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Lorenz Jarass* and Gustav M. Obermair**

A Proposal for the Efficient Taxation of All Business Income in the EU

There is a growing awareness in many EU member states that business taxation solely on the basis of "taxable profits" enables, in particular, multinational companies to avoid paying taxes, with negative consequences both for tax revenue and – in the longer run – also for the stability of the economy. The following article proposes the taxation of all compensation of capital – not only profit for equity, but also interest for outside capital and licence fees for outside rights – at the site of production.

German tax policies have failed to react adequately to the globalisation of the economy and to the complete liberalisation of the European financial market. As a result the tax rate actually paid on capital in Germany has been below 20% since 2001. This is lower than in all other EU15 countries (except Greece) where the average rate was well above 25% in 2001 to 2003,[1] and far below the typical nominal tax rates.

The dwindling of revenues from capital taxation has resulted in huge deficits, ever fewer public infrastructure investments and economically damaging increases in other taxes rates: VAT, for example, is to be increased from 16% to 19% in 2007. Globally operating enterprises have shifted the financing of their domestic subsidiaries more and more from equity towards at least formally foreign credits. Instead of taxable profits they declare domestic earnings as interest, which is transferred abroad free of domestic taxation. This trend discriminates against small and medium-sized enterprises that have less access to such financial instruments. As a result of these tax strategies Germany has less employment, less domestic buying power, and hence further decreased revenue from wage tax, social security contributions and consumption taxes: a vicious circle, and a downward spiral.

Will the governing bodies resist the pressure from big business, reduce harmful tax competition in Europe and prevent a further self-impoverishment of public institutions – municipalities, schools, hospitals and universities? A broadening of the tax base to include all compensation of capital might be helpful.

The German government has declared that the German enterprise tax system will be revised in 2008 and it will present a proposal later in 2006. In January 2006 the European tax commissioner Lásló Kovács proposed some first steps for the harmonisation of the corporation tax base in an "action group" of countries.

The Assignment of Statutory Levies to Production Factors

For a quantitative assessment of the trends described above this article and several previous reports[2] make use of the assignment of taxes to production factors that has also been used by the European Commission since 1998; their published figures,[3] based on the national governments' reporting, fully corroborate our results.

- Taxes and contributions on labour income are assigned as seen by employers as part of their gross labour cost. They comprise all the items that are regularly withheld by employers and paid to the respective authorities: wage tax, corrected for tax refunds, and both employees' and employers' share of compulsory social security contributions. This sum from tax and social security statistics divided by "compensation of employees" from the national accounts yields the effective load of taxes and contributions on labour.
- Taxes assigned to the income of the production factor capital are a somewhat mixed bag: they comprise all individual income taxes less the taxes withheld from wages, the income tax of unincorporated business, corporation tax and – where it exists – the regional or communal trade tax. Property and wealth

* Professor of Economics, University of Applied Sciences, Wiesbaden, Germany; member of the Federal German Committee on Enterprise Tax Reform 1998-2000; member of the Federal Scientific Advisory Board Local Tax Reform 2002-2003.

** Professor emeritus, University of Regensburg, Germany.

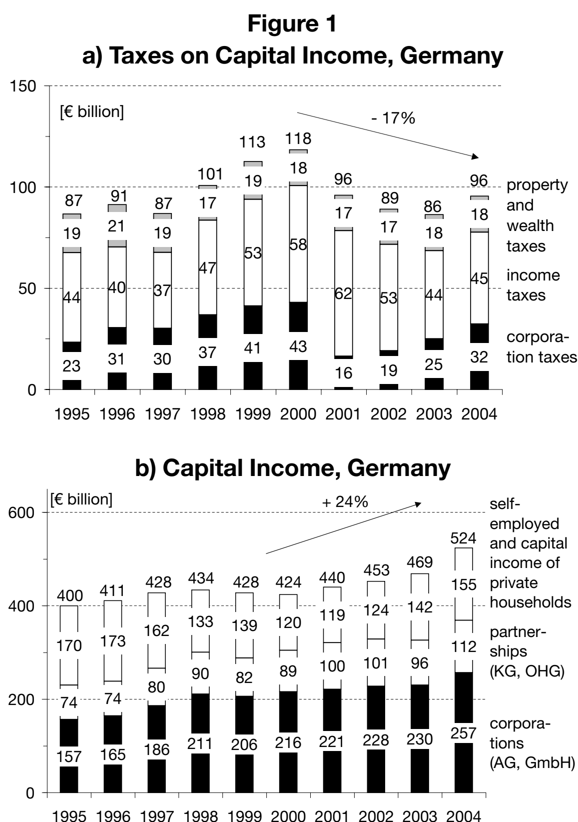
[1] Eurostat: Structures of the taxation systems in the European Union, Data 1995-2003, Luxembourg 2005, p. 90 (2004 edition for 2002 and 2001 figures, and 2003 edition), http://europa.eu.int/comm/taxation_customs/taxation/gen_info/economic_analysis/tax_structures/index_en.htm.

