Corporation tax

SUMMARY

This paper explores the economic consequences of proposed EU reforms for a common consolidated corporate tax base. The reforms replace separate accounting with formula apportionment as a way to allocate corporate tax bases across countries. To assess the economic implications, we use a numerical computable general equilibrium (CGE) model for Europe. It encompasses several decision margins of firms such as marginal investment, FDI decisions, and multinational profit shifting. The simulations suggest that consolidation does not yield substantial welfare gains for Europe. The variation of effects across countries is large and depends on the choice of the apportionment formula. Consolidation with formula apportionment does not weaken incentives for tax competition. Tax competition instead offers a rationale for rate harmonization, in addition to base harmonization.

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Corporate tax harmonization in the EU

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1. INTRODUCTION

The European Commission claims that existing corporate tax systems in Europe are highly inefficient (European Commission, 2001). This is partly due to the principle of separate accounting under which multinational enterprises (MNEs) file separate accounts in each country where they operate. Indeed, determining the exact source of profits is often difficult and arbitrary. It leaves opportunities for multinationals to engage in profit shifting to low-tax jurisdictions and causes disputes among governments and firms on the appropriate transfer prices for intra-company transactions. To reduce these inefficiencies, the European Commission (2004) proposes an alternative system based on consolidation with formula apportionment.

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Under that regime, also used in the United States and Canada, each multinational computes its EU-wide consolidated profits. These are allocated to Member States on the basis of an apportionment formula containing, for example, employment, payroll, assets, and/or sales. Each Member State can then tax the allocated profits at its own tax rate. In determining the consolidated tax base, the European Commission aims at a common definition of the tax base and one single formula. The proposal is labelled CCCTB: common consolidated corporate tax base.

This paper explores various margins which might be considered inefficient under the existing system, and which might be affected by such a reform, including profit shifting, factor allocations and loss consolidation. We do this by using a computable general equilibrium (CGE) model for the EU-27. The model has been designed to analyse corporate tax policy in the EU. It encompasses several behavioural distortions associated with corporation taxes, such as the debt/equity choice, marginal investment decisions, discrete location choices and profit shifting. The last two of these incorporate international spillovers. The model captures detailed aspects of the corporate tax systems of all Member States like statutory rates, fiscal depreciation schemes and nominal interest deductibility. Data from company financial reports are used to calibrate country-specific parameters such as debt-equity ratios and economic depreciation rates. The model allows for company losses in order to explore the impact of loss consolidation.

Only a few examples of relevant general equilibrium simulations are available in the literature. Edmiston (2002) applies a CGE model to strategic formula apportionment policies in the US. Sørensen (2004b) simulates with a CGE model for the OECD the welfare gains from a complete corporate income tax (CIT) rate and base harmonization in the EU. He does not consider the consolidation of the tax base with formula apportionment.

In principle, the CCCTB could reduce compliance costs as multinationals can reap economies of scale and scope in accounting practices. Moreover, multinationals no longer have to determine transfer prices for complicated intra-company transactions. The European Commission (2001) estimates the costs related to transfer pricing in multinational companies at 3% of the revenues they generate. However, it is difficult to determine the proportion of these costs that can be actually reduced via the CCCTB. For instance, transfer pricing vis-à-vis third countries will remain when consolidation is limited to the EU. Given this uncertainty we abstract from a change in compliance costs in the simulations of the CCCTB.

In simulating the CCCTB reform, we assume revenue neutrality in each country by an adjustment of other taxes, such as labour taxes, corporate tax rates or lump-sum taxes. The simulations suggest that the CCCTB does not yield substantial welfare gains, especially if other distortionary taxes are used to balance the government budget. This is because distortions in the current system are replaced by equally large new distortions induced by the formula. The introduction of loss consolidation can be welfare improving (Weiner, 2002; Devereux, 2004; Nicodème, 2007). How-

ever, this welfare gain disappears if the decline in tax revenue is compensated by higher labour or corporate tax rates. More substantial than the aggregate EU-wide economic effects are the economic consequences for individual countries. Indeed, we find that the distribution of corporate tax revenue, as well as country-specific welfare effects, is diverse. Moreover, they depend strongly on the choice of the apportionment formula. By considering alternative formulas, we assess which countries gain or lose from consolidation under alternative designs of the CCCTB. The openness of an economy, the statutory tax rate and in particular the capital intensity are shown to determine the distribution of gains and losses under alternative formulas.

The paper explores how the introduction of the CCCTB would affect behaviour by firms and governments. Under the current system of separate accounting, multinational assets and profits respond to differences in (effective) tax rates across countries. These effects tend to induce governments to compete for tax bases by lowering their tax rates. Under full consolidation of the tax base, profit shifting within the EU is no longer feasible. However, multinationals can still respond to tax rate differentials: by relocating factors to low-tax countries, they change the weights in the apportionment formula and thus reduce their overall tax liability (Hellerstein and McLure, 2004; Martens-Weiner, 2006). Hence, tax competition does not disappear under consolidation but will take a different form. In this paper we explore whether tax competition between governments would be likely to be more or less intense with consolidation with formula apportionment, and which countries would gain and lose. By simulating unilateral corporate tax cuts under both separate accounting and consolidation, we show that consolidation does not make tax cuts less beneficial for governments. Rather, low-tax countries benefit more from a unilateral tax cut than under separate accounting. This implies that consolidation with formula apportionment may cause further competition in tax rates in the EU, thereby exacerbating distortions in the allocation of capital. It offers an argument that tax base consolidation should be accompanied with rate harmonization. Indeed, our simulations suggest that rate harmonization produces modest welfare gains for the EU.

The debate on the CCCTB raises several fundamental questions that require consideration when assessing its attractiveness for the EU. One relevant question is the role of corporate taxation in European systems under a CCCTB. For instance, how should the CCCTB affect the integration of the corporate tax with personal taxes on capital income in Europe? Moreover, what principle should underlie corporate tax systems under a CCCTB, that is, source, residence or destination? This paper does not discuss these issues in detail, see for example Fuest (2008) for a discussion.

The rest of this paper is organized as follows. Section 2 elaborates on the EU debate on tax consolidation and the experiences in the United States and Canada. Section 3 describes our CGE model. Section 4 demonstrates the outcomes for the

CCCTB reform. Section 5 considers a range of alternative apportionment formulas. Section 6 looks at incentives for tax competition by comparing unilateral rate changes under separate accounting and consolidation. It also explores the impact of rate harmonization. Section 7 contains a sensitivity analysis of a number of simulations to show the robustness of our findings. Finally, Section 8 concludes.

2. THE EU DEBATE, AND LESSONS FROM ELSEWHERE

2.1. EU debate on corporate tax consolidation

Proposals to harmonize taxes in the European Union are not a new phenomenon. While the treaty articles have generated progress in the case of indirect taxation, the harmonization of corporate taxation is driven by the commitment to create a single market. This implies that the unanimity principle applies, which, in combination with widely diverging interests of the individual Member States, complicates the harmonization process. As a result, corporate tax harmonization efforts have not been very successful, despite many proposals having been made. The ongoing debate has had the important side effect of creating EU-level think tanks such as the 'Stockholm group' or the Centre for European Policy Studies (CEPS).[1]

Partly influenced by the business community, the focus of the current corporate tax harmonization debate has shifted to the removal of obstacles for cross-border investment and the difficulty of dealing with numerous different tax laws. While there has been progress in the removal of cross-border investment, for example the parent-subsidiary directive abolished withholding taxes on dividend flow between associated companies, the harmonization process has been sluggish. In 2004, Member States considered four methods of harmonizing corporate tax:

- a EU corporate tax rate (with full harmonization of rates and bases);
- a compulsory harmonized method to compute the tax base;
- the same harmonized method to compute tax bases but made optional; and
- a system of Home State Taxation (subsidiaries are taxed according to the headquarter country's tax law).

A majority of Member States agreed that a common harmonized tax base would be a most desirable way forward.[2]

Consequently a working group chaired by the European Commission was established to work out the exact details of a proposal of a common consolidated corporate tax base (CCCTB). Currently the European Commission appears to be in favour of an optional CCCTB with a weighted formula (sales by destination, assets

[1] See Radaelli and Kraemer (2008) for a detailed discussion of the actors in the EU tax policy.

[2] Nicodème (2007) provides a useful summary of the corporate tax harmonization debate in the European Union.

and employment) used for apportionment. There are no plans for harmonization of rates at the moment, as the Commission has repeatedly stressed.[3] The initial plan was to produce a legislative proposal by the end of 2008, but this has been delayed.

The current system of corporate income taxation in the European Union (EU) is based on separate accounting. It means that the taxable income of an MNE is determined as the income generated in each jurisdiction, in principle with arm's length prices used for intra-company transactions. Under the alternative system of consolidation, taxable income is aggregated over all Member States to yield a single aggregate tax base for each company in the EU. In the United States, Canada and the proposed CCCTB system in the EU, the consolidated tax base is apportioned to individual states or countries via a formula. In the US, states may use their own formula. Factors used include sales, payroll and assets. States can apply their own rate to the apportioned part of the corporate tax base. In the EU discussion on the CCCTB, the intention is to use a single and common formula to allocate profits across the EU Member States. Countries could then apply their own rate to the apportioned share of the tax base.

2.2. Lessons from the United States and Canada

The literature on formula apportionment concentrates on the distortions induced by the formula. The choice of the apportionment formula is important for two reasons. First, it determines the distribution of the tax base across jurisdictions. A state that is abundant in capital-intensive production will receive a relatively large share of profits if capital is used in the formula. A state with many consumers but no production facilities will gain more if sales are used to apportion the tax base. Hence, each country will have a different interest as to what apportionment factors are used. Second, formula apportionment imposes an implicit excise tax on the apportionment factor. Indeed, firms can influence their corporate tax liability by locating the factors that enter the formula in low-tax jurisdictions. As long as tax rates differ across states, the allocation of investment and employment will thus be influenced under formula apportionment. A well-developed empirical literature explores how the variation in the apportionment formulas and tax rates affects investment and employment by multinationals. The majority of these studies are for the United States. They confirm the impact of the formula on factor allocation (see, e.g., Weiner, 1994; Klassen and Shackelford, 1998; Gupta and Hofmann, 2003; and Goolsbee and Maydew, 2000). Canadian provinces use the same formula but differ in their tax rates. Multinationals can exploit these differences by reallocating factors to low-tax provinces. Mintz and Smart (2004) use Canadian administrative tax data

[3] See European Commission (2006).

and find that the elasticity of taxable income to tax rates is significantly higher for firms that engage in factor shifting. Also Weiner (1994) and Klassen and Shackelford (1998) find evidence for factor shifting to low-tax provinces.

3. THE CORTAX MODEL

This paper uses the CORTAX model to assess the economic impact of the CCCTB. CORTAX is an applied general equilibrium model describing the 27 countries of the EU, the United States and Japan. The model is designed to simulate the economic implications of unilateral and multilateral corporate tax policies. It concentrates on the long-run effects in the steady state. The structure of each country is the same and countries are linked via trade in goods and capital and via multinational firms. We set shares to replicate aggregates from national accounts data in 2005 and country averages from data on firm accounts in the ORBIS database, a comprehensive set of over 9 million companies based on standardized balance sheet information. Parameters in CORTAX also replicate empirical elasticities found in the economic literature. CORTAX is heavily inspired by the OECDTAX model of Sørensen (2001, 2004a). An earlier version was used for European tax policy analysis in Bettendorf *et al.* (2006, 2009a), Van der Horst *et al.* (2007) and De Mooij and Devereux (2009). A detailed description of the structure and parameterization of the model can be found in Bettendorf and Van der Horst (2008). Table 1 summarizes information about the calibration of key institutional, economic and behavioural parameters.

3.1. Government

The government does not optimize its policies. We simply modify tax and expenditure parameters exogenously. On the revenue side of the government budget, we

Table 1. Key elasticities in CORTAX

Elasticities of substitution		
Intertemporal		0.5
Intratemporal (consumption – leisure)		1.0
Capital – labour		0.7
Income share of location specific capital		2.5%
Income share intermediate inputs (of subsidiaries)		10.0%
Implied semi-elasticities	Min	Max
Labour supply to wage	0.08	0.31
Savings to interest rate	0.41	0.81
Capital stock to statutory CIT	−0.09	−0.64
Incoming FDI to statutory CIT	−0.10	−2.71
Debt share to statutory CIT	0.17	0.35
Incoming transfer price to statutory CIT	−0.69	−1.88

Source: Authors' calculations.

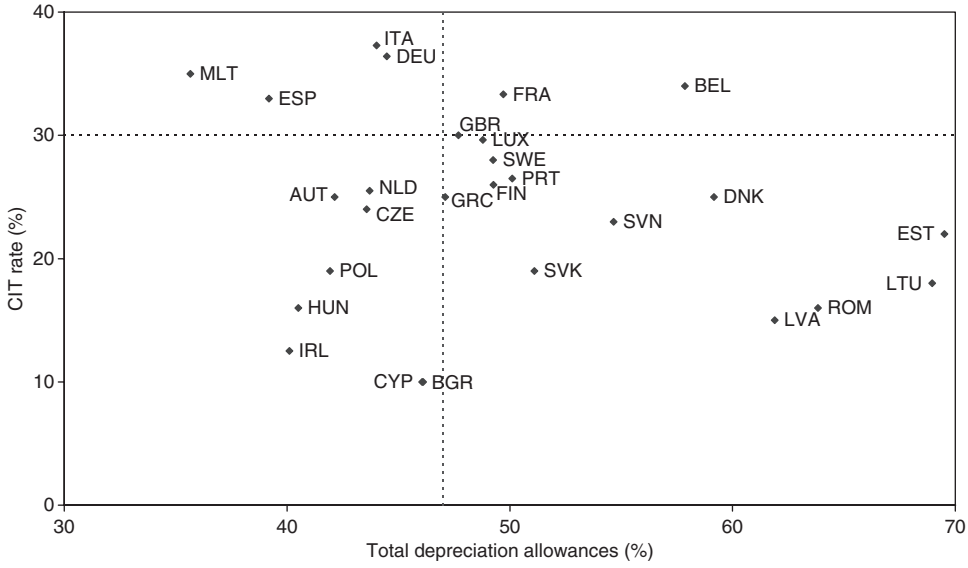

Figure 1. Tax rate and tax base in 2007

Note: EU averages are indicated with dashed lines.

have indirect taxes on consumption and direct taxes on corporate income and labour income. The expenditure side features government consumption, interest payments on public debt and lump-sum transfers. In performing simulations, we keep the government budget balanced by adjusting one of the tax parameters endogenously. We always keep government consumption and public debt constant as a fraction of GDP. The initial labour and consumption tax rates are calibrated by using effective taxes from Eurostat (2007). Corporate tax systems are calibrated using legal data on taxes and depreciation allowances for 2005.[4] In the baseline, corporate tax changes in 2006 and 2007 are simulated so that reforms are considered relative to the systems in 2007. Hence, we include the Allowance for Corporate Equity that Belgium introduced in 2006. The values of statutory corporate tax rates and the net present value of depreciation allowances are shown in Figure 1. More information on the calibration of the model is given in Table A2 in the Appendix.

