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Capital Taxation in an Enlarged EU: The Case for Tax Coordination

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Abstract

The paper reviews coordination steps in European capital income taxation (CIT) in the past and hints at unsolved problems of capital taxation in the EU-25. Based on this experience we argue that there is room for further coordination which properly implemented should be beneficial to the Member States without sacrificing national fiscal autonomy in capital taxation.

1. Introduction

Tax coordination as a measure against potentially harmful tax competition has been and will most likely remain a controversial topic in the political as well as in the academic arena (see, e.g., Cnossen 2001, 2003; Eggert and Genser, 2001). Within the EU, the principle of subsidiarity has been strengthened by the Treaty of Maastricht and again in the European Constitution. This principle guarantees the national parliaments an entitlement to set tax rates in line with national objectives, e.g., to cover the costs for an efficient pattern of public services, or to redistribute income equitably by a progressive tax-transfer scheme. Following Tiebout tax competition is beneficial, since it forces governments to balance efficiently tax revenue collected from and public services provided to societal groups. Furthermore, tax competition is regarded as a desirable means to tame “Leviathan” behavior of nonbenevolent governments. The European Commission, on the other hand, has frequently brought to the fore the issue of distortionary effects through tax competition. VAT and excise harmonization measures have been introduced to prevent distortion in intra EU trade and to fight fiscal externalities on neighbor countries through trade diversion (Cnossen, 2001; Genser, 2003). Moreover, the European Commission is afraid of governments who follow unfair tax practices by offering tax preferences to attract foreign capital investment. The 1997 Code of Conduct was a measure to cope with this phenomenon (European Commission 1997). Finally, tax competition may give rise to a race to the bottom in national tax rates on internationally mobile tax bases and national governments may end up with sub-optimally low levels of public services.

In the light of the arguments for and against tax competition, it seems fair to say that there is no simple solution to the dispute (cf., e.g., Cnossen, 2004; European Commission, 1992, 2001; Homburg, 1998; Mintz, 1999, 2002; Sørensen, 2000). There are certainly welfare gains and welfare losses associated with tax competition and the justification of a measure in favor of or against tax competition depends on the economic environment of the tax in question. While in the founding days of the EU income tax competition was not a pressing issue, being aware of the fact that the production factors labor and capital as well as the related income tax bases were regarded largely immobile between countries, the situation has changed in the last decades. Capital mobility has increased dramatically after the liberalization of the European capital market in the early nineties, and the global financial market as well as the growing importance of multinational firms with subsidiaries spread all over the world have created a new economic environment for national capital taxation.

Capital tax competition implies that national governments strategically adjust their tax policy to pay attention to new situations, particularly to tax rate changes of their competitors. In effect, national corporate income tax systems have undergone major changes in the EU as in most OECD countries which might be regarded as tax competition effects. Nevertheless, for a long time the EU authorities were very reluctant to propose harmonization measures for capital income taxation in Europe. Only after the 2004 enlargement when many of the New Member States reduced their corporate income tax rates to levels well below the traditional levels of the old OECD countries, proposals in favor of minimum corporate income tax rates within Europe became fashionable.

In this paper we try to answer the question whether EU enlargement should give rise to capital income tax coordination on the EU level. The remainder of the paper is organized as follows. In section 2, we review the European view on capital income taxation in the first four decades after the Treaty of Rome and identify proposals, objectives and measures in favor of capital tax harmonization. Section 3 focuses on unsolved problems for capital income taxation in the enlarged EU. In section 4 we provide guidelines for CIT coordination and conclude in section 5 that some CIT coordination steps are desirable from a welfare perspective and should be taken.

2. CIT Coordination in the EU

There is widespread belief that capital income taxation was not a major issue on the European Commission's agenda in the early days of European integration, but this view is biased. On the one hand, one of the basic obligations of the EC Treaty and thus binding for all Member States is the avoidance of international double taxation

(Article 293, EC-Treaty), which requires unilateral or bilateral measures to ensure that factor income earned and taxed at source in one Member State is not subject to additional income taxation in the residence country. The prominent factor exposed to international double taxation is capital, and the usual way to do so is by bilateral treaties following the recommendations of the OECD model treaty. On the other hand, there had been continuing interest in European capital taxation in the Community which can be easily documented by the reports requested by and delivered to the EU Commission.