[2] Lorenz Jarass, Gustav M. Obermair: More Jobs, Less Tax Evasion, Cleaner Environment, commissioned by the European Commission, DG XXI, June 1999, http://www.JARASS.com, publications, A. books and reports.

[3] Eurostat, op. cit.

Figure 1

a) Taxes on Capital Income, Germany



taxes ought mostly to be assigned not to capital income but to capital stock, yet EU statistics include them – although listed separately – in the general category “taxes on capital”; here they are displayed on top of the columns in Figure 1a. The national accounts give data for capital income, disaggregated into three classes: incorporated business, households incl. self-employed and government. The sum of the income of these classes is called “capital income” in the following. Hence the effective tax load on capital is evaluated as the quotient of “taxes on capital income” divided by “capital income”. Incorporated business comprises both corporations subject to corporation tax and partnerships subject to income tax. The disaggregation shown here is based on an evaluation of the German trade tax statistics.[4]

Capital Income and its Taxation Disaggregated

Figure 1 shows these quantities in more detail and their development over time since 1995.

The tax base “capital income” in Figure 1b is disaggregated into:

- lower black column: profit of corporations (in Germany “AG” and “GmbH”);
- upper white columns: income of non-incorporated business such as (limited) partnerships (in Germany “Kommanditgesellschaft” etc.) and of the self-employed.

The “taxes on capital income”[5] in Figure 1a are broken down as specified in tax statistics:[6]

- lower black column: corporation taxes and respective trade taxes (in Germany “Körperschaftsteuer” and the respective part of “Gewerbesteuer”);
- upper white column: income taxes and respective trade taxes (in Germany “Einkommensteuer” and the other part of “Gewerbesteuer”).
- to allow a comparison with the aggregated EU data the taxes on property and wealth are shown on top of the columns.

For comparison Figure 2 shows the corresponding data for the production factor labour.

Dramatic Shift

The data from the national accounts and from official tax statistics displayed in Figures 1 and 2 show the dramatic shift in the distribution of the load of direct taxes from capital to labour in Germany over the last 25 years. It has in fact accelerated since 2000, as indicated by the arrows above the columns in the figures: while from 2000 to 2004 capital income grew by 24%, the taxes paid on capital income fell by 17%, whereas labour income and levies on labour remained nearly constant over the last 5 years.

- Around 1980 the load of taxes and contributions on the production factor labour amounted to 33% of gross labour income; this was the same as the total tax load on capital income (i.e. incl. six percentage points for property taxes).
- By 2004 the load on labour had been increased by one tenth to 36% of labour income, whereas the tax load on capital income had been radically reduced to 18%, around one half of what it had been a quarter of a century before (incl. property taxes which have been decreased from six to three percentage points); the first drastic reduction to about 22% occurred from 1980 to 1990; after a short recovery to 28% in 2000, since 2001 we have seen a plunge to the present all-time low of 18%.

