may arise. The main benefit would be a dramatic reduction in red tape and the uncertainties inherent in SA/ALP.

[9] In the United States formula variation across jurisdictions is permitted. Its drawback is that the sum of profit shares may then not add up to unity, leading to double taxation or tax loopholes, thus reintroducing incentives for profit shifting.

Two alternative methods that have been proposed as alternatives to the current SA/ALP system are the HST and OCBT; both entail common-base consolidated taxation of MNEs corporate income. Under HST the common tax base is that of the state of legal residence of the parent company; in practice, it is a system of mutual recognition of national tax bases for the taxation of MNEs whereby companies subject to different tax laws would operate side-to-side within the same (national) market. Consequently, each tax jurisdiction may be required to assess and collect taxes on businesses operating under different laws and administrative traditions in fifteen, soon twenty-five, different countries. For this reason its proponents have acknowledged that HST will not work in practice unless the tax (and legal) systems of the participating countries are fairly close. (Klemm 2001)

Under OCBT, on the other hand, EU member states would have to agree on a common definition of taxable income, and MNEs would be allowed to opt for this definition of taxable income – consolidated at Union level, and then apportioned amongst jurisdictions with an agreed formula and taxed with national rates – instead of separate taxation in each country under SA/ALP. In this case, each tax administration would only have to deal, within its borders, with its own system and that of the Union.

Both HST and OCBT would be applicable, at least initially, only to MNEs and on an optional basis. Companies wanting to continue with SA/ALP would be able to do so. This may facilitate agreement at Union level since national tax systems would initially be less affected, while the properties of the new systems could be tested in a real-life experiment.[10]

However, a number of implications for economic and administrative efficiency would have to be fully evaluated (Klemm 2001). The most important one is related to the incentive for the adoption of the new system: those firms that gain most through the manipulation of transfer prices are the ones that are least likely to opt the new system. Furthermore, eventually the common-base definition would have to be extended to all corporate taxation since over time differences between the two systems would create opportunities for wasteful tax arbitrage and profit-shifting.

Another hurdle with these approaches concerns intra-group consolidation, since a uniform juridical/accounting model of company group and group taxation is not available. Indeed, intra-group profit and loss consolidation exists only in a few member states of the Union, and consolidation rules vary considerably among them. Critical issues in this regard are the identification of the group, with associated notions of controlling and controlled companies, and attendant criteria for asset and liability consolidation; in addition, all countries have specific anti-abuse legislation interfering with such matters as loss offsetting or the definition of reserves. In some countries a parent company will include the income of its subsidiaries in its own, and pay tax accordingly; in others the losses of one company may be "surrendered" to another company in the group. Given these differences, setting common standards for group taxation will not be any easier then agreeing on a common tax base.

[10] In this regard, it is interesting to note that initially the introduction of the IAS will only concern the consolidated accounts of MNEs listed on regulated EU stock exchanges.

6. Decentralised presumptive taxation of trans-national businesses

Even if it were possible to find satisfactory solutions to all the hurdles involved in defining a common consolidated base for corporate taxation, a specific difficulty would still remain concerning he very definition of corporate income. Corporate income is a largely conventional accounting magnitude, whose definition varies depending on the purpose one wants to serve. The increased importance of intangibles and human capital in company assets are blurring the traditional distinction between current and capital spending and changing the nature of risks and attendant allowances. Furthermore, the definition of taxable income often reflects implicit or explicit decisions to favour certain factors of production, form of investment and financing, and investment locations. Certainly, the arbitrary character of these differences does not help in finding a common ground internationally.

And yet, corporate income is not the only possible tax base: some form of taxation related to corporate inputs or outputs may provide a simpler and more efficient way to collect taxes from firms operating cross-border. Sadka and Tanzi (1993) once proposed to tax gross physical assets of enterprises as an indicator of normal or average income (cf. above Section 2). However, today their proposal is not likely to provide a reliable indicator of income due to the larger weight of intangibles and services in value added.[11] A more meaningful base could be offered by total gross liabilities, including capital and reserves. All discrimination between types of financing would then disappear, since equity and debt would be taxed alike. However, this variable could only be utilised for determining the total consolidated income of MNEs at EU level, since there would be no simple way of allocating assets and liabilities to decentralised business units within a group.

A radically different approach is also available that offers considerable advantages in terms of efficiency, simplicity and decentralisation, including full administrative autonomy of national tax authorities: it entails taxing at a moderate rate some agreed presumptive measure of business activity such as company value added, sales or employment. Of course, these are precisely the variables usually considered in formula apportionment; here, however, they would apply directly without having first to go through the complications of finding a common-base definition and consolidating company results at EU level. Reference to a broad base, with no exemptions or deductions, would allow to set low statutory rates.