3.2. Households

Following the overlapping generations model of Diamond, households live for two periods. One may interpret one period to cover 40 years. We express all variables

[4] In the calibration, we modify the tax base indicator for Estonia. In principle, the value of fiscal depreciation is zero in Estonia as no depreciation allowances are available. However, Estonia does not tax retained profits but only levies a 22% tax rate on profit distributions. Hence, corporate profits in Estonia go untaxed as long as they are not repatriated to the parent or distributed to shareholders. To bring the system more in line with other countries in the model, we modify the corporate tax base by assuming a positive allowance in Estonia so as to replicate its observed corporate tax-to-GDP ratio. We maintain the Estonian corporate tax rate at 22%.

in annual terms to facilitate the interpretation in terms of national accounts data. Behaviour within each 40-year period is assumed to be constant. Households make their decisions regarding work, consumption and saving by maximizing a life-time utility function subject to an intertemporal budget constraint. When young (i.e. the first period), households choose to allocate their time between leisure and work. When old (i.e. the second period) households do not work but only consume. Young households receive after-tax wage income and lump-sum transfers. This income at a young age is allocated over consumption and savings. Savings are invested in a mix of bonds and stocks, which are assumed to be imperfect substitutes and which yield different rates of return. In the second period, households are retired. Consumption at old age is financed by the assets saved from the first period plus an after-tax rate of return and by lump-sum transfers. Moreover, the older generation is assumed to own the fixed factor used by firms.

Household optimization yields expressions for labour supply, consumption, savings and the optimal asset portfolio. Asset returns are determined on world markets. The most important distortion is related to the consumption/leisure choice. Labour supply behaviour in CORTAX is governed by the usual income and substitution effects. Most empirical studies suggest that substitution effects dominate income effects so that the uncompensated elasticity of labour supply is positive (see Evers *et al.*, 2008). In CORTAX, we set for all countries the utility parameters so that we obtain a positive uncompensated elasticity of labour supply. Values differ due to country variation in hours worked, but on average the labour supply elasticity is 0.19.

3.3. Firms

In CORTAX, one representative domestic firm and one representative multinational headquarter is located in each country. The multinational owns a subsidiary in each foreign country. With 29 countries in CORTAX, we thus have 30 different firms operating in each country, namely the representative domestic firm, the representative headquarter and 28 subsidiaries that are owned by the headquarters in the other countries.

Each firm maximizes its value – equal to the net present value of all future cash flows – subject to the accumulation constraints and a production function. The production function features three primary factors: labour, capital and a fixed factor. Labour is immobile across borders and wages are determined on national labour markets. Capital is assumed to be perfectly mobile internationally so that the return to capital (after corporate taxes) is given for each country on the world capital market. The fixed factor is location-specific (e.g. land) and supplied inelastically. The income from the fixed factor reflects an economic rent. The fixed factor may have a variety of interpretations. For instance, it may represent location-specific agglomeration caused by increasing returns to scale in production, as emphasized in the

new economic geography literature (see e.g. Brakman *et al.*, 2001). Alternatively, it may reflect land as a location-specific fixed factor of production. Another interpretation is that the fixed factor is not location specific but firm specific, for example due to managerial skills, a brand name or patents. In that case, the factor may become responsive to tax, a case that we discuss in more detail below.

In calibrating the model of the firm, capital and labour parameters are determined by national accounts data on labour and capital income shares. The labour income share is approximately 0.7 on average in the EU and lies between 0.6 and 0.8 for different countries. Investment is determined by the cost of capital. The responsiveness of investment to the cost of capital depends on the substitution elasticity between labour and capital. Most general equilibrium models adopt values between 0.5 and 1.0. We use a value of 0.7 in the basic calibration. We have no direct information that we can use to calibrate the income share of the fixed factor in the model. We set it at 2.5% of value-added in each country. It is chosen such that CORTAX yields corporate tax-to-GDP ratios that fit observed values on average. A sensitivity analysis will shed light on the implications of this assumption.

The impact of the corporate tax on the cost of capital depends on the initial corporate tax system and is measured by the effective marginal tax rate (EMTR). The EMTR, computed as a weighted average of an investment financed by debt and equity, ranges from −1% in Belgium (which has an allowance for corporate equity in place) to 14% in Malta. The higher is the initial EMTR, the more responsive is investment to changes in the corporate tax rate. Table 1 shows that the tax-rate elasticity of investment to the corporate tax rate ranges between −0.1 and −0.6.

Firms finance their investment by issuing bonds and by retaining earnings (issuing new shares is excluded). The optimal financial structure depends on the difference between the after-tax cost of debt and equity. Along the lines of the trade-off theory, we include a financial distress cost associated with high debt positions. The marginal cost of debt finance increases in the debt share. In CORTAX, the convexity of the financial distress cost determines the impact of corporate taxation on a firm's financial policy. We set the parameters in this function so as to obtain a semi-elasticity of the debt share with respect to the corporate tax rate between 0.2 and 0.4, which is consistent with recent empirical studies (see Weichenrieder and Klautke, 2008).

The size of corporate tax distortions in CORTAX can be assessed by simulating a system that is neutral with respect to investment and financing decisions. De Mooij and Devereux (2009) explore an allowance for corporate equity (ACE) with CORTAX, which is known to be neutral with respect to financing and investment decisions. They report that an ACE financed by a lump-sum tax yields a welfare gain of 0.6% of GDP, on average in the EU. This welfare gain ranges from 0.3% of GDP in countries with small corporate tax distortions to more than 1% of GDP for countries with high effective marginal tax rates. This welfare gain is approxi-

mately one-third of the revenues raised by corporate taxes. Hence, corporate tax systems impose a sizeable excess burden via investment and financial distortions.

3.4. Multinationals

In maximizing the value of the firm, multinationals take the sum of the values in the headquarter and the subsidiaries. In addition to choices on investment and financial structure, multinationals decide about the location of investment across subsidiaries (denoted as foreign direct investment, FDI) and the allocation of profits. CORTAX assumes that the multinational owns a given fixed factor in each country which it can only use to produce via the subsidiary. The size of the fixed factor in each country is determined by data on bilateral foreign direct investment (FDI) stocks. These stocks differ considerably between countries in the EU. Stocks are generally small in Central and Eastern Europe, especially the outward stocks. They are large in some small Western EU countries, like the Netherlands, Belgium and Ireland. Luxembourg stands out with a sum of the inward and outward FDI stock of more than 10 times its GDP.[5] Given the fixed factor in each location, the multinational decides how much capital and labour to employ in each foreign subsidiary. The cost of capital determines the amount of capital the multinational is willing to invest. Thus, changes in inward FDI is governed by the EMTR in each location. The implied elasticity of FDI to the statutory rate ranges between −0.1 and −2.7, depending on the initial distortion of the corporate tax system.

Recent empirical studies emphasize that multinationals not only respond to changes in the cost of capital, but also to effective average tax rates (see, e.g., Devereux and Griffith, 1998; Devereux and Lockwood, 2006). Hence, inframarginal choices regarding profitable discrete investment locations depend on corporate taxes. In terms of our model, we may interpret this as if rents from the fixed factor are firm-specific, implying that the location of these rents can move across borders. Modelling this location choice from microeconomic principles within the context of CORTAX is difficult. Yet, a simple ad-hoc extension of CORTAX is to make the size of the fixed factor dependent on the corporate tax rate. In a sensitivity analysis, we consider how this extension affects our results. Thereby, we set the response of the fixed factor in subsidiaries such that CORTAX replicates an aggregate semi-elasticity of FDI to the effective average tax rate of −6.0. This equals the consensus estimate obtained in a recently updated meta analysis by De Mooij and Ederveen (2008). In the extended model, we assume that location choices are responsive only to tax differences within the EU, not between the EU and other world regions.

In CORTAX, foreign subsidiaries need intermediate inputs to produce output. These are supplied by the parent company. As there is only one homogeneous

[5] Throughout the article, we do not present outcomes for Luxembourg, which is a severe outlier due to its exceptional position in terms of foreign direct investment. Hence, we report effects for only 26 European countries.

good in the model, the arm's-length price for this intermediate input is equal to the market price determined on world markets. However, the parent company can charge a transfer price for intra-company deliveries that deviates from this arm's-length price. In particular, a headquarter company has an incentive to set an artificially low (high) transfer price for supplies to subsidiaries in countries that feature a lower (higher) statutory corporate tax rate. In this way, the multinational shifts profits from high- to low-tax countries, thereby reducing its overall tax liability. The benefits from profit shifting thus rise linearly in the tax difference between countries. We specify a convex cost function to capture the costs associated with manipulated transfer pricing, for example, due to fines imposed by governments. Hence, profit shifting to countries with very low corporate tax rates becomes increasingly costly at the margin. The elasticity of transfer pricing with respect to the corporate tax rate is determined by the parameters in the cost function and is set to obtain a tax elasticity of transfer pricing of around −1.4 on average over all countries. The tax elasticity ranges between −0.8 in low-tax countries and −2 in high-tax countries. To compare this to the empirical evidence on profit shifting, we translate it into a semi-elasticity of the corporate tax base. This depends on the share of intra-firm trade which, in CORTAX, is proportional to bilateral FDI stocks. The tax-rate elasticity of the corporate tax base has an average value of −0.23, implying that the corporate tax base shrinks by 0.23% due to profit shifting if the corporate tax rate is increased by one percentage point. This reasonably fits in the range of estimates found in the literature on transfer pricing, but is small in light of evidence on total profit shifting (see De Mooij, 2005 for a survey). The majority of countries feature a smaller elasticity as their multinational sector is small. This holds for most Central and Eastern European countries. For countries with a large multinational sector, elasticities are larger. In the Netherlands, a one percentage point higher corporate tax rate reduces the tax base via profit shifting by 0.8%.

3.5. Losses and loss carry forward

To be able to simulate the impact of loss consolidation, CORTAX contains a simple but straightforward modelling of aggregate losses by firms. We introduce random shocks in output or, equivalently, in the value of sales. Sales are high in the good outcome which generates positive profits. However, profitability is negative in the bad outcome with limited sales. Hence, *ex post* there are both profit-making firms and loss-making firms. We assume that firms are risk neutral. They decide on their optimal levels of investment, employment, debt, and transfer prices before knowing whether they are subject to a negative shock. Hence, they base their input decisions on expected sales and expected marginal productivities. The probabilities of profit and loss are assumed to be independent and not correlated between years. Table A1 in the Appendix shows ORBIS micro data about loss probabilities and the ratio of loss/profit in EU countries. The average loss probability is approxi-

mately 0.2, that is 20% of all firms with unconsolidated accounts make a loss each year. The average ratio of loss/profit equals approximately one. In the simulations, we use these averages to assess the impact of loss consolidation. In Section 7.2, we consider a sensitivity analysis and pay attention to country-specific variations.

In today's corporate tax regimes in Europe, losses can be carried forward and offset against future profits within the same country. Yet, losses are generally treated asymmetrically from profits in two respects. First, there are several limitations to loss offset: losses can usually only be set off against taxable profits within the same income category; some countries put a cap on losses that can be offset each year; if loss-making companies were taken over, restrictions to loss carry forwards would apply; and the number of years for which losses can be carried forward is usually restricted. These limitations imply that some losses dry up and cannot be used. Second, firms can only carry forward nominal losses, that is, without indexation. Due to discounting, its value declines over time.

In CORTAX, we adopt a simple first-order approach to capture the limitations to loss offset in current systems. In particular, we assume that losses can be carried forward only one year. If the company makes a loss in two consecutive years, the first-year loss dries up and cannot be offset against profits in the future. This is obviously not a proper reflection of the complex and diverse treatment of losses in EU tax systems. On the one hand, it may overstate restrictions to loss offset since the period of loss carry forward is generally longer while some countries also allow loss carry backward. On the other hand, it may underestimate the restrictions to loss offset as loss probabilities in consecutive years may be correlated, which increases the probability of dry up. What matters in the CORTAX simulations is the quantitative size of the restrictions to loss offset. As we may either under or overestimate this, Section 7 performs a sensitivity analysis to our assumptions.

3.6. Equilibrium and welfare

Equilibrium must hold on each market. On the goods market, a homogenous good is traded on a perfectly competitive world market. Thereby, countries cannot exert market power so that the terms of trade is fixed. On asset markets, bonds and equity of different origins are perfect substitutes and are freely traded on world markets so that returns are fixed for individual countries. Debt and equity are imperfect substitutes. The current account matches the change in the net foreign asset position for each country (including rest of the world), due to Walras law. As labour is immobile internationally, wages are determined nationally on competitive labour markets.

We compute the compensating variation to measure the welfare effects of policy changes. It is equal to the transfer that should be provided to households to maintain their utility at the pre-reform level. A positive compensating variation implies a welfare loss. In presenting the welfare effects of reforms, we put a minus for the

compensating variation so that a positive value denotes an increase in welfare. We express the welfare effect in terms of GDP.

3.7. Values and limitations of our approach

CORTAX is valuable for economic policy analysis as it combines three vital properties: theoretical rigour, empirical validity and institutional detail of corporate tax systems. Theoretical rigour implies that behavioural margins of firms and households are derived from microeconomic optimization. This allows for easy interpretation of the results. The general equilibrium setting implies that feedback effects of policies through market responses are included, such as via the labour market. Exploring policies in such a comprehensive and consistent framework offers potentially important insights for policy-makers. The empirical validation is reflected in share parameters that make the model replicate true economic data in the EU. This adds to the realism of the model. Moreover, by using available empirical evidence on behavioural responses, the model assesses the relative strength of various effects to tax reforms and, therefore, their economic and welfare effects. By quantifying different sides of relevant trade-offs, CORTAX is particularly relevant for policy-makers.

Yet, the CGE approach also suffers from limitations. Although assumptions in the model are based on the best-possible empirical information and widely accepted economic theories, it is still a simplified description of the real world. For instance, CORTAX ignores certain economic mechanisms, includes specifications that are not undisputed, and cannot take away the uncertainty about the strength of certain behavioural effects to tax policies.

We discuss four features of CORTAX that are particularly important to keep in mind when interpreting the outcomes. The first issue is the treatment of risk. The model distinguishes between debt and equity and assumes different rates of return for these two assets, which is consistent with *ex-post* returns in real world observations. The equity returns contain a risk premium, however, which forms a compensation for the higher uncertainty of equity stakes as compared to risk-free government bonds. CORTAX does not explicitly model risk and thus ignores the uncertainty cost of holding equity. In fact, the CES function for the asset portfolio of households is an imperfect shortcut to obtain an interior solution for household asset portfolios, but does not account for the cost of risk taking.

Second, CORTAX does not consider distributional concerns. While various taxes in the model cause distortions in investment and labour supply, there is no explicit underlying distributional reason why the government does this. Indeed, the optimal tax structure in the model would be to simply raise lump-sum taxes and eliminate all other taxes. One therefore needs to be careful in interpreting simulations where the tax burden is shifted from distortionary taxes to lump-sum taxes, or between different distortionary taxes, as this may have distributional implications which are overlooked.