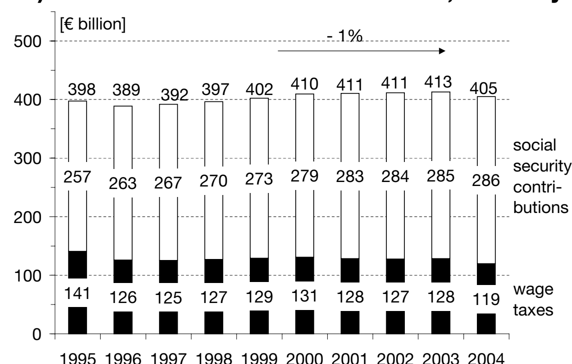
[4] Cf. Lorenz Jarass, Gustav M. Obermair: Geheimnisse der Unternehmenssteuern, Marburg 2005, Metropolis, 2nd edition, chapter 2, http://www.JARASS.com, publications, A. books and reports.

[5] All figures include the “solidarity surcharge” of 5.5% on both income and corporation tax.

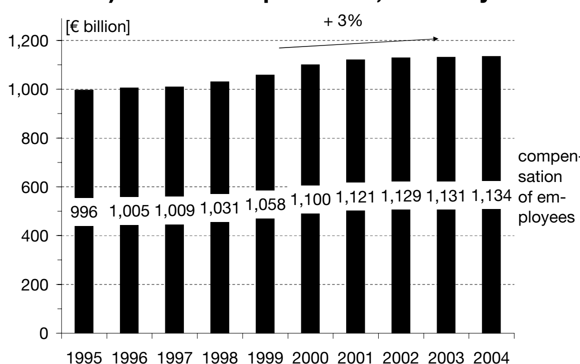
[6] Cf. Lorenz Jarass, Gustav M. Obermair: Geheimnisse der Unternehmenssteuern, op. cit.

Figure 2

a) Taxes and Contributions on Labour, Germany



b) Labour Compensation, Germany



- In absolute figures the total of taxes on capital came to one third of those on labour before 1980 and to less then one fifth since 2001, but not because capital income fell behind gross labour income during that period: on the contrary, the ratio of capital income to gross labour income grew from one quarter in 1980 to almost one third in 2004.
- From the point of view of employment the assumed positive effect of lowered business and enterprise taxation completely failed to materialise: between 2000 and 2004 German unemployment saw a further steady rise from below 4 million to more than 5 million persons.
- Comparable data for the EU15 countries[7] for 2002/2003 show that the tax load on capital including property taxes was – with the exception of Greece – by far the lowest in Germany with a paid rate of around 20% against the EU15 average of well above 25%. The load on labour was significantly above the EU15 average, but the growth of labour cost at 1.4% p.a. between 1995 and 2001 was one third of the EU average. At 0.8% p.a. growth in employment was by far the lowest in the EU even in the 1995 to 2001 period; since then it has become negative, i.e. the number of jobs has decreased.

This comparison certainly does not support the still widely held belief from the days of relatively closed national economies that stagnating wages, high and rising profits and low business taxation foster employment.

Profits, Tax Payments and Corporation Dividends

In the following under the heading "corporations" we single out those enterprises that are subject to corporation tax (in Germany mainly AG and GmbH). Table 1 shows the time series of the total profit of these corporations in line 1, their actual tax payments in line 2 and the dividends distributed to shareholders in line 3. The profits show, in contrast to widespread propaganda, a nearly continuous growth at an average rate of more than 5% p.a.; for industry, i.e. without the banking and insurance sector, profits have even grown by more than 7% p.a.

The actual tax payments, shown in line 2, show a dramatic breakdown in the year 2001 with a small recovery till 2004. This collapse of the revenue from corporations runs completely counter to their decidedly growing profits. The reduction of the nominal corporation tax rate from 40% to 25% in 2003 (the trade tax rate was not changed) can account for only a smaller part of the diminution of revenue; to a larger part it is due to other aspects of German tax laws and their defective reform, which will be described below. The effective tax load on corporations, line 2a, was always well below the nominal rate in force, which was above 50% till 2000 and around 40% since 2001; the effective tax load of 15% in 2004 was far less than half this nominal rate.

Since illegal tax avoidance or tax fraud probably does not play much of a role at the level of corporations, another explanation for the stark discrepancy between nominal and effective tax rates has to be sought. Corporate profit as exhibited in the national accounts and taxable profit to be declared to tax authorities have evidently been almost completely decoupled. Witness the case of BMW: for two consecutive years the CEO proclaimed "the most successful year in the history of the company" to the shareholders, but in the very same years the municipalities in which BMW production lines or administration are located did not receive any trade tax from BMW "because profits were counterbalanced by heavy losses".