2.1 Proposals for CIT Harmonization in the EU

Already in 1960 the European Commission required a fiscal and financial committee chaired by Fritz Neumark to deliver a report on the desirability of a coordinated corporation tax to support the establishment of the European common market. The recommendation of the Neumark Report (Commission European Economic Community, 1962; Thurston, 1963) was the introduction of a split rate system in the six founding Member States of the EC, proposing a flat rate around 50% on retained profits and a rate between 15% and 25% on distributed profits. Apparent disagreement on this proposal which favored the then German practice of double taxation relief on dividends but did not eliminate double taxation made the European Commission ask A.J. van den Tempel to deliver another report by end of the 1960s. The van den Tempel Report (Commission of the European Communities, 1970) recommended the classical corporation tax as the best solution for a harmonized system in the EC.

When the Commission realized that no accord was to be attained by abstaining from any form of double taxation relief it changed its strategy and worked out a proposal for a directive concerning the harmonization of company and dividend taxation calling for partial integration of the corporation tax and the personal income tax (Commission of the European Communities, 1975).

Besides partial integration the proposal suggested a rate band for corporation tax rates in Member States of 45% to 55%, partial imputation of the corporation tax paid on distributed profits to PIT on dividends in a band between 45% and 55% and a withholding tax on dividends of 25%. There was never a realistic chance for unanimous support for this draft directive and when the European Commission negotiated the White Book on the completion of the European internal market in the second half of the 1980s, it finally decided to repeal the proposal in 1990. But at the same time the European Commission succeeded in receiving unanimous support on three companion directives targeted at double taxation relief for European companies and the European Commission again installed an expert panel chaired by the former Dutch finance minister Onno Ruding to analyze the situation for company taxation in the EU internal market. The Ruding Committee delivered its report in 1992 and its answer to the crucial question: “Does uncoordinated capital taxation in the EU Member States provide an obstacle to doing business in the integrated internal market?", was in the affirmative. The Ruding Report (European Commission, 1992) did not only contain a comprehensive list of discriminatory effects of the then existing practice of capital taxation in the 12 Member States, it also proposed a stepwise coordination strategy to be implemented in three phases. The measures concentrated on an abolition of discriminatory taxation of cross country business activities of all enterprises, proposed a band for corporation tax rates between 30% and 40% and called for double taxation relief in phases 1 and 2 and sketched a final target of a common European CIT in phase 3. Remembering the difficulties in reaching a common platform for CIT coordination in the past, the European Commission only picked up the Ruding recommendations for European companies and denied any further coordination requirements. Finally in 2001, the most recent report of an expert panel on European company taxation was released. The Bolkestein Report (European Commission, 2001) can be regarded as a follow up report of the Ruding Report and approved the fundamental sources of distortionary CIT effects on entrepreneurial activities. But opposite to the Ruding committee the Bolkestein expert panel did not release a coordination strategy but provided a menu of four scenarios to overcome distortionary effects of the status quo of company taxation. The focus of these scenarios is profit consolidation of European companies operating in several EU Member States and avoidance of tax engineering incentives by utilizing formula apportionment as the mechanism to allocate the consolidated CIT base to national tax authorities (see, e.g., Devereux, 2004; Hellerstein and McLure 2004; Mintz, 2004).

Since none of these various proposals reviewed above was adopted by the EU the process of CIT harmonization certainly is a failure with respect to formal achievement of binding coordination rules. But such a judgement would be misleading because it ignores two aspects of the ongoing CIT discussion.

One aspect is the driving force behind this discussion. Although the proposals for a coordinated European CIT reviewed above certainly exhibit a broad diversity, it is possible to identify three economic objectives as a common denominator behind all the CIT reform proposals. First, all reports start out from the evidence of highly differing and nonneutral effective tax rates on capital returns as a consequence of uncoordinated national tax practices and call for a tax system which provides a level playing field for business activities across the common European market (Cnossen, 2004; European Commission, 1992). Second, non-discrimination of cross border activities of European companies has been regarded as a desideratum which can be directly derived from the principles of the Treaties of Rome and Maastricht. Third, mitigation of fiscal externalities triggered by strategic tax competition among Member States was regarded desirable, even though the empirical evidence never proved a "race to the bottom" in CIT rates (European Commission, 2004).

A second aspect is that CIT coordination results were achieved outside the CIT reform proposals mentioned above. These results are summarized in the following subsection.