Third, CORTAX assumes one homogenous good. The price of this good is determined on a competitive world market on which no country can exert market power. Therefore, the terms of trade is fixed for all countries. Reforms may well affect world markets, especially when the EU implements reforms jointly.

Finally, CORTAX assumes a competitive labour market. This is an unrealistic description of European labour markets, which are characterized by equilibrium unemployment. Bettendorf *et al.* (2009a) explore how labour market imperfections modify the impact of corporate tax changes on the economy via its effect on structural unemployment. They find that the cost of capital is an important determinant of the equilibrium unemployment rate. Therefore, policies that reduce the cost of capital can help to fight European unemployment. It magnifies the positive welfare impact of these policies. However, there is considerable uncertainty about the parameters determining the impact on equilibrium unemployment. In light of this uncertainty, we decided to assume a competitive labour market in our analysis.

Such caveats make us aware of the limitations of the CGE model. Yet, the consistency of the CORTAX framework offers common ground for a structured discussion about both the assumptions and the economic implications of corporate tax reforms. Sensitivity analysis further facilitates this by offering insight into how changes in certain assumptions affect the conclusions.

4. A COMMON CONSOLIDATED CORPORATE TAX BASE

The European Commission proposal for a CCCTB consists of two parts: a common corporate tax base (CCTB) and consolidation with formula apportionment (CFA). This section analyses the economic implications of both parts. Extensive results for individual countries are available on the Economic Policy website. In the text, we summarize the main findings.

4.1. A common corporate tax base

We first consider the impact of a common corporate tax base in the EU (CCTB). It consists of a common set of rules regarding fiscal depreciation, loss offset and tax incentives. In our simulations, we consider common rules that produce a tax base equal to the aggregate base generated by the regimes currently in place.[6] Hence, some countries broaden their tax base while others narrow it. The common base applies to both multinationals and domestic firms. If tax revenues change in a country due to changes in the corporate tax base, we adjust, respectively, lump-sum transfers, corporate tax rates or labour taxes to balance the government budget.

[6] This choice of the common base differs from the proposal by the European Commission, which involves a net broadening of the corporate tax bases in Europe in combination with a reduction in corporate tax rates (see, e.g., CCCTB Working Group, 2007; Spengel and Oestreicher, 2007).

Table 2 shows the aggregate economic impact of the CCTB for the EU as whole. The welfare effects for individual countries under lump sum revenue recycling are presented in Figure 1. Figure 2 compares these outcomes to those under the alternative balanced budget rules.

We see from Table 2 that the aggregate welfare effect of the common base is small under each balanced budget rule: welfare in Europe rises by a mere 0.01% of EU27 GDP. The small welfare gain is due to a smaller variation of effective marginal tax rates across countries. Indeed, the coefficient of variation of EMTRs declines from 0.63 today to 0.50 under the CCTB. The smaller dispersion of EMTRs reduces distortions in the allocation of mobile capital across countries. Intuitively, capital mobility equalizes after-tax rates of return. If EMTRs differ across countries, this implies that before-tax rates of return must differ. It reflects the

Table 2. Economic effects for the EU of a common corporate tax base

	Lump-sum transfers	Corporate tax rate	Labour tax rate
Corporate tax-to-GDP ratio	0.00	−0.03	0.00
Cost of capital	−0.01	−0.01	−0.01
Investment	0.22	0.20	0.19
Wage	0.10	0.08	0.10
Employment	0.03	0.03	0.00
GDP	0.09	0.10	0.07
Welfare	0.01	0.01	0.01

Source: Authors' calculations.

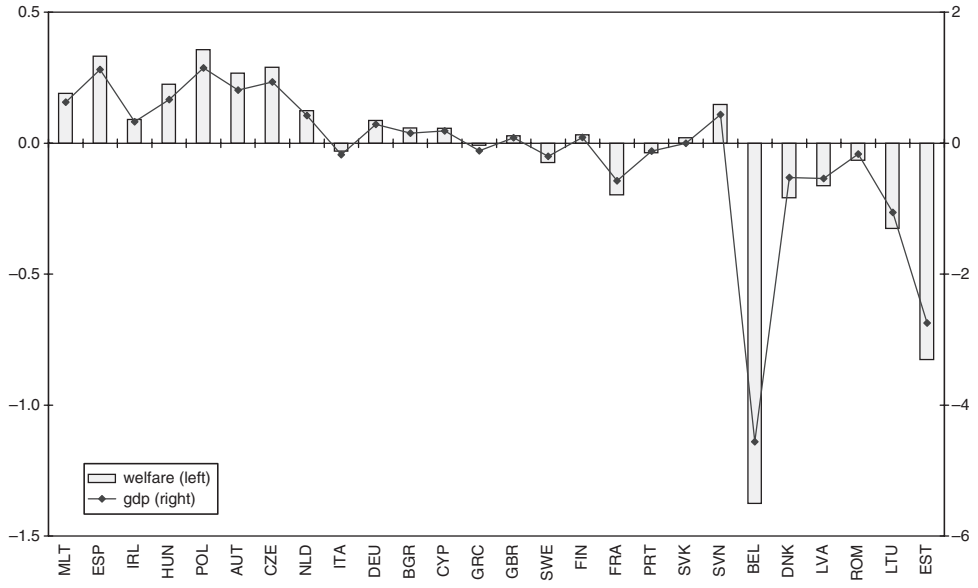

Figure 2. GDP and welfare effects of a common corporate tax base with lump sum balanced budget rule; countries are ranked at increasing depreciation allowances

distortion in capital export neutrality. Convergence of marginal effective tax rates mitigates this distortion as capital relocates from countries with a low before-tax return to countries with a high before-tax return.

Figure 2 shows that the welfare implications of the CCTB differ considerably across countries. Countries with a broad initial base are positioned left in the figure and countries with a narrow base right. On the vertical axis are the GDP and welfare effects induced by the introduction of the common European base. Figure 2 reveals that countries that narrow their tax base by means of more generous depreciation allowances under the common base rules experience a welfare gain. This is because the narrower tax base reduces the cost of capital so that investment expands. More investment raises the productivity of labour and is accompanied by higher wages. This encourages labour supply so that employment expands. The increase in investment and employment lead to a higher level of GDP. Due to smaller distortions in investment and labour supply, welfare ultimately increases up to almost 0.4% of GDP in Poland and Spain. Countries that gain also include Ireland, Hungary, Malta, Austria and the Czech Republic. In contrast, countries that broaden their base via less generous allowances for investment experience opposite effects. This applies to Estonia, Lithuania, Denmark and France among others. Belgium loses considerably due to the abolition of its ACE system, which raises the cost of capital substantially. Its welfare falls by 1.4% of GDP.

Figure 3 shows how the welfare effects for countries change if governments use distortionary taxes on labour or corporate income to balance their budget, instead of lump sum taxes. Thereby, countries are ranked according to the value of their depreciation allowances for tax purposes (from low on the left to high on the right). In the figure, points are linked through lines to facilitate comparison between the three simulations. Figure 3 shows that the adjustment via distortionary taxes does not change the sign of the effect for individual countries, but it results in a flattening of the effects of the CCTB. Hence, countries that narrow their base still benefit from the reduction in the cost of capital. Yet, the welfare effects are smaller due to higher distortionary taxes which are necessary after the narrowing of the corporate tax base. Countries broadening their base use the extra funds to cut distortionary taxes. This mitigates the adverse implications of the higher cost of capital induced by base broadening.

4.2. Consolidation with formula apportionment

To avoid mixing up the welfare effects of a common tax base and the welfare effect of consolidation with formula apportionment (CFA), this subsection takes the common base as a starting point. The effects of CFA are thus assessed relative to a European common corporate tax base. As in the previous simulation, we assume that governments adjust lump-sum transfers, corporate tax rates or labour taxes to balance their budget if revenues change due to the reform.

Figure 3. Welfare effects of a common corporate tax base with alternative balanced budget rules; countries are ranked at increasing depreciation allowances

CFA means for a multinational that the tax bases of the parent and its subsidiaries are added into one aggregate. This tax base is apportioned to the participating countries by using a prescribed formula. In particular, the share of the tax base of firm i allocated to country j equals:

$$\omega_{ij} = w^L \frac{L_{ij}}{L_i} + w^K \frac{K_{ij}}{K_i} + w^Y \frac{Y_{ij}}{Y_i} \tag{1}$$

where w^L, w^K, and w^Y denote the formula factors adding up to one: $w^L + w^K + w^Y = 1$. X_{ij} denotes the share of multinational i's factor X_i that is operational in country j, where $X = L, K, Y$ reflect, respectively, employment, assets and sales. In our simulations, we consider the origin of the sales (i.e. in the jurisdiction in which the good or service is produced) as we have no information to identify the destination of final sales (where the final consumer resides: see Section 5 for a discussion). The weights in the formula are fixed for all countries and determined at the supranational level. This section shows the impact of CFA with a formula of 1/3 for employment, assets and output. The apportioned profits are taxed at national corporate tax rates. These rates remain unchanged as compared to the situation in 2007, unless indicated otherwise.

CFA exerts a direct effect on the distribution of the corporate tax base between countries, that is, even without behavioural responses by firms. We first discuss these direct revenue effects. Subsequently, we explore the behavioural consequences of CFA and the corresponding economic effects.

4.2.1. Direct effects on corporate tax revenue. The introduction of CFA affects corporate tax revenue in European countries for two reasons: reallocation and loss consolidation. First, CFA modifies the distribution of the European corporate tax base between Member States. A number of studies assess these distributional effects by using micro data from firm accounts (see, e.g., Fuest *et al.*, 2007; Devereux and Loretz, 2008). They report a substantial reallocation of revenue, depending on the choice of the apportionment formula. In CORTAX, the direct reallocation of the corporate tax base is governed by national accounts data from Eurostat, which determine country-specific shares in the formula.

Second, loss consolidation affects the tax burden of multinationals. There are a number of considerations when comparing a system of loss-carry forward within each country to a system with immediate cross-border loss offset. To completely model the different treatment of losses one would need to simulate a number of periods with different potential outcomes. Further, it would be necessary to consider each possible outcome in each country simultaneously. For example, if there are even only two possible outcomes in each period (profit or loss), across 27 EU Member States in which each individual company is active, we would need to consider 2^{27} different states in each period. However, we can consider the basic mechanisms in a two-country framework with two – one positive and one negative – outcomes. To understand the impact of a switch to a cross-border loss consolidation system it is useful first to consider the impact of uncertainty on the expected tax burden under a loss carry-forward system. For simplicity, consider a firm with an investment with two possible outcomes: with probability p it creates a profit of g and with the probability $(1 - p)$ it creates a loss of $b < 0$. Hence the expected profit is $E = pg + (1 - p)b$. In the event of a profit, the firm faces a tax liability of tg. In the event of a loss, it generally cannot claim an immediate tax rebate, but must carry forward the loss to set against profits in a subsequent period. Given a discount factor of $0 < d < 1$, the present value of the reduction in tax due to the loss is tbd. We can define an 'effective expected tax liability' under this system as $T = t[pg + (1 - p)bd]$. Dividing by expected profit yields an 'effective expected tax rate', $y = T/E$. Given that $b < 0$ and $d < 1$, then $y > t$: the effective tax rate exceeds the statutory rate. This is true as long as there is some possibility of a loss which would not receive an immediate tax rebate ($p < 1$). The extent by which y exceeds t increases the further into the future that the loss must be carried forward. The extent to which y exceeds t represents a greater disincentive to investment relative to the case of a symmetric tax system (in which $y = t$). For a given level of uncertainty, an increase in profitability tends to increase T, but lower y. For example, a smaller b, holding p and g constant, implies that a smaller taxable loss would need to be carried forward in the event of a loss. Further, given a level of expected profit, higher uncertainty is associated with a larger y. For example, an increase in g with an equal but offsetting reduction in b, holding p constant so that E is unchanged, would result in a higher T and a higher y.

Now consider the case of a system of loss consolidation between two countries, i and j, where each country hosts a similar investment which may make a profit or loss. Assume for simplicity that each country has an equal apportionment, so that the effective statutory rate is $t^* = 0.5(t_i + t_j)$. If we assume that $g > b$ in each country, then the probability that aggregate taxable profit is negative is $p^* = (1 - p_i)(1 - p_j)$: this implies that there is a lower probability of a taxable loss which would need to be carried forward than in the case without loss consolidation. This implies that the disincentive to investment arising from the asymmetric treatment of profit and loss is lower than in the case without loss consolidation. These observations imply two effects of an introduction of a loss consolidation system. First, for a given expected profit, since the country with the more uncertain outcome gains more in expected tax revenues in the absence of consolidation, it would lose more than the other country if loss consolidation were introduced. Second, for given levels of uncertainty, the country with the higher profit would lose more revenue when consolidated with the profits or losses in the other country. The effect on the distortion to investment also depends on tax rates. If tax rates differ across countries, it is possible that offsetting losses in a high-tax country against profit in a low-tax country may increase the effective tax liability on the firm. This is because it is possible that the present value of losses carried forward (say $t_i b_i d$ if the loss is incurred in country i) exceeds the value of losses immediately offset under formula apportionment ($t^* b_i$).

In our simulations, we make a first-order approximation of the impact of loss consolidation on revenues by assuming that all losses that occur in European subsidiaries can be offset by profits elsewhere under consolidation. Under loss carry forward, firms that make a loss in two consecutive periods cannot offset the loss of the first period. Moreover, losses that can be offset are discounted one period. Hence, loss consolidation in CORTAX will always reduce the tax burden of the multinational relative to loss carry forward. To illustrate the underlying mechanism, the following example shows the impact of loss consolidation on the corporate tax base in CORTAX. Suppose there are 100 firms. Among them, 80 make a profit of 1,000 and 20 make a loss of 1,000. The total taxable base of profit-making firms is therefore 80,000 if the losses cannot be offset and 60,000 if losses are offset immediately. Under loss consolidation, the tax base is thus 25% smaller. As the tax reduction applies only to multinational firms, we multiply this by the share of multinationals in the economy, which is approximately 60% in Europe. Consolidation would then reduce the corporate tax burden by 15%.[7] In the steady state equilibrium of CORTAX, the reduction in the tax base is smaller due to losses carried forward from the past. In CORTAX, 80% of the previous-period losses (i.e. the probability of profit) can be offset against profits in the next period. In our exam-

[7] Fuest *et al.* (2007) estimate this impact and find a decline in the tax base of 20% using data on German multinationals. ORBIS suggests that the share of multinationals in Germany is 70%. It would imply a direct reduction of 17.5% in Germany.

ple, this equals a loss compensation of 16,000. Yet, this compensation needs to be discounted at, say, 5% interest, which reduces its current value to 15,200. Compared to immediate loss offset under consolidation of 20,000, the value of losses decreases by 4,800. It implies a reduction of the corporate tax base by 4,800/64,800 = 7.5% when moving from loss carry forward to loss consolidation. Assuming a share of multinationals of 60% of all companies, the aggregate decline in the tax base in the steady state would be 4.5%.