[7] Eurostat, op. cit.

Table 1
German Corporations – Profits, Taxes, Dividends
(€ billion)

		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
(1)	profits	157	165	186	211	206	216	221	228	230	257
(2)	tax payment	28	36	35	42	46	48	21	24	30	37
(2a)	effective tax rate = 2/1	18%	22%	19%	20%	22%	22%	10%	11%	13%	15%
(2b)	nominal tax rate	54%	54%	54%	54%	50%	50%	39%	39%	39%	39%
(2c)	profits taxed = 2/2b	52	66	65	77	93	96	55	62	78	97
(2d)	share of profits taxed = 2c/1	0.33	0.40	0.35	0.37	0.45	0.44	0.25	0.27	0.34	0.38
(3)	dividends	54	57	66	83	91	102	116	111	113	125
(3a)	ratio = 3/2	1.9	1.6	1.9	2.0	2.0	2.1	5.4	4.6	3.8	3.3

A look at corporation dividends (cf. lines 3 and 3a of Table 1) corroborates this decoupling process: dividends in the years 2002-2004 are roughly twice those of around 1997, while the tax revenue has fallen back to the 1997 level. A very simple calculation shows the discrepancy between distributed profit and taxed profit: assume a company's profit before taxes to be 100 units and a modest actual tax payment of 33%; 67 units would be left for reinvestment or distribution. So even if the company – unwisely – decided to distribute this entire sum to the shareholders every year, the dividends would amount to exactly twice the tax payment. Line 3a in Table 1 seems to confirm this simple result up to 1999 – only that the nominal tax rate (incl. trade tax) for corporations was over 50% then, and the maximum distributable profit should therefore have been about equal to the tax payment. In the last 3 years, however, with a nominal tax rate of 39% and hence a maximum distributable dividend of 1.5 times the paid taxes, the dividend in fact amounted to four times the taxes paid and more.

This result confirms the previous conclusions, shown in line 2d: for German corporations a degree of – mostly legal – tax avoidance has become possible, in which the profit declared to the tax administration is only one third and less of the profit available for distribution and reinvestment despite a tax cut from 54% to 39%. The results are well known: Germany's non-compliance with the Maastricht stability rules, a sharp drop in public investments, in particular at the communal level, the continuing weakness of domestic demand, increasing unemployment and hence a further decrease in revenue and social contributions – a vicious circle.

How Government Tax Policy Can Ruin Public Finance

Traditional tax laws were written to apply to relatively closed national economies. For a long time and until quite recently national governments and legislators paid little attention to the impact of the impending globalisation on national fiscal policy and on the actual tax revenue. Only when the liberalisation of the international capital market and the opening of the internal European frontiers already prevailed did a number of previously neglected and indeed negligibly small gaps in tax laws open up to become tremendous loopholes for completely legal tax avoidance, in particular in the hands of big internationally operating corporations and their tax divisions, that outnumber and often outwit national tax offices.

Conservative governments have clearly not been too eager to close these holes. On the contrary: the Kohl government, in power till 1998, had opened up a number of additional ones. So in 1998 it could be hoped that the new Schröder government would react to this challenge. Indeed Oskar Lafontaine, the much-reviled first minister of finance, did work in this direction – compare the tax payments from 1998 to 2000 in Figure 1a – only to be replaced a year later by Hans Eichel, who was more lenient.

Since the end of 1998 a commission for business tax reform had elaborated a consistent set of recommendations to make taxation simpler and more systematic, to reduce the nominal rates and alleviate some burdens while keeping the total revenue approximately constant. But then a lot of things went wrong: the reform became more favourable to big business than even the more business-oriented advisers had recommended, measures to counterfinance the reductions were not enacted and later a law to close fiscal loopholes was – under enormous pressure from the business community – made toothless and in fact counterproductive in parliament.

Main Reasons for the Decline of Tax Revenues

Here are some of the old and new legal tax strategies that have contributed most to the decline of public revenue.