2.2 CIT Harmonization Steps in the EU

When the European Commission released its proposal for a draft directive on harmonizing company and dividend taxation in 1975, three draft directives had already been pending dealing with discriminatory taxation of multinational European companies. The Parent/Subsidiary Directive and the Merger Directive were released in 1969, the Arbitration Directive in 1974. Progress on negotiations on these issues was deplorably slow, but in 1990 all three packages passed.

The Parent/Subsidiary Directive (Council Directive 1990/435/EEC) abolished the international double taxation of dividends between parent company and defined subsidiaries which fulfill, e.g., a substantial ownership condition. The directive requires the elimination of double taxation through exemption or crediting and it does not allow withholding taxes on dividends paid out under the regulations of the directive.

The Merger Directive (Council Directive 1990/434/EEC) postpones the taxation of capital gains which would become due if companies merge, separate or reorganize. Basically, the directive extends going national tax preferences for a reorganization of corporations within a country to analogous reorganization measures when the parent company and its subsidiaries are located in different states.

The arbitration directive was replaced by an Arbitration Convention (Convention 1990/436/EEC), which required a compensating correction of corporate income tax bases under the "arms' length principle" when transfer price corrections by the tax authority in one Member State changed the tax balance of a company. Without compensating changes of tax balances transfer price corrections would lead to international double taxation. In 2004, the Council reemphasized the objective of double taxation avoidance by approval of a Code of Conduct for the effective implementation of the Arbitration Convention (COM (2004) 297).

In 1997, the European Commission Council approved a European Commission proposal (European Commission, 1997) against unfair tax competition. The measures proposed under this "Code of Conduct" for business taxation, however, are not targeted at strategic tax rate reductions per se, but only at discriminatory tax preferences for foreigners that are not available to resident taxpayers. The Member States of the EU commit themselves to refrain from:

– tax preferences which are offered only to nonresidents
– tax advantages granted to firms with no real economic activity in the country
– rules for profit determination that depart from internationally accepted accounting principles

– non transparent administrative practices in enforcing tax measures.

In the following years, the installed Code of Conduct Group (Business Taxation) identified 40 unfair and harmful tax practices in EU Member States (and another 26 in associated territories) which violate the code of conduct. Although the regulations of the code are not mandatory, the EU Member States agreed on eliminating these practices, the bulk of which is associated with services in the financial sector and within multinational groups.

In 2003, the Council adopted a package of three measures affecting European CIT, consisting of the Political Code of Conduct to eliminate harmful tax competition in business taxation, the Interest Savings Directive and the Interest and Royalty Directive.

Whereas the formal adoption of the Code of Conduct for business taxation is an affirmation of the 1997 approval, the two directives directly affect CIT in the Member States.

The Savings Directive (Council Directive 2003/48/EC) backs income tax collection on interest income of residents earned in other Member States. Foreign interest income, which to a large extent was able to escape residential income taxation will become enforceable under the directive by mandatory exchange of information. There is, however, a period of transition when three Member States (Austria, Belgium, and Luxemburg) keep bank secrecy but committed themselves to charge a withholding tax of 15% (increasing to 20% and finally 35% after 3 years respectively) on interest income of foreigners. Three quarters of the revenue of this withheld tax is forwarded to the saver's residence fisk. The three Member States will switch to information exchange, if appropriate arrangements are attained with Switzerland (as well as Andorra, Liechtenstein, Monaco, and San Marino) and the United States.

The Interest and Royalty Directive (Council Directive 2003/49/EC) eliminates withholding taxes on interest payments as well as on royalty payments between associated companies located in different EU Member States.

