

Corporate income tax reform in the EU

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Corporate tax reforms in the EU are motivated by evidence that the current system is unfair and inefficient. Uncoordinated national tax regimes can feature tax loopholes and inconsistencies in the treatment of corporate profits across borders that give rise to strategic tax planning by multinational corporations. There is growing recognition of these issues and a renewed impetus to address them. Attempts to improve international coordination of national corporate tax policies are being undertaken through the OECD Base Erosion and Profit Shifting (BEPS) Project.

In this paper, we evaluate the effects that changing the corporate income tax (CIT) rate may have on EU countries using a Computable General Equilibrium (CGE) model. The model captures the key features of the corporate tax regimes including investment decisions, loss compensation, multinational profit shifting and the debt-equity choice of firms. This is a multi-regional model including all 28 EU member states, the USA and Japan. It encapsulates the behaviour of all economic agents, reflecting both the direct and indirect effects of policy changes on macroeconomic variables, such as GDP, investment and employment.

We simulate the impact of removing differences in corporate tax rates across EU countries and their effect on tax competition considering both uncoordinated and coordinated changes. For each of the three simulations, revenue neutrality is maintained by adjusting labour taxes to compensate for any revenue increase or shortfall caused. In addition, sensitivity analysis is performed, ensuring budget neutrality through adjusting transfer to pensioners or government expenditure. We first consider simulations where one country raises or lowers its rate in isolation. We simulate an upward adjustment in a low CIT tax economy, namely Ireland, up to the level of a higher tax economy, namely Germany. These two countries represent to polar examples since Ireland has the lowest statutory CIT rate in the EU and in Germany, which is the largest country in the Union, the CIT rate is among the highest. Second, we simulate the reverse case, where Germany reduces its rate to the Irish level. In each case, we observe the impact on the country affected as well as the international spillover effects. The third simulation supposes that all EU member states choose to harmonise their CIT rates at the EU average level.

The first two simulations reveal that a tax shift from labour tax to corporate tax (Ireland) has a negative impact on GDP, whilst a tax shift from corporate tax to labour tax (Germany) has a positive impact on GDP. On the other hand, the impact on (after-tax) wages moves in the opposite direction. As anticipated, the German CIT rate simulation causes larger spillover effects, with all other countries' GDP being negatively affected to some degree. Nevertheless, the benefits to Germany are sufficient to slightly raise EU GDP by 0.19 percent.

The third simulation, where CIT rates are harmonised across the EU, tends to suggest that a tax shift from corporate tax to labour tax raises GDP, whilst the opposite tax shift lowers GDP; this holds true for 22 out of 28 EU countries. The aggregate impact is a small fall in EU GDP of 0.13 percent. This result broadly holds for the alternative budget-neutral closures. A benefit of CIT rate harmonisation is that it removes much of the incentive to engage in profit shifting.

We conclude that reforming corporate taxes can generate substantial responses within the implementing country as well as beyond its own borders. Harmonisation of CIT rates would likely involve winners and losers, and as such, may be best pursued gradually and as part of a broader package of corporate tax reform.