- *Group taxation*, that is increasingly used for tax avoidance. The principle of the "corporation" as it is generally defined, i.e. as a legal entity acting independently of others, is arbitrarily violated if all the separate corporations that are subsidiaries of a parent company, like the 100-odd daughters of Siemens AG, may add up their profits and losses and pay taxes only on the balance, if there is any; this way even the most profitable ones pay hardly any taxes. If the government does not allow 100 bakeries in Berlin to throw their balances together and pay tax only on the possible remains, why should it permit it with respect to big business? In view of the Marks & Spencer ruling of the European Court this problem becomes even more urgent: if group taxation is not limited as soon as possible within the domestic tax regimes irrespective of the domestic or foreign tax residence of the individual company, then non-discrimination rules will soon make the taxation of big business futile all over the EU25.
- *Loss carried forward* within a company, that in Germany is not limited in time and has only been limited to 60% of annual profit since 2004: this is a provision that has made highly risky speculation safe – in the case of failure the treasury, and hence in the end the general taxpayer, has to bear the cost, yet in the case of success hardly any taxes are paid. In 2002 the DAX30 corporations had accumulated a total loss carried forward of €100 billion, about three times their average reported annual profits. Due to the big difference between high profits reported to the shareholders and low profits – and even losses – reported to the tax authorities, the loss carry-forward was steadily increasing even in the high-profit years 1999-2001.
- *Two one-time effects* of the 2001 reform, from which the revenue is only slowly recovering: the complete tax exemption of the proceeds from the sale of holdings (a huge Christmas 2000 present to big business expected by nobody) and a tax refund of one euro for every six euro paid to the shareholders out of reserves built from profits that were previously taxed at a higher rate – a privilege granted after a threat to sue the government for "violation of private property"; no individual taxpayer is able to demand such refunds as a result of the decrease in the peak income tax rate from 53% in 1999 to 42% in 2005.
- *Increasing tax-driven replacement of self-financing* by outside financing through foreign creditors: interest on borrowing paid to creditors abroad or licence fees paid to licensors abroad are not taxed in Germany even though the value is produced here; only a trade tax of around 5% is levied on such interest – one of the reasons why big business is so determined to get rid of trade tax as the last remnant of domestic tax sovereignty. This is where unfair tax competition within the EU also comes into the picture: by granting preferential tax regimes to foreign holdings and credit institutes a growing number of member states induces them to set up tax residence outside the country in which the value production takes place. This leads to the "erosion of the base" which for some years now has been deplored by the European Commission: mutual impoverishment makes each state poorer in the end. Moreover, the transaction costs of such strategies make them inaccessible to small and most medium-sized businesses, another form of unfair competition between regional enterprises and international trusts.
- Last but not least, since 1999 the *tax-deductibility of expenditure for investments abroad* has been granted although profits from this expenditure are not liable for taxation in Germany. This is in clear violation of one of the principles of German income tax law (§3c EStG): "Expenditures connected with income that is tax-exempt in Germany are not deductible."[8] The exception from this rule as far as the cost of foreign investments is concerned was introduced only in 1999 due to strong pressure from big industry – with disastrous effects for employment in Germany: most of the expenditures from the transfer of hundreds of thousands of jobs into low-wage and low nominal tax countries can be balanced against the profits made in Germany – costs for planning, administration and all debt interest of the foreign subsidiary. Only the costs of wages, depreciation and material must be declared in the low-tax country, where the profit is also taxed, and the profit after this low tax can be transferred back into Germany, where a final tax of 2% – two percent! – is due.

As a result German wage-earners are subsidising the export of their own jobs in many diverse ways.

If the volatility of big business makes taxation so difficult, one drastic solution could be for governments to relinquish all claims on business income as a tax base and shift taxation entirely towards individual income, property and consumption. As described above, *de facto* even though not yet *de jure* this has already happened to a large extent in countries like Germany,

[8] This general rule is applied very extensively as regards wage-earners: their compulsory social security contributions that are certainly connected with, and in fact even indispensable for, their income are tax deductible only up to a limit.

where in 2004 corporation tax yielded about the same revenue as tobacco tax.

There are, however, good reasons to keep the range and variety of tax bases as wide as possible and tax them evenly at relatively low rates: this keeps the revenue more stable against economic fluctuations and makes the evasion of any one specific tax – given the high transaction cost – less attractive.

