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PLATFORM FOR TAX GOOD GOVERNANCE

Competitiveness and Tax Competition

Discussion paper for the Platform on Tax Good Governance

Meeting of 12 September 2018

The purpose of this paper is to set out some of the elements to consider in the context of competitiveness and tax competition – within the EU and vis-à-vis the rest of the world. The paper is intended as a first basis for discussion on this topic and therefore is not exhaustive.

Platform members are invited to contribute their own views on how the EU and its Member States can increase their competitiveness via tax policy, how this can be achieved without compromising fairness and what approach to tax competition would be most appropriate for the future.

Disclaimer:

This is a Commission services working paper prepared by DG TAXUD for discussion purposes. It does not represent a formal Commission or Commission services position or policy. The paper is therefore without prejudice to any position which may be taken by the Commission in the future

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INTRODUCTION

Globalisation and the growing importance of digitalisation and intangible assets to value creation have put increasing pressure on nation states to compete to promote investment. The growing role of multinationals in the world economy, reduction in trade barriers and improvements to technology are particularly important drivers of this competition. Together, they mean that businesses are increasingly able to serve markets remotely and have more options available to them when it comes to locating their productive activities than they did in the past.

Tax policy is one tool available to countries to enhance their competitiveness. It is perhaps not surprising then that corporate income taxes have fallen dramatically across the world over the last thirty years as countries have sought to attract business investment, nowhere more so than in the EU. Several Member States have also introduced other tax regimes designed to promote investment.

Countries also compete to attract taxable revenues, as taxation policies can strongly influence where companies report profits for tax purposes¹. This has two important implications. Firstly, competition can produce mismatches between the place where economic activities take place and where the profits resulting from those activities are taxed. Secondly, tax policies in one country can undermine the tax base in another country.

Tax competition between Member States is largely unregulated. However, through the Code of Conduct for Business Taxation, Member States have given a political commitment to refrain from harmful tax practices and unfair tax competition. EU state aid rules also prevent countries from selectively providing favourable tax treatments to certain businesses. However, these do not limit the ability of countries to use their corporate income tax systems as a whole to compete internationally. There are even fewer restrictions outside the EU, although BEPS and the EU list of non-cooperative jurisdictions may reduce the most harmful forms of tax competition.

There are signs that tax competition is intensifying internationally. Outside the EU, several OECD economies have made major reforms to boost the competitiveness of their corporate income tax systems. Most significantly, the recent tax reform in the United States put a strong focus on boosting US competitiveness, including by reducing the federal corporate income tax rate from 35% to 21%.

It is therefore timely to examine the role that taxation should play in boosting EU competitiveness and to consider how EU tax policy should be shaped accordingly. This reflection should not be considered in isolation however, and must also be weighed against other tax policy priorities, particularly the need for fair and effective taxation.

ELEMENTS FOR A COMPETITIVE TAX SYSTEM

Competitiveness is generally measured by an environment that promotes investment and innovation by businesses and allows them to compete in international markets, while also attracting investment from international companies. Many different factors determine where a company chooses to invest, and finding the right balance can be delicate and complex. These factors include strong institutions, good infrastructure, skilled and educated workforces and

¹ A recent IMF study finds that before-tax profits increase by 1% when the corporate income tax rate reduces by 1%.

the rule of law. Taxation policy is simply another factor, and its importance for the company will vary depending on the type of investment and the degree of competition in that market.

Companies tend to be more competitive when the tax burden decreases. In some respects, tax is like any other cost. Reducing the tax burden increases profitability and frees up resources for companies to invest or to reduce their prices. Consequently, lowering tax rates can improve the competitiveness of domestic companies and improve the attractiveness of a country for overseas investors. On the other hand, if lower corporate tax receipts lead to lower public expenditures on infrastructure or higher taxes on labour, this could be detrimental to a country's overall competitiveness. Therefore, a balance must be struck and the appropriate mix will vary between countries.