Figure 4 shows the direct impact of CFA with the 1/3 formula on corporate tax-to-GDP ratios according to CORTAX. Countries are ranked according to their capital/labour ratio from left (lowest) to right (highest). This capital/labour ratio explains part of the country differences (see below). On aggregate for the EU, the reduction in corporate tax revenue is 0.17% of GDP (see the dotted line in Figure 4) or nearly 5% of corporate tax revenues, which is due to loss consolidation. The effect for individual countries is partly the result of a differential impact of loss consolidation. In particular, the reduction in revenue due to loss consolidation is larger for countries featuring a high corporate tax rate and a large multinational sector.

The redistribution effect of formula apportionment depends on three factors. First, the capital/labour ratio determines the extent to which the asset factor relative to the employment factor influences the division of the corporate tax base across countries. Figure 4 shows that labour-intensive countries (on the left-hand side) are more likely to gain from CFA under the 1/3 formula than the capital-

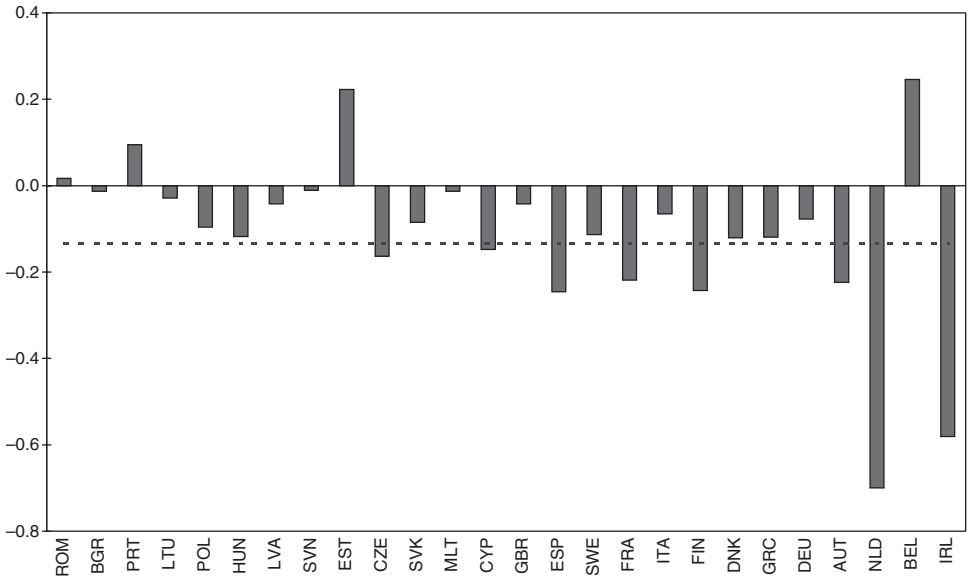

Figure 4. Direct impact of CFA (with 1/3 formula) on corporate tax-to-GDP ratios; countries are ranked at increasing FDI shares (dashed line is EU average)

intensive countries (on the right-hand side). For instance, Portugal gains because of its high labour intensity of production, while Germany loses due to its capital-intensive production. Second, the current corporate tax rate determines whether a country initially benefits or loses from profit shifting. In particular, low-tax countries like Ireland initially gain and high-tax countries like Belgium initially lose. Eliminating profit shifting takes away these benefits or losses. Third, CFA matters only for multinationals. Hence, countries with a large multinational sector are affected more than countries with a small multinational sector. The Netherlands and Ireland lose between 0.4% and 0.5% of GDP because they combine a large multinational sector with a relatively low tax rate and a high capital/labour ratio. Belgium gains due to its high tax rate in combination with a large multinational sector.

4.2.2. Economic effects. CFA affects economic behaviour in CORTAX through four main channels. First, multinationals can no longer shift profits to subsidiaries within Europe. Indeed, profits are consolidated so that transfer prices are no longer needed. The elimination of profit shifting reduces corporate tax revenue in low-tax countries that currently benefit from it and raises revenue in high-tax countries (see Figure 4). However, profit shifting is not a zero-sum game in CORTAX (see also Hong and Smart, 2007). The reason is that profit shifting allows multinationals to reduce their overall tax burden. This reduces the cost of capital, encourages investment and boosts GDP. Taking away this opportunity effectively raises the tax burden for multinationals and exerts opposite effects on the economy. Note that profit shifting vis-à-vis the United States and Japan remains as it is, that is, based on separate accounting. In determining transfer prices, multinationals take the weighted average European rate into account (see Equation (2) below) as the relevant tax rate applying to profits allocated in the EU.

The second effect of CFA involves the EMTR or cost of capital. With separate accounting, national corporate tax rates based on the source principle affect the cost of capital for subsidiaries in countries where they operate. Under consolidation, however, the cost of capital is not directly influenced by national tax rates. The reason is that the income generated by a multinational is summed up to a consolidated base. The location of investment thus does not matter for the tax base of the multinational. The tax rate applying to the profit of the multinational under CFA (τ_i^{cfa}) can be written as a weighted average of the tax rates applied by the participating jurisdictions (τ_j) according to:

$$\tau_i^{cfa} = \sum_j \omega_{ij} \tau_j \tag{2}$$

where firm-specific weights ω_{ij} are determined by expression (1). CFA thus effectively means an equalization of EMTRs. Countries with a low EMTR thus lose their competitive advantage in attracting mobile capital compared to countries with a high EMTR.

But CFA does cause distortions in factor allocation. This third effect is opposite to the second. In particular, under CFA, multinationals can change the shares ω_{ij} in expression (2), thereby affecting the tax burden applying to the entire multinational profit. Indeed, by relocating inputs appearing in formula (1) from high tax to low-tax countries, firms reduce the weight of high-tax countries and increase the weight of low-tax countries. This reduces the tax burden τ_i^{cfa}. Hence, formula apportionment induces new behavioural distortions as long as corporate tax rates differ across countries. Effectively, statutory corporate tax rates become excises on the factors that appear in the formula. Thus, formula apportionment replaces the current distortion in capital and profit allocation by a new distortion that depends on the formula factors. CORTAX sheds light on whether this improves allocative efficiency or not and which countries benefit and lose.

The fourth effect of CFA is due to loss consolidation. Box 1 demonstrates how loss consolidation affects relative prices in CORTAX. It suggests that loss consolidation reduces the effective labour costs. This is because wages are always directly deductible from the multinationals' corporate tax bill in the CFA regime, which is not the case under loss carry forward. Loss consolidation does not necessarily reduce the cost of capital though. On the one hand, deductible capital costs become more valuable under consolidation as such costs can be deducted earlier and always. On the other hand, any positive *marginal* returns on investment are taxed immediately and cannot be postponed or waived in case of a loss. This increases the cost of capital. The CORTAX simulations reveal how in different countries the costs of labour and capital are affected. This drives the impact on employment and investment.

Box 1. Incentives under loss consolidation and loss carry forward

Assume a firm that produces output by combining labour and capital. *Ex ante*, firms are equal. *Ex post*, they may suffer a random shock in the value of sales. In the good outcome, the revenue from sales equals Y_t^g. In the bad outcome, there is a lower value Y_t^b, such that profits are negative. *Ex post*, a share of q firms obtain a good outcome and a share $1 - q$ obtains a bad outcome. Assuming risk neutrality, firms consider the expected output value when determining their demand for inputs.

Under loss carry forward, firms cannot immediately offset losses. We assume they carry forward their loss one year and then offset it against a possible profit. The expected tax base is determined by profitable firms minus the taxable loss they carry from the previous year (Λ_t):

$$E(\Pi_t^L) = q[Y_t^g - wL_t - \varphi I_t + (1-q)\Lambda_t]$$

$$\text{where } \Lambda_t = \frac{1}{1+r}(Y_t^b - wL_t - \varphi I_t) < 0 \tag{3}$$

where wL_t denote labour costs, I_t is investment and φ stands for an investment tax credit.

Under loss consolidation, we assume that all losses can be immediately offset against profits elsewhere in the multinational group. The expected aggregate corporate tax base is:

$$E(\Pi_t^C) = qY_t^g + (1-q)Y_t^b - wL_t - \varphi I_t \tag{4}$$

The difference in tax bases between consolidation and loss carry forward is:

$$E(\Pi_t^C) - E(\Pi_t^L) = (1-\theta)[Y_t^b - wL_t - \varphi I_t] < 0 \tag{5}$$

where $\theta = q[1 + (1-q)/(1+r)] \leq 1$. Hence, the tax base is unambiguously smaller under consolidation.

The first-order conditions for capital and labour demand under loss carry forward are:

$$qY_K^g + (1-q)Y_K^b = \frac{1-\varphi\tau}{1-\tau}r + \frac{\tau}{1-\tau}\xi(\varphi r - Y_K^b) \tag{6}$$

$$qY_L^g + (1-q)Y_L^b = w + \frac{\tau}{1-\tau}\xi(w - Y_L^b) \tag{7}$$

where subscripts denote marginal productivities, r is the return to equity, τ is the corporate tax rate and $\xi = (1-q)(1-q/(1+r)) \leq 1$. Under immediate loss offset, the first-order conditions are:

$$qY_K^g + (1-q)Y_K^b = \frac{1-\varphi\tau}{1-\tau}r \tag{8}$$

$$qY_L^g + (1-q)Y_L^b = w \tag{9}$$

Expressions (6) to (9) show that firms set the expected marginal productivity of capital and labour equal to their respective prices. According to (8), the corporate tax raises the cost of capital as long as investment is not fully deductible, i.e. $\varphi < 1$. The first-order conditions in (6) and (7) differ from (8) and (9) due to the second term on the RHS in (6) and (7). Comparing (7) and (9) shows that consolidation unambiguously reduces labour costs, because $w > Y_L^b$. Intuitively, limited loss offset implies that part of labour costs cannot be deducted if a firm makes a loss in two consecutive bad years.

Comparing (6) and (8) shows that consolidation may raise or reduce the cost of capital as compared to loss carry forward. This depends on the corporate tax system: if only a small share of investments are deductible (i.e. if φ is small), the reduced taxation of production in bad outcomes Y_K^b implies a reduction in the cost of capital. If φ is larger, consolidation raises the cost of capital because returns in consecutive bad outcomes will be untaxed as well.

Table 3. Economic effects for the EU of consolidation with formula apportionment

	Lump-sum transfers	Corporate tax rate	Labour tax rate
Corporate tax-to-GDP ratio	−0.29	−0.11	−0.30
Cost of capital	−0.05	−0.02	−0.05
Investment	0.38	−0.13	0.23
Wage	0.41	0.20	0.42
Employment	0.17	0.09	0.02
GDP	0.18	−0.06	0.03
Welfare	0.08	0.02	−0.03

Source: Authors' calculations.

Table 3 shows the balance of these four effects according to CORTAX under three balanced budget rules: lump-sum taxes, corporate taxes and labour taxes. The first column of Table 3 shows that CFA improves welfare in Europe by 0.08% of GDP under lump sum adjustment. The cost of capital falls by 0.05 percentage points and investment rises by 0.38%. Employment and GDP expand by 0.17% and 0.18%, respectively. The aggregate welfare gain from CFA in the first column of Table 3 is mainly driven by loss consolidation. Indeed, the lower tax burden implies a reduction in labour costs and the cost of capital. As this is financed by lump-sum taxation, it creates a net welfare gain.

However, if other distortionary taxes are used to balance the government budget, the second and third columns of Table 3 show that the positive economic effects of CFA are smaller. Higher corporate tax rates are particularly harmful for investment as they raise the cost of capital. Higher labour taxes especially hurt labour supply incentives and reduce employment. The welfare gain of CFA drops under both simulations.

Figure 5 shows the GDP and welfare effects of CFA for individual countries under lump sum adjustment. Countries are ranked according to their capital intensity (which is positively correlated with the size of the multinational sector). We see that country differences are large, with some countries actually losing from the introduction of CFA. For a number of countries, we find that welfare and GDP move in opposite directions, that is, welfare rises while GDP declines or vice versa. In particular, GDP tends to increase most in capital-intensive countries featuring a

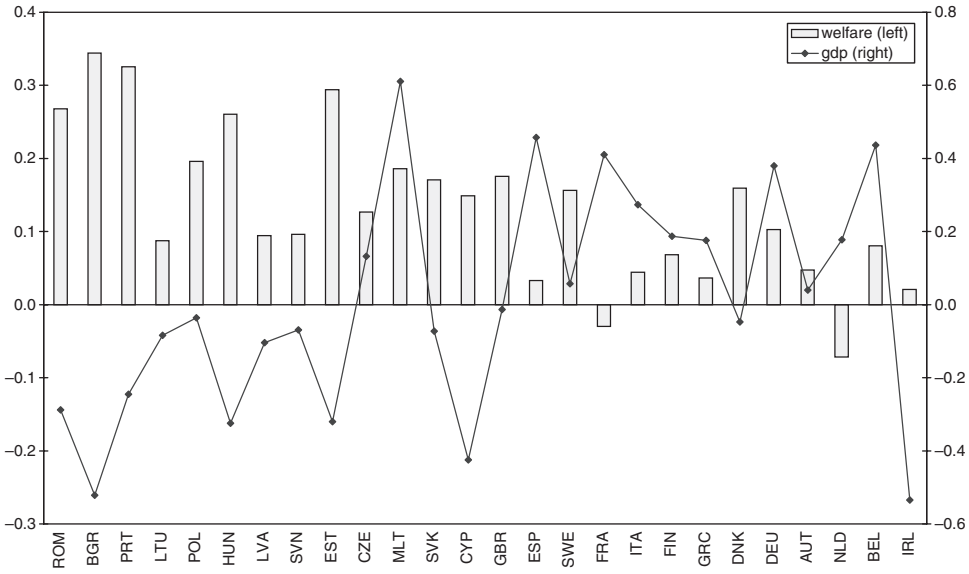

Figure 5. GDP and welfare effect of CFA for different countries with lump-sum taxation; countries are ranked at increasing capital intensity

relatively high corporate tax rate, like Belgium, Germany, France and Spain. These countries benefit from CFA as the effective tax rate on multinational investment falls under consolidation. This induces these multinationals to raise investments domestically, which exerts a positive effect on GDP, especially when multinationals are important. In capital-intensive countries with a low tax rate, such as Ireland, the opposite holds. Indeed, the tax rate on multinational investment in Ireland under CFA is higher than the Irish statutory rate, which depresses Irish multinational investment and therefore its GDP. For labour-intensive countries, these effects are generally smaller as investment changes less. Moreover, most of these countries feature relatively low corporate tax rates and therefore lose investment on account of CFA.