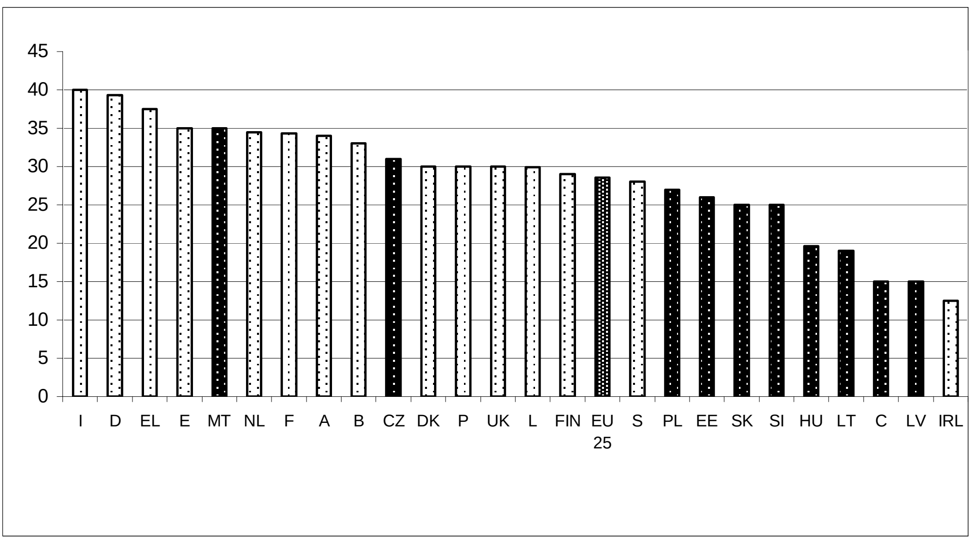
Moreover, the European Commission has also announced a new proposal for a directive on cross border losses.

An evaluation of the coordination achievement in European capital taxation has to acknowledge that the discrimination of transborder activities has been reduced considerably. International double taxation of income has been abolished for income flows between associated corporations. Transborder mergers, acquisitions and other restructuring measures do no generate taxable capital gains and receive the same preferential treatment as corresponding activities within national boundaries. Effective tax rate differentials on corporate profits were reduced, mainly as a matter of cuts in statutory CIT rates in EU Member States, but are still high. International tax arbitrage has been reduced, as foreign interest income is taxed more effectively, but there are differentials for tax engineering, in particular for shifting paper profits. Tax compliance costs are still high for companies with subsidiaries in different EU Member States as a matter of separate accounting requirements and coping with a complex network of bilateral double taxation treaties.

3. Unsolved CIT Problems in an Enlarged EU

The ten new members of the EU-25 are forced to adjust their tax system in line with the acquis communautaire, but they are also free to position themselves in the European internal capital market and to attract mobile capital by low tax rates.

Chart 1: Statutory CIT Rates in the EU (2003)



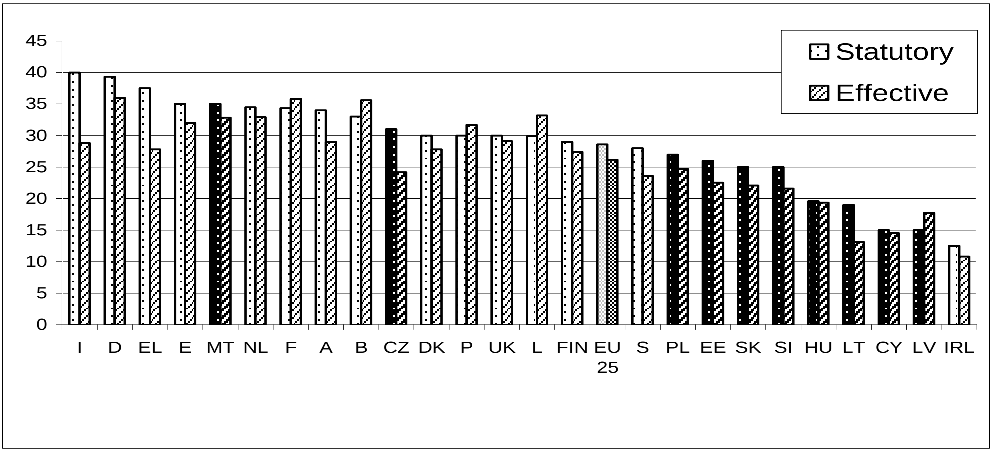
Note: White shaded bars represent the EU-15 Member States, black shaded bars the 10 New Member States, and the grey shaded bar the unweighted EU-25 average.

Source: Bundesministerium der Finanzen (2004).

Chart 1 confirms that the statutory corporate income tax rate in the accession countries (unweighted average in 2004, 23,8%) is significantly lower than in the traditional 15 Member States (2004 31,8%). All accession countries except Malta and the Czech Republic charge a corporate income tax rate, which is lower than the EU-25 average, while all EU-15 states except Sweden and Ireland charge a corporate income tax rate higher than the EU average.