Tax competitiveness is about more than just tax rates. Changes to the tax base can create a more favourable environment for investments than reductions to the tax rate. For example, a company has income of €100 and invests €100 in new equipment. If the tax rate falls from 20% to 15%, the company's tax liability will reduce from €20 to €15. However, if the tax rate stays at 20% but the country allows the company to offset the cost of the new equipment against its income, the company's tax liability will be €0. It follows that adjustments to the tax base can be just as important to improving a country's competitiveness. These could include immediate expensing, cash flow taxation or allowing the deductibility of equity financing costs. Tax incentives – such as R&D credits or incentives for venture capital and business angels – can also have a marked impact on the level of investment.

The tax environment is another important factor. Businesses and investors frequently cite legal certainty, stability, predictability, the simplicity of tax rules, favourable employment incentives and tax treaty agreements as important considerations for location decisions. Measures that reduce compliance and administrative costs can therefore enhance competitiveness (e.g. the VAT One Stop Shop and Dispute Resolution Mechanism).

Finally, the importance of creating a truly competitive environment should not be underestimated. Only competition on a level playing field allows that the best ideas and innovations and the most efficient businesses succeed in the market.

THE GLOBAL CONTEXT

Tax competition continues to intensify around the world and there appears to be little appetite at an international level to regulate or control this competition. The long-term trend of falling tax rates on corporate income looks likely to continue. Even countries that previously refused to engage in tax competition, such as Japan and the United States, have enacted or announced substantial cuts to tax rates in recent years. Several countries are also strengthening tax incentives designed to attract technology businesses and boost long-term innovation.

Against this background, it is more important than ever that the EU remains competitive. The 'winner takes all' nature of the digital economy and the growth of emerging economies means competition for investments will only increase in the coming years. The EU has already made great strides to empower Europe to embrace the economic opportunities of the future through initiatives such as the Digital Single Market and Capital Markets Union.

However, in the face of intense tax competition internationally, the EU and its Member States need to consider whether their current taxation policies support sustainable and inclusive growth. The focus until now has largely been on maintaining a level playing field and ensuring that businesses make a fair contribution. These remain key priorities, which EU tax

policy will continue to promote. Competition must be fair and support, rather than undermine, the social cohesion and prosperity of our societies. However, the EU also needs to make sure that its taxation policies complement the benefits of the Single Market and make the EU an attractive place to invest and do business.

A SINGLE APPROACH FOR THE SINGLE MARKET?

From an EU perspective, a key question is whether a controlled approach to tax competition in the EU would help or hinder Member States' collective competitiveness.

The current approach allows Member States to take into account their size and economic structure in the design of their tax policies. It provides considerable flexibility for national tax systems to respond to international developments. In continuing such an approach, EU would rely on the more successful competitors in taxation to raise the overall level of competitiveness for the Union as a whole. In such a case, there may be the need to redefine current boundaries of unfair tax competition (i.e. the mix of the Code of Conduct and state aid rules) to make sure competition does not undermine public provision or result in negative spillovers on other countries.

Another approach would be to move towards a more coordinated system. In such a case, Member States would find a common ground on which to compete with third countries, while reducing intra-EU competition. This approach would minimise loopholes, legal clashes, unnecessary administration and uncertainty for businesses in the Single Market. At the same time, EU tax policy would need to re-focus on delivering elements that would allow Member States to respond effectively to external competitive pressures.

A strong and coherent EU approach to tax competition vis-a-vis the rest of the world should increase the EU's ability to influence the international norms in this area. This, in turn, could help to ensure that the international framework is also conducive to growth and competitiveness in Europe.

Topics for Discussion

1. What do you consider are the key elements in taxation needed to boost EU competitiveness (e.g. rate, base, administration etc.)?
2. What are the biggest risks to EU competitiveness today, from a tax perspective?
3. Does internal competition within the EU enhance or detract from overall EU competitiveness?
4. How can we enhance competitiveness without compromising the EU agenda for fair taxation?