The welfare-effect of CFA is sometimes opposite from the GDP effect for three reasons. First, labour-intensive countries benefit more from the *ex-ante* redistribution of taxable profits. This is also shown in Figure 4, which shows the revenue impact exclusive of economic effects. The benefits from the extra tax revenues are distributed to households in a lump-sum fashion, which raises consumption and welfare. Given our assumption of a fixed terms of trade, this additional consumption does not affect GDP but is imported. Second, labour-intensive and low-tax countries experience a substantial net flow of FDI. In particular, net FDI expands in labour-intensive countries such as Romania and Cyprus and in low-tax countries like Ireland. It declines, however, in most capital-intensive countries, such as the United Kingdom and Belgium. The reason for this is that multinationals expand their subsidiaries in low-tax countries so as to shift a larger share of their taxable base to

Figure 6. Welfare effect of CFA for different countries, alternative balanced budget rules; countries are ranked at increasing capital intensity

these locations. The expansion of FDI broadens the base of taxable income. This taxable income is earned in high-tax countries where the MNE parent is located, but to a large extent taxed in low-tax countries. In other words, the GDP expansion in high-tax countries leads to a tax boost in low-tax countries via the apportionment formula. Finally, GDP is affected differently from welfare by changes in employment. Indeed, the rise of employment in capital-intensive countries causes an expansion of GDP, but a much smaller increase in welfare as it comes at a cost of less leisure time.

The welfare gains and losses are even more dispersed if governments adjust distortionary taxes on labour or capital income instead of lump-sum transfers, see Figure 6. Capital-intensive countries need to raise tax rates more to compensate their revenue loss induced by loss consolidation. This reduces their welfare. Labour-intensive countries are more likely to reduce tax rates, as they gain revenue under CFA. Hence, they experience larger welfare gains if distortionary taxes are reduced.

5. CHOICE OF THE APPORTIONMENT FORMULA

The direct distributional and economic effects of CFA depend on the choice of the apportionment formula. This section shows this by exploring the effects of CFA under four pure formulas, based on employment, payroll, assets or output. As in the previous section, we assess the impact of CFA relative to a scenario with a CCTB in the EU. If revenues change due to a CFA reform, we assume that a

Table 4. Economic effects of CFA for the EU under alternative formulas, corporate tax rate adjustment

	Employment	Payroll	Capital	Production	Equal shares
CIT revenues	−0.15	−0.10	−0.11	−0.10	−0.11
Cost of capital	−0.05	−0.02	−0.01	−0.01	−0.02
Investment	−0.11	−0.15	−0.13	−0.19	−0.13
Wage	0.30	0.19	0.17	0.16	0.20
Employment	0.09	0.11	0.09	0.09	0.09
GDP	−0.15	−0.04	−0.05	−0.06	−0.06
Welfare	0.00	0.02	0.01	0.02	0.02

Source: Authors' calculations.

country adjusts corporate tax rates to balance its budget. The relative performance of different formulas does not change if we adopt alternative balanced budget rules. Table 4 summarizes the economic effects for the EU as a whole.

Table 4 suggests that the choice of the formula matters marginally for aggregate welfare in Europe. The reason is that the economic effects are driven primarily by the tax relief associated with loss consolidation. This is on average independent of the formula choice. What we see is that the welfare gains are slightly larger under the pure payroll and production formulas as compared to the pure employment and capital formulas. The reason is that wages and the value of production both depend on the size of the fixed factor. This part of the apportionment formula is non-distortionary and, therefore, formulas based on it are less distortionary. Employment and assets do not directly depend on the fixed factor. Hence, these formulas are slightly more distortionary and yield smaller welfare gains.

5.1. Employment and assets formula

Figure 7 presents the change in welfare under both a pure employment formula and a pure asset formula in different countries if corporate tax rates are used to balance the budget. The figure reveals a negative correlation of the welfare effects with the initial capital/labour ratio (on the horizontal axis) if apportionment is based on employment shares. Hence, poor labour-intensive countries in Central and Eastern Europe benefit more from CFA than the rich capital-intensive countries in Western Europe.[8] First, the initial redistribution of the tax base is more favourable as a large share is apportioned to labour-intensive countries. Second, low tax rates are more effective in attracting multinational activity if the formula is determined by the relatively abundant factor. Especially Bulgaria and Romania benefit, as they combine a labour-intensive production structure with relatively low corporate tax rates. The most capital-intensive countries, Belgium, Ireland and the Netherlands, suffer a welfare loss.

[8] This is in line with the findings of Devereux and Loretz (2008).

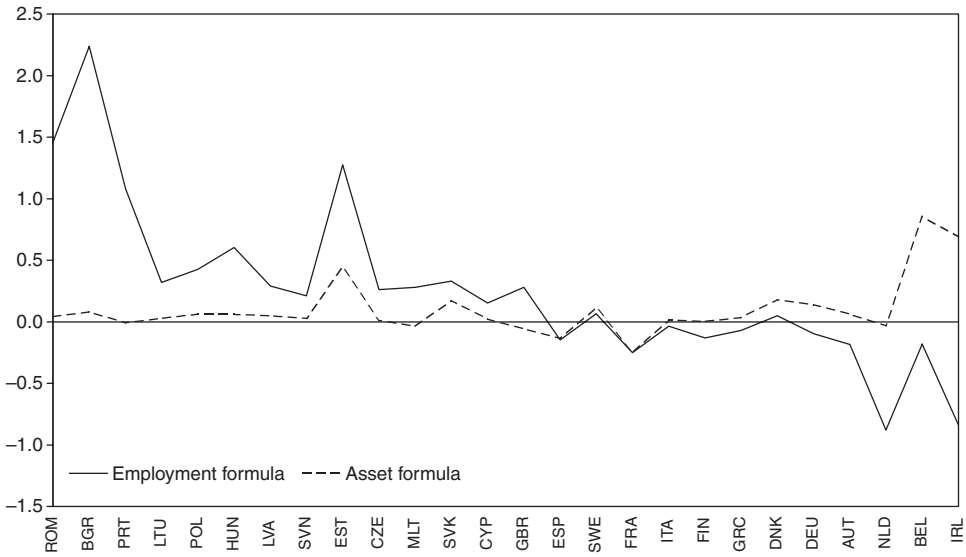

Figure 7. Effect on welfare of CFA with a pure employment and asset formula; countries are ranked at increasing capital intensity

Under a pure asset formula, capital-intensive countries benefit from receiving a relatively large share of the European tax base of multinationals. Moreover, a pure asset formula implies that the corporate tax rate has a relatively large effect on the asset allocation of multinationals. Capital-intensive countries with a low corporate tax rate therefore benefit most from CFA with the asset formula and labour-intensive countries with high tax rates lose. Figure 7 shows the positive correlation between the welfare effect of CFA and the initial capital/labour ratio. Interesting is that Ireland and the Netherlands experience a lower corporate tax-to-GDP ratio due to the abolition of profit shifting, although this effect is smaller than under the 1/3 formula. Yet, the welfare effect in these countries is positive because multinationals relocate their assets due to relatively low corporate tax rates.

The variation of the welfare effects across countries is larger under the employment formula than under the asset formula. The reason is that distortions induced by the current corporate tax systems are more similar to the distortions under CFA with a pure asset formula. Under a pure employment formula, distortions in response to the formula are more different as employment by multinationals is more weakly linked to the current distribution of profits. Given the uneven distribution of labour, abundant in low-wage countries but scarce in high-wage countries, the effects for individual countries vary more under the employment formula than under the asset formula.

5.2. Payroll, production and sales formulas

Applying the source principle of taxation is difficult in practice, both under separate accounting and under consolidation with formula apportionment. This is due to the

complex structures of multinational activities, which render it virtually impossible to determine the source of profits. Under consolidation, one may approximate the source of profits by using input factors in the formula. Indeed, employment, assets and output approximate the source of where profits are generated and thus come close to achieving taxation on the basis of the source principle.

An alternative is the destination principle, that is, the destination of sales of final products where consumers reside. In the United States, sales have become the most popular formula. Also in the European debate sales are generally considered as a potential apportionment formula under the CCCTB. In this debate the usual measurement of sales is by destination. That is, if a company in country X exports its output to country Y, then the sale is in country Y. This makes the tax on profit much closer to a destination-based consumption tax. If sales by destination were the only factor in the apportionment formula, then a company's tax liability would not depend on where it undertook any of its activities other than the sale to the final consumer. It follows that the tax system would not distort decisions as to the location of productive activity, headquarters or other aspects of the company's operations. It is for these reasons that there have been independent proposals to base the corporation tax system on a destination basis (Bond and Devereux, 2002; Auerbach *et al.*, 2009).

However, we are not able to analyse the CCCTB under a sales-by-destination formula. This is because we do not have reliable data on the link between production and sales. In order to implement this, we would need information on the geographical scope of sales by subsidiaries of multinational companies. Such data are not currently available.

6. CORPORATE TAX RATES

In the European CCCTB proposal, countries are free to choose their own corporate tax rate. This leaves room for tax competition between countries with respect to rates. Indeed, we have seen that apportionment based on employment, assets or payroll induces multinationals to reallocate factors to low-tax jurisdictions. Governments may strategically respond by setting low tax rates in order to attract these multinational factors. An important question for policy is whether tax competition becomes more or less intense under CFA as compared to separate accounting.

6.1. Tax competition under consolidation

The effects of moving to CFA on tax competition are theoretically ambiguous (see e.g. Pethig and Wagener, 2003; Sørensen, 2004b; and Kind *et al.*, 2005). It depends on the strength of international spillovers of tax policies. Governments under separate accounting have an incentive to underbid each other's tax rates to attract paper profits, while with CFA they keep tax rates low to attract multinational activ-

ities (Gordon and Wilson, 1986). Which of these spillovers dominate remains an empirical issue. This section explores whether the incentives for tax competition under CFA are stronger than under separate accounting. To that end, we simulate a unilateral 5 percentage point reduction in the corporate tax rate in each EU country, both under the current regime of separate accounting (with a CCTB already in place) and under the CFA regime. In both simulations, governments reduce lump-sum transfers to balance their budget. Hence, the corporate tax relief typically improves welfare by alleviating distortions in investment. On average, welfare in a country increases by 0.2% of GDP. The interesting question is whether these welfare improvements differ across the two regimes. If this is the case, it suggests that spillovers differ in size. Indeed, if the same unilateral tax cut raises welfare more under CFA than under separate accounting, spillovers are larger under CFA and the incentives for tax competition are expected to intensify.

Figure 8 shows the economic impact of a 5 percentage point unilateral corporate tax rate reduction for individual countries under separate accounting and CFA with a 1/3 formula. In the figure, points are linked to each other via two lines: a solid line for the CFA regime and a dashed line for the separate accounting regime. Countries are ranked according to their initial corporate tax rate.[9]

Figure 8. Effect of a five percentage point unilateral tax reduction on welfare under separate accounting (SA) and CFA; countries are ranked at increasing tax rates

[9] These outcomes are qualitatively the same if we take pure employment or asset formulas, although the distributional effects are different. In particular, low-tax countries in Eastern Europe will experience a considerably larger welfare gain from a unilateral tax rate reduction under a pure employment formula.

On average, we find that the welfare effect of a unilateral tax reduction is equivalent across the two regimes. However, the effect differs between low-tax and high-tax countries. Indeed, Figure 8 shows that tax reductions yield larger welfare gains in low-tax countries under the CFA regime. In contrast, tax reductions in high-tax countries yield smaller welfare gains under the CFA regime. The explanation is the following. The costs of transfer price manipulation are convex. It implies that the marginal costs of profit shifting increases if a tax rate falls further relative to other countries. Hence, additional tax rate reductions in low-tax countries yield only small benefits because of the rapidly rising costs of profit shifting. In contrast, the marginal cost of profit shifting for high-tax countries are low. Hence, tax-rate reductions are relatively beneficial. Under the CFA regime, this asymmetry between high-tax countries and low-tax countries disappears because the profit shifting mechanism is absent. Instead, new fiscal spillovers arise that depend less on the initial tax rate. Therefore, low-tax countries find it relatively more and high-tax countries relatively less beneficial to cut their rates under the CFA regime. This finding suggests that under CFA, low-tax countries will find it more beneficial to cut their rates so that they more aggressively compete. High-tax countries find it less beneficial to reduce their rate. The likely result is a further divergence of corporate tax rates across countries. This makes the debate on rate harmonization more relevant.

6.2. Harmonization of rates

We simulate the welfare effects of rate harmonization under the CCCTB. Important is the choice of the common tax rate in Europe. We choose a common rate of 32.5%, which implies the same impact on corporate tax revenues as the CCCTB with today's corporate tax rates in Europe. Changes in tax revenues are compensated with a change in either lump-sum transfers or the labour tax rate. Table 5

Table 5. Economic effects for the EU of a CCCTB with country-specific and common corporate tax rate

	No rate harmonization (see Table 3)		Harmonization at a common rate of 32.5%	
Budget closing rule	Lump-sum transfers	Labour tax	Lump-sum transfers	Labour tax
CIT revenues	−0.29	−0.30	−0.32	−0.33
Cost of capital	−0.05	−0.05	−0.02	−0.02
Investment	0.38	0.23	0.41	0.25
Wage	0.41	0.42	0.51	0.52
Employment	0.17	0.02	0.19	0.03
GDP	0.18	0.03	0.28	0.13
Welfare	0.08	−0.03	0.14	0.04

Source: Authors' calculations.

compares the CCCTB with rate harmonization at 32.5% with the CCCTB where corporate tax rates remain unchanged.

Table 5 shows that welfare expands by about 0.14% and 0.04% of GDP if government budgets are closed with lump-sum transfers and labour taxes respectively. Both are higher than with country-specific changes in the corporate tax rate (as repeated from Table 3). It reflects the more efficient allocation of capital in the EU due to the equalization of tax rates. The allocation formula no longer exerts an effect on factor allocation when rates are harmonized. Hence, distortions in factor allocation are eliminated. This increases average rates of returns in Europe, which shows up in higher welfare.

7. SENSITIVITY ANALYSIS

The discussion of consolidation and formula apportionment has centred on the average welfare effect (generally negligible) and its distribution across countries (quite uneven). In addition, the distribution is shown to depend on initial tax rates, capital intensity and openness as measured by the size of the multinational sector. This section explores how robust these results are to alternative values of key elasticities and modelling assumptions. Section 7.1 shows that the economic effects of consolidation do not depend much on the substitution between labour and capital or the inclusion of responses to dividend and capital gains taxes. More important are the size of the fixed factor, the responsiveness of paper profits to tax differentials and the inclusion of a discrete location choice of multinationals. The role of losses is discussed in Section 7.2.