The span and variance of statutory rates across the EU provides incentives for tax arbitrage in various ways. A lower statutory rate directly affects the shifting of paper profits by transfer pricing, thin capitalization and allocation of overhead costs. But statutory tax rate differentials have also been proven as the most important determinant for the international dispersion of effective tax rates, marginal and average (European Commission, 2001; Cnossen, 2004).

Chart 2: Statutory and Effective Average CIT Rates (2003)



Note: White shaded bars represent the EU-15 Member States, black shaded bars the 10 New Member States, and the grey shaded bar the unweighted EU-25 average.

Source: Spengel and Wiegard (2004).

Chart 2 reflects a high correlation between statutory and effective average corporate income tax rates for 2003. Again the effective average tax rates for the accession countries (21,3%) are significantly smaller than those of the EU-15 states (29,4%), and this time nine accession countries, including also the Czech Republic are below the EU-25 average.

Lower marginal effective tax rates provide a rate of return incentive for capital investment, lower average effective tax rates provide an incentive to relocate firms and headquarters to low tax countries.

While channelling capital to the new accession countries is certainly useful as long as there is capital shortage and the marginal capital productivity is high, tax incentives stimulate capital inflows also when the marginal capital productivity in the country of investment is lower than the EU equilibrium level.

With the accession countries being part of the European internal capital market, low transaction costs of capital flows and increasing dispersion in effective marginal tax rates, capital export neutrality will be violated and the allocation of the European capital stock will be distorted.

With an increasing dispersion on effective tax rates on capital returns within EU-25 countries, capital import neutrality will be violated and the allocation of EU capital supply will be distorted.

Finally, the increasing dispersion of statutory CIT rates triggers profit shifting across borders and creates negative fiscal externalities across EU fisks (Haufler and Schjelderup, 2000; Huizinga and Nielsen, 1997).

In the medium run CIT competition in the enlarged internal capital market of the EU-25 is likely to reduce the level of CIT rates in the Member States. Since high tax countries will face the pressure to reduce their CIT rates the variance of CIT rates will go down. The remaining dispersion of statutory tax rates will leave sufficient room for tax arbitrage and tax engineering due to the rapid increase of companies with associated subsidiaries in the New Member States. CIT measures which helped to end tax discrimination to multinational European companies and to establish an efficient European capital market will intensify capital tax competition in the enlarged Europe.

4. CIT Solutions for an Enlarged EU

CIT coordination in the EU has to be evaluated in two dimensions. From a purely economic perspective, CIT coordination should favor the efficient supply and utilization of capital in the enlarged internal capital market. From a political economy perspective, CIT coordination has to pass the unanimity hurdle in the Ecofin Council. Although efficiency as well as political approval are dependent on the economic and political environment, it seems worthwhile to look at the history of CIT reform proposals with respect to three primary targets:

- a harmonization of statutory corporate income tax rates
- a harmonization of corporate income tax bases, and
- introducing a common European corporate income tax.

4.1 Harmonization of Corporate Income Tax Rates

Harmonization of statutory rates has been an element of the reform proposal of the Ruding Committee as well as an element of the Draft Directive of 1975. Both reform proposals included bands for the statutory corporate income tax rates. Rate harmonization would not align statutory rates, its impact on effective tax rates would also contribute to a move towards a level playing field in international capital taxation.

On the other hand, fixing a lower band as a floor to national corporate income tax rates of 45% (as proposed in 1975) or 30% (as proposed in 1992) would certainly have hampered the accommodation of EU countries to the international development, since it would have required an unanimous agreement on a reduction of lower band rate in the Council. Moreover, harmonized tax rates have turned out as a matter of disagreement among EU Member States, not only with respect to the draft directive but also with respect to VAT and excise taxes.

In face of the current broad dispersion of statutory corporate income tax rates it would be certainly more difficult than in the past to reach consensus on a rate band with an appropriate floor which would reduce the dispersion of statutory and subsequently effective CIT rates.

4.2 Harmonization of Corporate Income Tax Bases

Harmonization of tax bases has been addressed in all reform proposals, most prominently in the Bolkestein Report (European Commission, 2001). Base harmonization serves two objectives.