Application of this model requires the adoption of pure source taxation, as mentioned earlier. Ideally, further taxation of savings income in the recipient country should also be avoided; however, agreement on this may prove elusive, since it pertains to the domain of personal income taxation, a closely guarded reserve of national tax policies.

[11] The authors were aware of the problem, but still chose physical assets precisely because they wanted to encourage investment in intangibles (p. 69). However, they did not probably foresee at that time that intangibles and services would take up overwhelming importance in value-generation on many new activities, and that sole reference to gross assets in their case would really leave little to tax.

The choice of the common tax base should avoid introducing unwanted incentives or penalties for different productive factors, assets and forms of financing. A straightforward solution would be to adopt the tax base already in use in the EU for the VAT; of course, there would be no allowance for losses, in accordance with a "benefit view" of corporate taxation and the stated goal of encouraging productive uses of assets. Taxes paid would not be deductible against any other tax liability. Interest rate payments on debt would also be taxed on an equal basis with earnings and the commonly observed bias in favour of debt financing would be removed.

A major advantage is that the administrative and accounting apparatus is already in place. This presumptive taxation also has the desirable feature, in a decentralised setting, of being consistent with capital import neutrality while allowing tax-rate competition between jurisdictions.

7. Conclusions

The existing system for trans-border taxation of corporate income in the European Union produces large distortions in the allocation of capital and perverse incentives to engage in profit shifting across member states and tax avoidance. With growing integration in the internal market, compliance costs and the erosion of tax bases are likely to increase. This hampers the proper functioning of the internal market and justifies fresh initiatives at Community level.

An efficient tax system should have three features: as much as possible, it should do away with separate income accounting by tax jurisdiction and arm's length pricing of intra-firms transactions; it should have a single common definition of the corporate tax base; and it should abandon effective income as the target variable in favour of normal income or some other presumptive measure of corporate activity.

There is no need to harmonise tax rates within the European Union since tax competition between jurisdictions to attract productive capital is efficiency enhancing. Over time, corporate tax-rate disparities across countries are likely to diminish but will not disappear, since the location of investment responds to many factors, of which taxation is only one. In equilibrium, corporate taxes will tend to approximate, or at least not significantly exceed, the net overall benefits of each location. National tax policies and administrative autonomy in tax administration can be preserved, with resulting benefits of flexibility, accountability to national electorates and fiscal discipline.

There are two possible approaches in designing an efficient trans-border corporate tax system for the European Union. The first is to consolidate the EU-wide operations of MNEs, using the agreed common base as the reference variable, and then to apportion this total tax base using some presumptive indicators of activity in each tax jurisdiction – hence, implicitly, of the likely benefits stemming from each location. The common tax base should not necessarily be some notion of income or profit; on grounds of efficiency and simplicity, reference to total company liabilities or other similarly broad measures of business activity would offer considerable advantages. The apportionment formula should respect requisites of neutrality between productive factors and forms of corporate financing.

Two systems that may be able to meet these requirements and appear to deserve further exploration in this context are Home State Taxation and Optional Common Base Taxation. *Prima facie*, the latter appears better able to pass the test of administrative feasibility.

A radically different approach would be to design a fully decentralised system whereby each national authority would tax corporate activity at freely chosen statutory rates while using a common definition of the tax base. The common tax base would have to be an objective, easily measurable indicator of business units activity; total valued added – as already used in the current EU indirect taxation system – would seem to offer strong advantages of neutrality and administrative convenience, since the infrastructure of VAT could be used for assessment purposes. Measures of company assets and liability would no longer do since there would be no simple way to allocate them among companies' decentralised business units.

Company taxation would have to follow "pure" source principles, with moderate rates and no exemptions for interest payments or other cost items; all cross-border payments within MNEs or from them to shareholders would be tax-exempt. There would be no EU-wide consolidation; hence profit and loss offsetting would not be allowed. This may not be too serious a drawback, to the extent that one is willing to consider corporate taxation as a sort of counterpart to locational benefits and to recognise that, on efficiency grounds, it is better not to tax actual corporate income.

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Table 1: Statutory and effective marginal (EMTR) and average (EATR) tax rates (only corporation taxes).

	Statutory rates (1)	EMTR	EATR
Austria	34,00	20,90	29,80
Belgium	40,17	22,40	34,50
Denmark	32,00	21,90	28,80
Finland	28,00	19,90	25,50
France	40,00	33,20	37,50
Germany	52,35	31,00	39,10
Greece	40,00	18,20	29,60
Ireland	10,00	11,70	10,50
Italy	41,25	-4,10	29,80
Luxembourg	37,45	20,70	32,20
Netherlands	35,00	22,60	31,00
Portugal	37,40	22,50	32,60
Spain	35,00	22,80	31,00
Sweden	28,00	14,30	22,90
UK	30,00	24,70	28,20

Source: EC Commission 2001a
(1) Including surcharges and local taxes