7.1. Economic effects of consolidation under alternative assumptions

This section presents how sensitive our results are for a number of assumptions in the model. We consider one key reform proposal to illustrate the sensitivity of our results, namely the introduction of CFA with the 1/3 formula, where governments use corporate tax rates to balance their budget (see Table 3). We consider the implications for this simulation under five changes in CORTAX: (1) a smaller elasticity of substitution between labour and capital (from 0.7 to 0.5); (2) a different assumption regarding the distortionary impact of dividend taxes; (3) a smaller size of the fixed factor in the calibration (from 2.5% to 1.5%); (4) a larger response of transfer prices to tax differences (50% larger response); and (5) the inclusion of discrete location choices between countries. Table 6 reports in the first column the EU-average change in welfare under the five alternative assumptions, and compares it with the outcomes from the basic simulation, presented in the first row of the table. Moreover, Table 6 summarizes the sensitivity of individual country effects by

Table 6. Sensitivity of welfare effects of consolidation with formula apportionment (equal shares and corporate tax rate adjustment)

	EU average	Covariance with		
		Tax rate	Capital intensity	Openness
CFA (base case)	0.02	−0.003	−0.193	−0.050
Limited K-L substitution	0.03	−0.003	−0.192	−0.050
No personal taxation	0.02	−0.004	−0.178	−0.046
Smaller fixed factor	−0.02	−0.005	−0.367	−0.105
Intensified paper profit shifting	0.02	−0.002	−0.230	−0.074
Location choice	−0.05	−0.007	−0.414	−0.162

means of covariances.[10] In particular, the first row shows the covariance of the welfare effect of the CFA reform with three country characteristics: (1) the initial corporate tax rate; (2) the capital intensity; and (3) the degree of openness measured by FDI stocks. We see that the welfare effect is positively correlated with low corporate tax rates, low capital intensity and a small multinational sector (see Section 4). Table 6 shows how these country characteristics affect the size of the welfare effect of the CFA reform under alternative assumptions.

The second row of Table 6 shows the welfare effects of CFA for a lower elasticity of substitution between labour and capital. This elasticity is generally considered to be an important determinant of the economic effects of corporate tax reforms. In particular the response of investments to the user cost depends on this elasticity. Simulations with CORTAX in Bettendorf *et al.* (2006) show that a limitation of the substitution possibilities reduces the responsiveness of capital and GDP to a change in the tax rate. Table 6 shows that the welfare changes in the CFA reform are negligible, however. The reason is that the economic and welfare changes are not induced by changes in the user cost of capital, but by changes in profit shifting and the (implicit) taxation of the apportionment factors. These tax planning strategies do not depend much on the elasticity of substitution between labour and capital.

The third row adopts an alternative assumption regarding the distortionary effect of personal taxes on capital income. In particular, CORTAX adopts the assumption under the old view of dividend taxation that personal capital taxes on capital affect the investment. In the third row of Table 6, we have taken the new view and assume that these taxes are not relevant for investment. We see that the welfare effects are very similar. Hence, the assumption of how personal taxes affect investments does not change the impact of CFA much.

The fourth row of Table 6 assumes a smaller fixed factor than in the original CORTAX version. This renders the CIT more distortionary, as a smaller part

[10] A limitation of covariances is that they are sensitive to scaling, which implies that the columns in Table 7 cannot be compared. However, variation in the rows of the table reveals whether the initial tax rate, capital intensity and openess has a weaker or stronger impact on the welfare distribution.

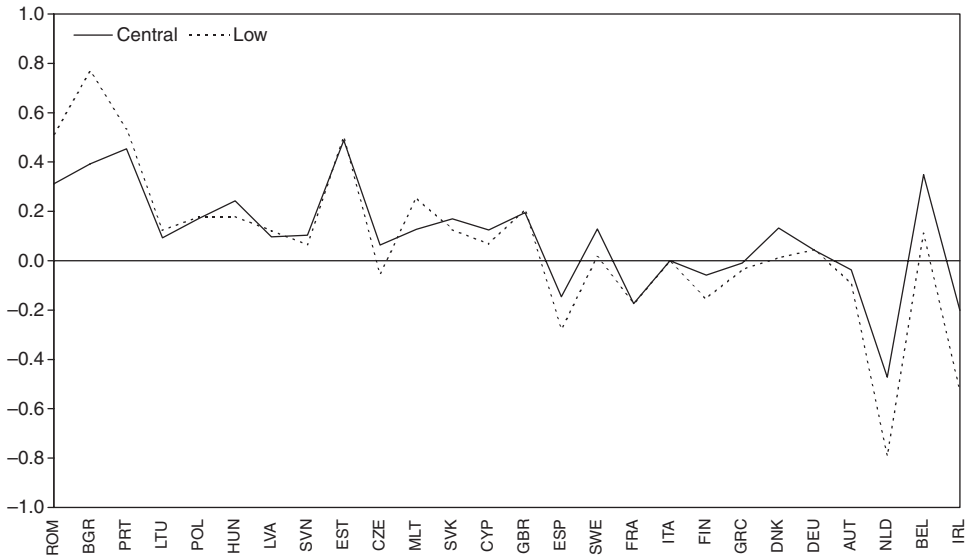

Figure 9. Welfare effects of CFA, with a smaller share of fixed income; countries are ranked at increasing capital intensity

applies to the non-distortionary economic rent. As a result, we find that CFA yields a welfare loss on average in the EU, rather than a welfare gain. The welfare loss is particularly pronounced in countries featuring high corporate tax rates, high capital intensity and a large multinational sector, which we obtain from the larger covariances. Figure 9 shows the welfare effects for individual countries under the two alternative calibrations. The countries are ranked according to their capital intensity from left to right. We see that labour-intensive countries like Romania, Bulgaria and Portugal gain more under a smaller fixed factor. This is because they are able to reduce their tax rates, which yields larger gains if these taxes are more distortionary. Capital-intensive countries like the Netherlands, Belgium and Ireland lose more.

The fifth row of Table 6 shows the sensitivity of the results if the response of transfer prices to tax differentials is larger due to the smaller cost of profit shifting. On average in the EU, the implications are limited. However, the impact for individual countries changes more substantially. For instance, the welfare effect for low-tax countries becomes smaller. The reason is that transfer pricing only matters under separate accounting. Low-tax countries benefit more from transfer price manipulation if the costs decline. Therefore, they gain less from the shift towards CFA. The variation of effects of the CFA reform therefore becomes smaller. We also see that the effects of CFA are more favourable for labour-intensive countries and for countries with a small multinational sector (as this sector currently gains more from profit shifting).

The last row of Table 6 shows the CFA reform in a version of CORTAX that includes the discrete location choice of multinational enterprises. We see that this is

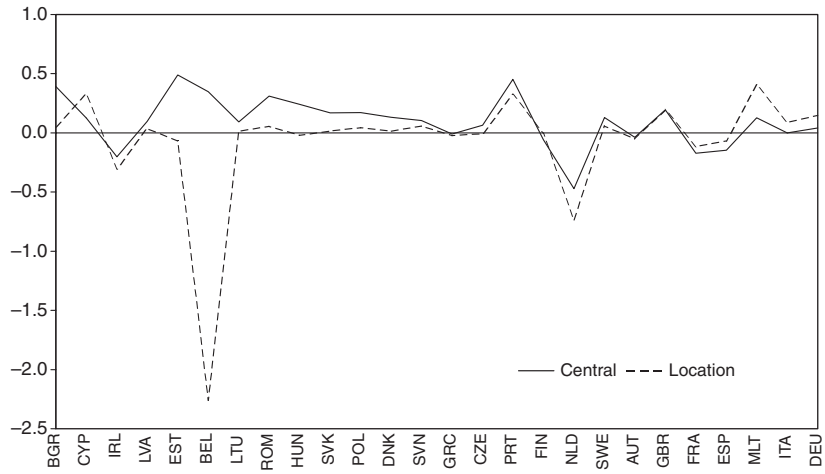

Figure 10. Welfare effects of CFA, with endogenous location choice; countries are ranked at increasing tax rates

important for the economic effects of the CFA reform. In particular, the average EU effect becomes more negative. The reason is that the responsiveness of multinationals to the allocation formula becomes larger if the fixed factor moves across jurisdictions. Indeed, by locating a larger share of the fixed factor in low-tax countries, the multinational reduces its tax liability. CFA thus exacerbates distortions in capital allocation, which causes larger adverse welfare effects in the EU. This negative welfare effect for the EU as a whole comes along with a divergence of effects between countries. Indeed, the covariances in Table 6 increase. The country variation is also shown in Figure 10, which presents the welfare effect of CFA in both versions of CORTAX, that is, with and without endogenous location choice. Countries in this figure are ranked according to their corporate tax rate (after the introduction of the CCTB).

Figure 10 shows that high-tax countries benefit more from the CFA reform if location is endogenous. The intuition is as follows. In the initial situation with separate accounting, differences in statutory tax rates determine location choice. This is unfavourable for high-tax countries. Consolidation implies that the effective tax rate, on which firms base their investment decisions, becomes a weighted average of the statutory rates (see Equation (2)). The resulting convergence of effective tax rates implies that the disadvantage of high-tax countries is mitigated. This also explains the large difference in effects for Belgium. Belgium is a low-tax country in our baseline with a statutory rate of 14%, because it has abolished its ACE system under the CCTB (which is our starting point for the CFA reform). With discrete location choice, Belgium has gained substantial inflows of fixed capital due to its low rate. This benefit is offset, however, by consolidation. This explains the welfare loss for Belgium and some other low-tax countries.

7.2. Consolidation and losses

The CORTAX assumptions regarding losses imply that the corporate tax burden is relatively high in the current system of separate accounting with loss carry forward relative to CFA. Indeed, losses can immediately be offset under CFA against profits in another country, which leads to tax relief. It generates a welfare gain if governments compensate this revenue loss with a reduction in lump-sum transfers. The welfare gain is smaller if corporate or labour tax rates are adjusted. The size of these effects depends on the specific CORTAX assumptions regarding loss consolidation. Restrictions to current loss offset might well be less strict, while the possibilities for immediate loss compensation under CFA might be more limited than we have assumed. Accordingly, the impact of loss consolidation would be smaller than assumed in CORTAX.

To shed light on this, we may consider alternative assumptions regarding loss probabilities and the size of losses. Although this keeps the same modelling of the difference between loss carry forward and loss consolidation, it modifies the size of the shock accordingly. CORTAX assumes that losses occur on average once in every five years (i.e. $q = 0.8$ in Equation (3)) and that the size of losses and profits are equal. If losses would occur less frequently, for example once in every ten years, or when the size of losses would be halved, this reduces the size of the shock from loss consolidation. Table 7 reveals how this modifies the outcomes for the CFA reform. We see that CFA with lump-sum transfers becomes less beneficial: the welfare gain drops from 0.08% of GDP to 0.02% or 0.04%. However, the welfare effect changes less when corporate or labour taxes are used to balance the budget. Indeed, tax relief by loss consolidation yields only small welfare effects under these alternative balanced-budget rules. Reducing the size of the shock thus only proportionally modifies the size of the effects.

CORTAX uses the average probability and size of losses in the EU. Country-specific information can be deduced from the firm-level data, yielding loss probability and loss-to-profit ratios per country.[11] Country-specific information about losses

Table 7. Welfare effect of consolidation under alternative assumptions about losses and alternative budget rules

	CFA (base case)	Lower loss probability	Smaller loss to profit ratio
Lump-sum transfers	0.08	0.02	0.04
Corporate tax rate	0.02	0.00	0.01
Labour tax rate	−0.03	−0.01	−0.01

Source: Authors' calculations.

[11] Note that the calculated values may depend on a very small number of firms, in particular in small countries. Moreover, they may reflect booms or busts in an economy and need not hold outside the sample (2003–2007).

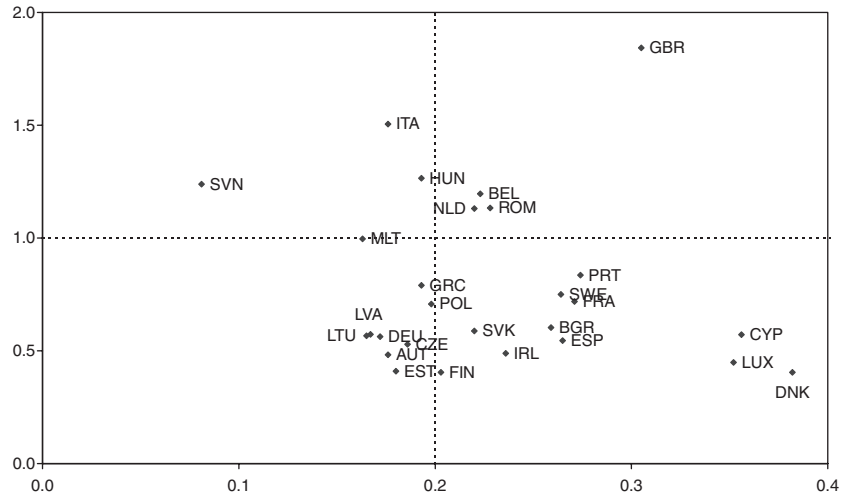

Figure 11. Loss probability (*x*-axis) and loss-to-profit ratio (*y*-axis) in the European Union

is summarized in Figure 11.[12] The horizontal axis shows the fraction of loss-making firms, about 20% on average in the EU. The vertical axis shows the loss-to-profit ratio, defined as the average size of losses per loss-making firm divided by the average size of profits in profit-making firms. This ratio is approximately one, on average in the EU. Figure 11 shows that Denmark, Cyprus and Luxembourg have a high share of loss-making firms (between 35% and 40%), but that the average loss per firm is relatively small (about 50% of the profits in profit-making firms). The United Kingdom stands out as a country where a high share (30%) of firms is making losses and where these losses are relatively large. The average return is therefore low, only 1% on average.

Figure 12 shows the implications of CFA if we adopt these country-specific loss probabilities and loss/profit ratios in CORTAX. In the figure, countries are again ranked according to their initial capital-labour ratio (as in Figure 4). We see that labour-intensive countries still gain from CFA. Country-specific losses affect welfare for a few countries, in particular the United Kingdom and the Netherlands. Welfare in the UK declines in Figure 12, because CIT revenues drop and are compensated with a higher corporate tax rate.

This relatively large drop in CIT revenues when moving from separate accounting to CFA seems counterintuitive. In particular, larger losses made by UK firms reduce corporate tax revenues in the United Kingdom to their full extent under separate accounting. Under CFA, the same losses will be apportioned to all Member States. It would imply that high losses in the United

[12] Table A1 in the appendix provides more details on the distribution of losses and the rate of return.