At the national level, the determination of the corporate income tax base affects the tax burden and the effective tax rate on corporate income. If high and low tax countries use the tax base as well as the tax rate to determine their aspired tax burden on corporate profits, then harmonization would cut back one pillar of effective tax rate dispersion und the cross country variance of effective tax rates will decrease. Under this scenario tax base harmonization would contribute to a level playing field. But the effect of tax base harmonization may well be the other way round. If high tax countries grant preferential treatment via generous deductions from taxable corporate income, e.g. investment or depreciation allowances, whereas low tax countries offer less tax preferences, then tax base harmonization will increase the dispersion of effective tax rates across countries (Sørensen, 2004).

For internationally operating companies the tax base of each subsidiary has to be calculated according to the tax code of the country where the subsidiary is located. Dealing with various tax codes and tax administrations increases compliance costs for the company. These costs comprise information, book keeping and filing costs, but there are also costs of consolidation and the risk of double taxation if a tax authority corrects taxable items which enter the tax balances of associated subsidiaries located in different states. Harmonizing the tax base for corporate income taxation is a desideratum of the Bolkestein Report, in order to cut compliance costs for multinational European companies.

The Bolkestein Report offers three scenarios of tax base harmonization. The first two scenarios are optional and allow a multinational company to calculate its own tax base and the tax bases of its associated subsidiaries separately or to calculate a consolidated tax base:

– The "home state taxation" regime denotes a corporate income tax system in which an internationally operating parent company can opt for a consolidated tax balance which includes all its associated subsidiaries and which is calculated according to the tax code of the company's country of residence.
– The "consolidated common tax base" regime denotes a corporate income tax system in which an internationally operating parent company can opt

for a consolidated tax balance, which is calculated according to specific tax rules which are defined independently from the tax rules of the EU Member States.
- The "compulsory harmonized tax base" regime denotes a corporate income tax system in which the corporate tax base is calculated according to the same binding rules for all companies in the EU.

Replacing separate accounting by consolidated accounting does not only reduce compliance costs since a multinational company will have to deal with only one system of tax accounting. Consolidation also eliminates incentives for profit shifting across borders which saves resource costs for companies as well as for tax authorities. Companies will no longer have to invest in tax engineering to shift profits to subsidiaries in low tax countries, tax authorities will be able to reduce efforts in monitoring and control to disclose transfer pricing. Consolidation will also solve the still unsettled problem of cross border loss offsets. Eliminating this remaining element of discrimination for multinational companies is of particular importance to accession states, since startup subsidiaries which usually create losses in the first years, would no longer be disadvantaged.

Consolidation does, however, not come without costs. Consolidation eliminates tax benefits through strategic utilization of tax preferences in specific EU Member States. The Bolkestein Report accounted for this firm-specific cost of consolidation by offering consolidation as an option, which can be declined by companies who prefer to stick to separate accounting. But upholding the separate accounting option is likely to destroy the resource cost saving to companies who would be forced to compare the options, as well as to tax authorities, who will be forced to monitor different systems of tax accounting.

Consolidation does not solve the problem of apportioning the consolidated tax base to the subsidiaries of a multinational corporation. The proposed solution is formula apportionment, a technique which has been applied within federal states. Finding an appropriate formula for international apportionment might turn out a difficult task, but a redistribution based on business figures, e.g. the Massachusetts formula in the U.S. (apportionment formula based on capital assets, wage bill and business sales, each weighted by one third), certainly is a useful candidate. Whenever a consensus on an apportionment formula based on business data is attained there might return an incentive for multinational companies to manipulate the weights for tax purposes. In this case fixed weights for groups of companies or sectors might be discussed to avoid manipulation incentives at the company level (Nielsen, Raymondos-Møller, and Schjelderup, 2003).

4.3 Introducing a Common European Corporate Income Tax

A common corporate income tax for the EU was mentioned as a long-term objective in the Ruding Report. The political reservation towards the staggered proposals of the Ruding reform may well be based on the fact that the phase 1 and 2 coordination steps were regarded as steps towards a European corporate income tax.

Although tax base and tax rate harmonization in European corporate income taxation seem to be back on the EU agenda, the transfer of the power to tax corporate profits from the national level to the EU will hardly get any support in the Council. Opposition will be even stronger since the European Commission had raised the issue of a further source of EU revenue and referred to a European corporate income tax in the past.

4.4 Guidelines for CIT Coordination in the EU

Experience with past coordination steps in European corporate income taxation and the changing environment for tax competition in the enlarged European capital market support further reform steps.