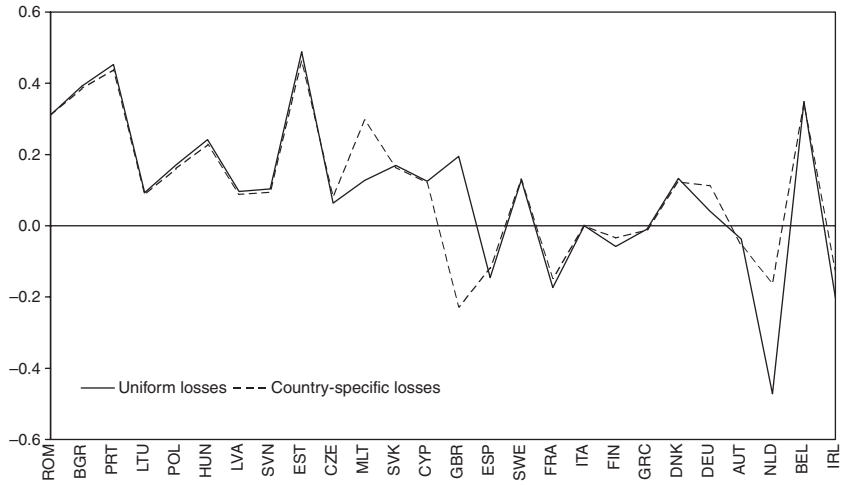

Figure 12. Change in welfare of CFA with corporate tax adjustment, with uniform and country-specific losses

Kingdom reduce corporate tax revenue more under separate accounting than under consolidation. However, this intuition overlooks the general equilibrium implications of higher losses which are captured by CORTAX. In particular, higher losses also cause lower expected productivity in a country, which is accompanied by lower wages. In this way, workers share in the incidence of the higher losses. The reduction in wages offsets the negative impact on corporate tax revenues. This offset is larger under separate accounting because part of the losses under CFA are shared with other governments. Effectively, CFA implies that not only larger losses are apportioned to other Member States, but higher profits as a result of lower wages too. On balance, the question is who bears the largest share of the higher losses. The answer according to CORTAX is that the largest share of the revenue loss accrues to the UK government.[13] Welfare in the United Kingdom declines if the UK government raises corporate taxes to compensate for this revenue loss. Indeed, the higher UK tax rate causes a relocation of employment, capital and output out of the United Kingdom. Countries to which UK firms relocate, like the Netherlands and Ireland, benefit.

8. CONCLUSION

This paper explores the economic impact of a common consolidated corporate tax base in the EU using a numerical CGE model for the EU. We find that neither a common base nor consolidation with formula apportionment will yield substantial welfare gains in Europe. The largest welfare gain of 0.08% of GDP is obtained in

[13] In terms of Equation (1), $\omega_{UK,UK}$ appears to be relatively large (about 0.44).

the case with lump-sum financing. Why doesn't welfare improve more? First, corporate tax revenues amount to only 3.5% of GDP and only a fraction of this is paid by multinationals. Reforms in the corporate tax regime of multinationals will therefore only yield modest macroeconomic effects. Second, consolidation and formula apportionment does not affect key distortions in marginal investment choices and portfolio decisions. Indeed, we see that the cost of capital is hardly affected by the consolidation reform. Thus, this key distortion remains intact. Third, in tackling international distortions of corporate tax regimes, consolidation with formula apportionment is not well targeted. In particular, the European Commission (2001) argues that distortions in the allocation of capital across Member States of the EU are caused primarily by differences in statutory corporate tax rates between countries. Under the consolidation scenario, these rate differences are not affected. Our simulations with full harmonization of tax rates and bases show indeed bigger welfare gains (see also Sørensen, 2004a). Fourth, consolidation aims at a similar treatment of multinationals in different countries, but introduces an unequal treatment of multinationals and domestic firms operating in the same country. Hence, the reform reduces one distortion but creates another.

We find that variation of economic effects across countries is large: some countries gain while others lose. This holds both for the introduction of a common base and for the shift from separate accounting to consolidation with formula apportionment. The dispersion of effects forms a serious complication in achieving political agreement on corporate tax harmonization. However, the distributional impact depends strongly on the choice of the apportionment formula. This leaves some degrees of freedom to finding a feasible outcome. Yet, using input factors in the formula to approximate the source principle of taxation reduces efficiency as remaining tax differences distort factor allocations across countries. Using sales by destination as the sole formula factor is more efficient, but reduces the degrees of freedom to steer distributional effects across countries.

The simulations reveal that consolidation does not reduce the incentives for tax competition in the EU. In fact, we find that especially low-tax countries will benefit even more from unilateral tax cuts under consolidation as compared to separate accounting. Hence, consolidation may cause a further divergence in tax rates across European countries. It offers another argument for rate harmonization. Indeed, our simulations suggest that rate harmonization, in combination with a common consolidated base, will improve welfare in Europe.

While our analysis sheds light on the economic implications of tax harmonization via a number of economic mechanisms, CORTAX does not capture all possible channels determining the desirability of harmonization. First, our analysis ignores compliance and administrative costs. One reason for consolidation is to save on compliance costs for multinationals, for example the costs associated with the complicated determination of transfer prices. Quantitative research on compliance costs due to transfer pricing is, however, scarce. Moreover, it is not clear

what will be the compliance costs under formula apportionment, which depends on particular details in the definition of the tax base. Second, our model does not capture the impact on risk taking. For instance, loss consolidation implies that profits and losses are treated more symmetrically. This strengthens the insurance function of the corporate tax system and may encourage risk taking. Third, we do not consider all possible behavioural responses of multinationals to harmonization. For instance, a multinational cannot choose to become national, its organizational structure is unaffected, decisions on intrafirm financing structures are not modelled, and we only consider an *ad-hoc* extension of the model to include discrete location decisions. We cannot *a priori* say how the inclusion of those alternative channels will change our results. Future research could extend our analysis in these directions to shed a broader light on the ultimate welfare effects of tax harmonization in the EU.

Discussion

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The paper uses an applied general equilibrium model for the EU especially designed to analyse corporate tax reforms. The model captures key decisions for firms to analyse profit shifting, investment distortions, debt-equity decisions, and imperfect loss offsets. The paper analyses the introduction of a Common Consolidated Corporate Tax Base (CCCTB) in the EU with and without formula apportionment (CFA) of profits. Any change in corporate tax revenue is offset by an appropriate change in lump-sum taxes, corporate income taxes, or labour income taxes.

A CCCTB without CFA has negligible effects on EU welfare: +0.01% of GDP for all possible tax adjustments that were analysed. The formula apportionment method to allocate corporate profits over EU countries is important and introduces as much distortions as the CCCTB aims to remove. The effects of a CCCTB with CFA on overall EU welfare are small: +0.08% GDP (lump-sum taxes), +0.02% GDP (corporate taxes), −0.03% GDP (labour taxes). The distributional and welfare effects for EU Member States can substantially differ across countries depending on which factors are employed in the CFA.

The main effect of CFA works through the tax treatment of loss offsets. Imperfect loss offsets generate an implicit tax on labour demand. Under the CCCTB losses can be consolidated, which results in a lower implicit tax on labour, and therefore generates fewer distortions. The imperfect loss offset also creates an implicit tax on capital income. However, this effect is offset by tax deductions for costs of investment.

The authors demonstrate that unilateral changes in corporate taxes are more attractive with a CCCTB plus CFA. Therefore, such a policy promotes tax competition. Finally, the authors demonstrate that tax rate harmonization yields some modest welfare gains: +0.14% GDP (lump-sum taxes) and +0.04% GDP (labour taxes).

The topic of this paper is highly policy relevant and is of a general interest to all policy-makers within and outside the EU. The paper basically demonstrates that the EU proposal to introduce a CCCTB combined with CFA in the EU is a non-starter; the welfare effects of doing so are negligible. The analysis is competently executed. Extensive sensitivity analysis reveals that the conclusions are robust. A number of comments are in order.

The analyses where lump-sum taxes are adjusted should be taken with a grain of salt. If welfare gains are found, this is because distortionary taxes are lowered by raising lump-sum taxes. Why not raise all revenue with lump-sum taxes then? Tax distortions should be motivated by their favourable distributional effects. However, these distributional concerns are absent from the analysis. Thus, the welfare gains of lump-sum taxes implicitly originate from sacrificing on the redistributional tasks of the government. In my view, the correct benchmark should be: keeping lump-sum taxes fixed and raising distorting taxes to balance the budget. However, in that case, the potential welfare improving effects of the CCCTB are generally negative.

The authors develop a general equilibrium model, but there are only few general equilibrium feedbacks in the model. There is one internationally tradable good and the terms of trade are fixed. Interest rates and asset prices are constant and determined on world markets. Since the authors focus on steady states of the model, also the wage rate and the user-cost of capital are constant. One may question whether this modelling strategy is reasonable for a model covering the EU-27, the United States and Japan. This range of countries covers a huge part of the world economy. General equilibrium feedbacks in international goods and capital markets can be potentially relevant. Hence, one cannot be completely confident whether the reported quantitative effects are biased due to ignoring these general equilibrium feedbacks.

The authors furthermore assume that there is a fixed factor of production and there is no entry of firms as the number of firms in each country is fixed. This fixed factor generates quasi-rents equal to 2.5% GDP. This fixed factor renders the corporate income tax less distortionary, since the corporate tax skims off quasi-rents. Still, the question is how important this fixed factor is, since empirical evidence is not available. One could argue that, under perfect capital mobility and free entry of firms, all quasi-rents are competed away. This could imply that the already small welfare effects are overestimated. Indeed, the robustness analysis demonstrates that the very small positive welfare effect turns negative when the fixed factor is reduced in size.

The authors assume that labour markets are perfectly competitive. They acknowledge that this is probably not the best description of European labour markets. However, with imperfectly competitive labour markets, policies that reduce user cost of capital help to reduce unemployment (see Bettendorf *et al.*, 2009a). Since the authors find that the CCCTB proposals reduce the user cost of capital, this could imply that the welfare effects of the tax reform are underestimated when one would allow for imperfectly competitive labour markets.

The quantitative results of the formula apportionment are importantly driven by changes in the tax treatment of loss offsets. Without the CCCTB loss offsets are imperfect, since losses can only be carried forward one year. With the introduction of a CCCTB multinationals can offset losses of subsidiaries, which effectively results in perfect loss consolidation. The authors assume bimodal profit distributions by allowing for only two states of nature: one with positive and one with negative profits. Although the model nicely fits aggregate profits and losses, one may wonder whether this very stylized description of losses fully captures real-world profit distributions. Future research could explore this issue further.

The authors make a number of simplifying assumptions which could affect the outcomes of the analysis. The portfolio choices of households are driven by preferences to hold a mix of debt and equity. The model abstains from risk and provides no micro-foundation of the equity premium. Moreover, the costs of financial distress are modelled by convex costs of raising debt. Again, the model contains no micro-foundation of agency problems related to financial distress, which could explain the rising costs of capital when firms have a larger leverage. Similarly, the authors assume convex costs of deviating from arm's-length pricing without specifying the micro-foundation giving rise to this relationship. One can ask whether tax harmonization could affect any of the underlying micro-mechanisms. Could, for example, costs of financial distress decline due to better loss-consolidation possibilities? In that case, welfare gains would be underestimated. Could the costs of profit shifting be affected, since loss consolidation and the allocation of sales, assets and labour provide additional channels to shift profits besides arm's-length pricing? If overall profit shifting increases, the welfare effects could be smaller.

Finally, given the political sensitivity of the proposals being analysed, the authors are right to be cautious. However, the authors could have been much more explicit in emphasizing that the CCCTB with CFA has negligible welfare effects. Moreover, the CCCTB could make matters even worse given that incentives for tax competition intensify. So it seems to be time to leave the CCCTB for what it is: a non-starter. Policy should focus on eliminating investment and leverage distortions and tax rate harmonization. For example, an EU-wide introduction of an ACE combined with tax-rate harmonization would directly tackle the most pressing problems of the corporate income tax.

Etienne Wasmer

Sciences Po

Currently in Europe, corporate taxation is highly heterogeneous across countries. There are country-specific definitions of tax base, country-specific tax rates, country-specific depreciation allowances, no rule for consolidation of losses, and so on. The point of Bettendorf *et al.*'s paper is to investigate whether more harmonization would generate welfare gains. The question is all the more important than the political battle between the Left and the Right or between integrationists and Eurosceptics, which is focused on whether fiscal competition should be banned.

The paper shows, based on a model called CORTAX, that consolidation of tax systems does not lead to substantial welfare gains. For instance, one of the provocative results of the paper is that a common corporate tax base in Europe would lead to an estimated welfare gain of only 0.0001 of GDP (according to their Table 2), so to speak zero.[14]

This is an apparently strong result, all the more surprising given the relatively large heterogeneity in fiscal policies. Table 8 calculates some statistics about the relative dispersion of three parameters of corporate tax policies, measured as the ratio of the standard deviation to the sample mean (coefficient of variation, CV hereafter). Consider first column (I). In the OECD, the CV of corporate income tax is no less than 0.34, it is 0.32 in the EU27, it falls to 0.21 if one considers the EU15 only. In the core of founding members of Europe (EU6, that is France, Germany, Italy and the Benelux), the variation is even smaller, and reaches 0.12. These numbers quite clearly show that the successive enlargements of Europe have led to a complete change of the fiscal environment, with much more heterogeneity of tax systems. In a way, this also changed the substance of Europe itself. While tax harmonization and solid welfare states might have been thinkable with a few core European countries, it is, *de facto*, no longer in the political agenda, given the considerable heterogeneity across fiscal systems. Countries with more pro-corporation tax systems will likely be more reluctant to give up their comparative advantage, leading to a *political complementarity*.

Table 8. Standard deviations over the mean of corporate tax policies

	(I) CIT rate (CV)	(II) NPV allow (CV)	(III) EMTR % (CV)
OECD	0.34	0.18	0.63
EU27	0.32	0.18	0.60
EU15	0.21	0.12	0.53
EU6 (F-G-I-Benelux)	0.12	0.11	0.67

[14] And possibly less than the total wage costs of the many European and country officials negotiating the details of the convergence and the organization costs of the many European summits.

Column (II) shows a similar profile in NPV allowances dispersion. It is 50% less heterogeneous in the EU15 than in the EU27: the OECD and the EU27 are similarly heterogeneous areas with regards to their corporate tax system. The last column (III) shows the dispersion of the effective marginal tax rate (EMTR). Here however, the dispersion does not decrease monotonically with the size of the geographical area. The reason is that there is an outlier, Belgium, where EMTR is negative. The relative importance of Belgium increases in the EU6 with respect to the EU15 or EU27.

Assessment

Often the discussion on tax consolidation versus tax competition policies in Europe are literary or ideological. This paper is therefore welcome in trying to bring some structure to the debate. However, for reasons that will appear throughout this discussion, there is no good reason to buy the main result. The paper is only a useful first step.

In a way, the result of the paper is quite paradoxical, because the theoretical reasoning is quite clear: one should expect to find large distortions from unconsolidated tax systems. A parallel with a well-known result in taxation is enlightening. Consider the optimal tax profile of corporate taxation *in time*. Suppose that it varies from one period to another, as was the case in the United States with a few episodes of tax break. Firms have some fair degree of discretion in accounting. Their ability to undertake 'creative' accounting and smooth or instead vary profits over time is large. For this reason, optimal taxation cannot vary much in time, otherwise firms will react in shaping their time income profile optimally. A one-shot drop in corporate tax break would lead to an unusually large increase in 'profits'. Said otherwise, profits may be volatile and very elastic with respect to effective taxation.

Transpose now the reasoning in space, not in time. Spatial heterogeneity in taxes produces the same incentives to manipulate accounting, all the more that spatial heterogeneity is stable in time and expected. Large corporations will therefore optimally choose to realize more profits *where* (and not when) taxation is lower.