Consolidated accounting for European multinationals seems an appropriate measure to reduce compliance costs for companies and to fight strategic profit shifting within the EU.

Comparing the proposals of the Bolkestein Report none of these scenarios seems convincing.

The separate accounting option is costly and keeps tax engineering incentives alive, the compulsory common tax base for all companies creates adjustment costs for small scale companies without international subsidiaries. Compulsory "home state taxation" might create a new form of tax competition, viz. attracting headquarters of multinational companies.

Recommendation 1:

Consolidation of company profits should be mandatory for EU multinational companies according to harmonized corporate income tax accounting standards.

Consolidated corporate profits must be allocated to companies in EU Member States according to apportionment factors which should not give rise to strategic manipulation.

Recommendation 2:

The reallocation of consolidated profits to taxable subsidiaries of multinational corporations should be based on an apportionment formula using multiple weights based on easily verifiable business figures.

National autonomy on tax rates offers fiscal autonomy, alignment of company and personal income taxation and complies with the subsidiarity principle. Thus, a coordination of corporate income tax rates does not seem desirable for the moment.

Recommendation 3:

National autonomy in setting corporate income tax rates on taxable corporate profits should prevail.

There are, however, arguments to introduce a floor for corporate income taxes in the EU to prevent a race to the bottom. But there is also an incentive in the other direction once consolidated profits are apportioned among EU Member States. As formula apportionment provides a largely inelastic tax base, there is an incentive to apply a high corporate income tax. Since in each Member State the same corporate income tax rate is applied to apportioned profits and profits of purely domestic firms, a "race to the top" seems unlikely as well.

4.4 Gains from CIT Harmonization

Further steps in CIT Harmonization sketched in section 4.4 are restricted to harmonized tax accounting standards for multinational companies and the approval of an adequate apportionment formula. Since multinationals are important players in the internal market, a common strategy in treating this companies identically for tax purposes and in sharing tax revenue in a transparent and equitable way might be in the interest of all Member States.

But here are additional welfare gains which must be considered in an evaluation of the proposed harmonization scenario. First, consolidation reduces tax compliance costs. Second, reduced or vanishing profit shifting eliminates fiscal externalities and reduces monitoring and control costs of tax authorities. Third, harmonized accounting standards eliminate national tax handles for unfair tax practices. Fourth, consolidation secures full international loss offset. Fifth, consolidation, apportionment, and application of different national tax rates comply with capital export neutrality. Consolidation ensures that a marginal euro earned in any country of the internal market is taxed at the same average tax rate. Seventh, fiscal autonomy in corporate profit taxation is granted, in line with the subsidiarity principle. Eighth, consolidation creates no impairment with the integration of PIT and CIT in Member States.

But we would also like to hint at problems which are associated with the coordination proposals. The negotiation on appropriate weights in the apportionment formula will be difficult and lengthy, although the application of the formula is restricted to the profits of multinational companies. This discussion will also have to deal with company profits in non-EU countries. The usual practice in federal states is to stop formula apportionment "at the water's edge", which would mean to apply the formula to the consolidated profits within the EU but to keep separate accounting for company profits earned outside the EU.

5. Concluding Remarks

In this paper we tried to show that corporate income tax coordination is not a new agenda for European tax harmonization but a necessary adaptation of tax practices to the new challenges of the internal capital market in the enlarged EU-25.

The recommendations for CIT coordination sketched in the paper concentrate on the treatment of multinational corporations in Europe and can thus be regarded as a consequent extension of coordination steps which have proven useful in the past.

The unanimity requirement for tax coordination makes it necessary to analyze carefully economic as well as political economy effects. We hope to have sketched the scope of welfare gains of further coordination and admit that quantitative analyses are needed to make the beneficial effects transparent to the governments of the member countries.

Welfare gains from the coordination proposal accrue through reduced cost of tax compliance, reduced tax engineering and rent seeking, and reduced costs for tax administration and monitoring. These gains are attained without restricting the right of Member States to set their corporate income tax rates and without interfering in their national tradition of integration capital income taxation at the company and the personal level. Moreover, the proposed coordination steps would not impede further coordination in European capital taxation as addressed in the alternative reform agenda of Sijbren Cnossen (Cnossen 2004, and in this volume).

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