So, why is it that the paper finds little welfare gains? One reason is that there are many issues left aside. One such issue is the heterogeneity across firms. In reality, small and large firms may not be affected equally by tax harmonization. Cross-country dispersion in corporate tax parameters will be of more benefit to large corporations than to small (local) firms, since only large firms can afford developing subsidiaries in different countries in order to attain fiscal optimization. Small businesses are penalized by the fiscal distortion due to the lack of tax harmonization. Harmonized tax systems would lead instead to the emergence of more small firms, generate more innovation and potentially generate large welfare gains.

A second issue is related to taxation of other factors and the provision of public goods. Optimal corporate taxation has implications on the taxation of other

factors and on the provision of public goods. Countries taxing more the inelastic factors such as labour to finance public goods face significant unemployment, especially in combination with minimum wage laws. Lower government revenues will lower the level of public goods. The Bowen-Lindhal-Samuelson condition states that the optimal provision of public good is such that the marginal rate of transformation between public goods and private goods has to equal the sum across individuals of the marginal rate of substitution in the consumption of public goods relative to private goods. With limited government resources, this condition will be more unlikely to be satisfied, as lower public goods raise the right-hand side and possibly reduces the left-hand side in a world of decreasing returns to scale.

Does the calibrated model account for these mechanisms? Actually no, since none of them is present in the paper. This model is a competitive one, augmented with tax wedges. There is no public good provision. There is no involuntary unemployment. The determination of employment comes from an arbitrage between consumption and leisure. Therefore, lower employment induced by higher labour taxes would only have a small welfare effect because people consume more leisure in substitution. Finally, there are no distortions between small and large firms, contrary to models such as Melitz's (2003) *Econometrica* paper. Finally, there is no endogenous growth.

The point made above is not a criticism of the current paper: clearly, no paper could do all of these things. It is simply to provide some reasons not to believe too strongly in the main result, that is, the absence of welfare gains from fiscal consolidation. The paper's result should be understood as follows: in the absence of the various mechanisms described above, the (unrealistic) model predicts very modest welfare gains from harmonization. It is an important theoretical result, that should lead the researcher to explore the impact of each of the mechanisms listed above to verify the robustness of the conclusion.

The next question in this comment will be to understand where the small impact of harmonization comes from. I propose two explanations.

The first explanation is a particular and ad hoc feature of the model. In the model, firms have a limited ability to exercise tax optimization across countries. In particular, they face a cost of setting the relative transfer price across subsidiaries in different countries. This cost is assumed to be convex.

It may be – but this remains to be verified – that this *ad hoc* feature seriously limits the ability of large firms to do creative accounting in using the dispersion of fiscal policies across country. If this is the case that this limits distortions, then some robustness check is needed. The paper discusses how the elasticity ε_q is set in the calibration, but does not discuss its value or robustness to alternative values, in particular for low values or even in the absence of this *ad hoc* cost. My suspicion is that the lower this elasticity, the larger the gains from tax harmonization, and that the gain may become much more important.

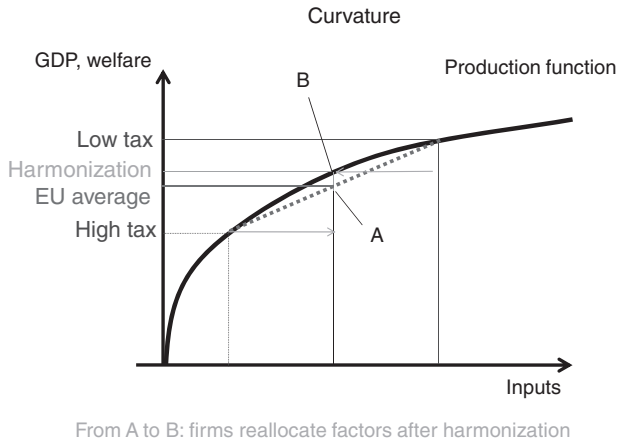

Figure 13. Tax harmonization in a decreasing returns to scale economy

The second explanation is that this is all about curvatures and a firm's ability to substitute. Figure 13 provides some insight into what is meant here. The figure compares two situations, one with two countries with either low and high tax rates. In this case, the EU average lies somewhere in the middle of a segment represented by point A in the dashed line on the graphic; and a situation with harmonized tax rates, point B in the figure, where firms sets factors optimally.

The distance between point A and point B represents indirectly the expected gains from fiscal harmonization. The closer they are, the less one would change the outcome after consolidation. The distance between A and B clearly depends on the curvature of the production function, and it is larger, the further away from a straight line. Inversely, the closer from a constant returns to scale world, the smaller the curvature and the smaller the welfare gains from harmonization.

A second graphical perspective in the leisure-consumption space brings a similar interpretation in terms of curvature. A consolidated tax system is represented by an equilibrium lying on the indifference curve below (Figure 14), while a heterogeneous tax system corresponds to an equilibrium on the dashed line. The two outcomes are all the closer, the less convex is the indifference curve.

The bottom line is that low curvature in production function or high substitutability between leisure and consumption (1.0 in the model according to Table 1) are likely to reduce the calibrated gains from tax harmonization.

Finally, the model uses a very low elasticity of intertemporal substitution, 0.5 in the model, while traditional RBC models are often based on values between 15 and 20. The low value suggests that there would be very small changes in yearly GDP in response to changes in tax conditions, which is another reason for obtaining small effects from tax policy changes.

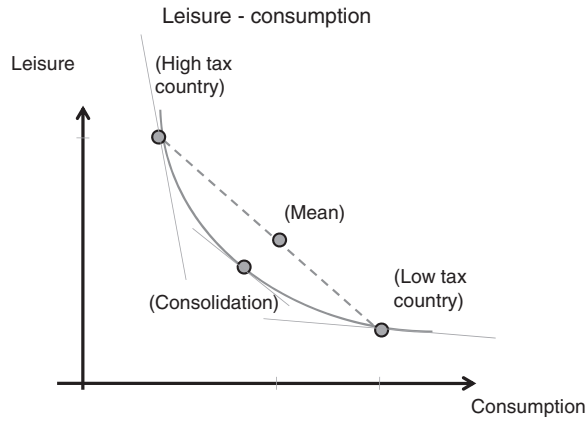

Figure 14. Tax harmonization with convex preferences

The partial conclusion here is that the model is designed to generate zero aggregate effect. Ingredients that would generate larger 'welfare' effects instead are ignored. One of them in particular is the existence of involuntary unemployment, which would introduce a wedge between the value of unemployment and the value of employment. In particular, each job loss due to excessive taxation in a country has a larger cost to the economy than when the unemployed can consume more leisure in substitution.

Let me stress this specific point. This adverse effect of employment loss due to the lack of fiscal harmonization would be magnified if one considers what appears to be a solid result from 'happiness studies' (e.g. Helliwell and Huang, 2010): an individual's well-being depends quite strongly on their employment status. The gap in the level of happiness between the employed and the unemployed is equal to five times the marginal utility of employment income. Using this reasoning to provide a numerical value for the marginal rate of substitution between income and unemployment, each job loss from a rise in labour wedge causes a welfare decline five times as large as the wage loss. Instead, in the model, the welfare loss, as explained above, is marginal, because it is actually mitigated by the additional consumption of leisure.

To conclude, European policy-makers should not read only the abstract of Bettendorf *et al.*'s paper, but also realize the various assumptions made and the potential limits in the robustness of the main conclusion.

Panel discussion

Kevin O'Rourke opened the discussion and asked for further explanation of the role of the cost of transfer pricing in the model, since it is an almost costless way of

redistributing profits between locations with no loss in welfare from an aggregate European welfare perspective. However, if the EU were to adopt a formula-based approach, this could lead to a distortion in the location of production as firms may not remain in areas where it was optimal before tax harmonization. He wondered if it was the high cost of transfer pricing in the model offsetting this negative effect. He also pointed out that in terms of the distribution of the welfare effects countries such as Ireland and Latvia, where unemployment is a significant issue, would want this factor included in the equation.

Katrin Assenmacher-Wesche did not fully agree that tax harmonization was a good proposal as the cost of compliance may be quite high and in turn multinational companies may consider moving to another country outside the CCCTB set of countries. Katrin Assenmacher-Wesche did not accept that competition would lead to a race to the bottom in tax rates between countries. In Switzerland, a common method in calculating the tax rate per person has been agreed and each community then sets its own tax level. There was no evidence to suggest that communities undercut each other's tax rates. She also noted that transparency is an important aspect of the system as it encourages more productive use of tax revenues and maintained people's willingness to pay.

Gianmarco Ottaviano and Kevin O'Rourke focused on the assumptions the authors made regarding the firm's production structure. Kevin O'Rourke commented that part of the cost of transfer pricing was the need to set up in a number of locations and this would suggest that the number of subsidiaries in the model should be endogenous. As the authors have assumed that there is a subsidiary in every region this margin is not captured in their model.

In response to a number of comments made by the discussants and panel members on the small size of the effect, Albert van der Horst pointed out that if both the tax rate and tax base were harmonized then the net welfare effect was a gain of 0.15% of GDP in the EU which he considered to be meaningful. Albert van der Horst and Ruud de Mooij acknowledged that the paper only focused on tax harmonization and many distortions, such as the different treatment of debt and equity across countries, remained. Addressing these distortions could have a large effect on welfare from the EU perspective.

In response to questions on their modelling assumptions, Albert van der Horst argued that from the EU perspective there is very little change in capital demand and therefore they expect very little pressure on the interest rate; this supports their inclusion of a fixed world rate of return in their model. On the micro foundations of the debt equity ratio and profit shifting assumptions, he explained that the elasticities with respect to tax differentials used to calibrate these costs in their model were taken from empirical studies. On the cost of transfer pricing, he mentioned that there is very limited evidence on the cost of transfer pricing but research using firm data shows that transfer pricing only occurs between the parent and its subsidi-

ary and not between subsidiaries. This could be taken as an indication that transfer pricing is not easy or inexpensive.

Ruud de Mooij agreed with the comment that their model does not explicitly model risk-taking by firms and individuals. CCCTB may affect welfare via risk-taking through its impact on loss consolidation. Loss consolidation helps to improve loss offsets and therefore may help to improve the insurance function of the corporate tax system and may lead to an increase in welfare. In a final comment, he pointed out that the CCCTB proposal made by the EU is not compulsory for firms to enter. He suspected that only large firms and MNEs would opt into the system and noted that this would create more distortions between national versus international and small versus large firms.

Appendix

Table A1. Distribution of losses and profits

	Average return on assets (2003–2007)				Return on assets		
	10th percentile (%)	Median (%)	90th percentile (%)	Loss probability (%)	Loss-making firms (%)	Profit-making firms (%)	Loss-to-profit ratio
Austria	−2.6	4.9	17.8	17.6	−7.3	8.8	0.48
Belgium	−2.2	3.6	16.4	22.3	−4.7	8.0	1.20
Bulgaria	−4.7	3.8	20.4	25.9	−6.3	9.8	0.60
Cyprus	−10.2	1.2	10.7	35.6	−8.6	6.8	0.57
Czech Rep.	−2.7	5.0	20.7	18.6	−6.8	9.9	0.53
Germany	−2.4	5.6	20.8	17.2	−7.2	10.0	0.56
Denmark	−2.4	2.1	15.3	38.2	−3.2	8.7	0.40
Spain	−1.9	3.1	14.4	26.5	−3.7	7.5	0.55
Estonia	−1.6	7.2	24.2	18.0	−5.7	12.2	0.41
Finland	−2.9	6.1	23.4	20.3	−6.5	11.6	0.40
France	−3.7	3.7	17.3	27.1	−5.5	8.9	0.72
United Kingdom	−7.7	3.8	16.9	30.5	−8.4	9.1	1.84
Greece	−3.2	4.6	15.8	19.3	−6.5	8.1	0.79
Hungary	−3.5	5.0	18.4	19.3	−7.2	9.1	1.27
Ireland	−4.1	4.5	16.9	23.6	−6.8	8.7	0.49
Italy	−1.9	3.5	11.7	17.6	−6.0	6.1	1.50
Lithuania	−2.7	5.9	21.2	16.5	−6.9	10.4	0.57
Luxembourg	−3.1	2.7	18.1	35.2	−4.0	9.7	0.45
Latvia	−3.1	6.6	22.4	16.7	−8.6	11.0	0.57
Malta	−0.7	2.3	21.7	16.3	−5.6	11.9	1.00
Netherlands	−3.4	5.8	21.3	22.0	−6.4	10.8	1.13
Poland	−3.2	5.9	22.6	19.8	−7.0	11.0	0.71
Portugal	−3.1	2.9	12.7	27.4	−4.3	6.7	0.84
Romania	−7.4	5.5	24.8	22.8	−10.1	11.9	1.13
Slovak Rep.	−4.5	4.0	18.8	22.0	−7.1	8.9	0.59
Slovenia	0.2	4.3	13.8	8.1	−6.0	6.7	1.24
Sweden	−4.2	4.5	19.0	26.4	−6.6	9.9	0.75

Source: Authors' calculations on the ORBIS database.

Table A2. Calibration of CORTAX, 2007

	Corporate tax rate	NPV of depreciation allowances	EMTR	Inbound + outbound FDI	Investment elasticity w.r.t. CIT rate	Inward-FDI elasticity w.r.t. CIT rate	Elasticity of CIT base w.r.t. CIT rate
	%	% price	%	% GDP	Semi-elasticity	Semi-elasticity	Semi-elasticity
Austria	25	42	6	28	−0.3	−2.5	−0.1
Belgium	34	58	−1	104	−0.2	−0.9	−0.6
Bulgaria	10	46	3	3	−0.4	−0.8	0.0
Cyprus	10	46	3	38	−0.3	−1.6	0.0
Czech Republic	24	44	9	11	−0.6	−0.6	0.0
Denmark	25	59	6	48	−0.3	−0.4	−0.2
Estonia	22	70	0	16	−0.1	−0.6	−0.1
Finland	26	49	8	39	−0.4	−0.6	−0.1
France	33	50	8	36	−0.3	−1.3	−0.2
Germany	36	44	9	25	−0.4	−2.1	−0.2
Greece	25	47	7	4	−0.5	−0.8	0.0
Hungary	16	41	5	13	−0.4	−1.7	0.0
Ireland	13	40	3	126	−0.3	−2.4	−0.1
Italy	37	44	7	9	−0.4	−2.7	−0.1
Latvia	15	62	3	3	−0.3	−1.5	0.0
Lithuania	18	69	3	3	−0.3	−0.9	0.0
Luxembourg	30	49	14	1,372	−0.1	0.1	−0.7
Malta	35	36	16	20	−0.6	0.9	−0.1
Netherlands	26	44	7	158	−0.2	−1.6	−0.5
Poland	19	42	7	4	−0.5	−1.3	0.0
Portugal	27	50	5	14	−0.3	−2.0	−0.1
Romania	16	64	3	2	−0.2	−1.7	0.0
Slovak Republic	19	51	5	9	−0.4	−0.1	0.0
Slovenia	23	55	6	5	−0.2	−0.2	0.0
Spain	33	39	12	19	−0.6	−1.6	−0.1
Sweden	28	49	6	60	−0.2	−1.6	−0.2
United Kingdom	30	48	5	46	−0.2	−2.4	−0.3

Source: Authors' calculations.

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