Historical Roots of the Problem

Historical developments going back to the 1920s have led – more or less in all OECD countries and around the world – to the following system of taxation of income from business activities:

- certain parts of the compensation of capital (e.g. profit) are taxed according to the principle "residence of producer";
- other parts of the compensation of capital (e.g. interest) are taxed according to the principle "residence of beneficiary".

At a time when most investments and returns were domestic, this double system could not give rise to great distortions deriving from tax regimes varying widely from country to country. The globalisation of production and trade, the complete liberalisation of the international money market and hence the ever growing global flow of financial instruments has led to a completely new situation and created the phenomenon that is described precisely by the term "harmful tax competition".

- A growing number of countries have established preferential tax regimes for international business (tax havens).
- A growing share of domestic surplus in the non-tax-havens is legally, e.g. via transfer to international holdings, or illegally, e.g. via untrue transfer pricing, transformed into non-domestic income and thus shifted to tax havens.
- The growing sector of financial services and of production of immaterial goods eludes a clear-cut definition of the country of production and thus altogether evades taxation according to "residence of producer". At the same time payments to the service provider that might be taxable can easily be shifted to a country with a preferential tax regime.

As a consequence at the country level we see the increasing erosion of the base "business income", and at the enterprise level a growing tax discrimination of domestic, and in particular of small, business which cannot participate in the "internationalisation" of their gross income.

Due to different tax rates within Europe any enterprise conducting activities in two or more countries has opportunities for transnational profit-shifting. This leads to a substantial redistribution of national corporate tax revenues: some European states appear to gain extra revenues from intra-European profit-shifting by multinationals at the expense of those countries like Germany where the same enterprises still conduct a large part of their actual industrial production.[9]

For example: the German subsidiary of the multinational furniture and household goods group IKEA had zero equity in Germany in 2003 and is financed entirely by credits amounting to a debt of €1.3 billion. Three per cent of its gross turnover of around €2.3 billion is paid as a licence fee for the use of the trade mark "IKEA". Both interest for the credits and licence fees are legally deducted as costs in Germany and finally transferred to Switzerland, thereby escaping almost any taxation. Expenses for financing the ongoing expansion into eastern Europe and Russia are deducted in Germany, whereas the resulting profits are tax-free in Germany; due to the recent ECJ decision on Marks & Spencer IKEA will also be allowed to deduct all the liquidation costs of a possible failed investment in EU eastern Europe. The result of this is, that although IKEA-Germany is very profitable it hardly pays any taxes and pushes efficient family-owned furniture stores out of the market, which cannot avoid paying their due domestic taxes of up to 40%.

Doubtful Remedies

An ever growing, increasingly difficult and non-transparent apparatus of national rules and regulations, of binational or multinational agreements, supranational directives and international controls may, in our opinion, at best reduce these harmful effects.

As shown above in Table 1 and our comments on it, it appears that the nominal tax rate has little effect on the actual tax payments of big business. Hence it is not the level of the nominal tax rate that determines the actual tax payments, but rather the extent to which the tax base "taxable profit" bears any resemblance to the actual proceeds of a corporation. In other words: not the *reality* of nominal tax rates, but the *realism* of the tax base for capital income determines the actual revenue.

[9] Cf. Harry Huizinga (Tilburg University), Luc Laeven (World Bank): International Profit Shifting within European Multinationals, mimeo, May 2005.

"The European Commission believes that the only systematic way to address the underlying tax obstacles … is to provide companies with a consolidated corporate tax base for their EU-wide activities".[10] There is a growing awareness in many EU member states that business taxation solely on the basis of "taxable profits" has negative consequences both for the revenue and – in the longer run – also for the stability of the economy. Driven by tax avoidance mentality, companies – in particular subsidiaries of multinationals – tend to use mostly outside financing from abroad, as described in the IKEA example. Instead of domestic profit they produce mostly interest that is transferred abroad tax-free and eventually finds its way to a tax haven harbouring the institution that is the final beneficiary. Small and medium enterprises, not able to use these instruments, pay the full domestic taxes and are thus driven out of the market.

Tax on Total Compensation of Capital

The erosion of the tax base capital that the EC has long warned against might be reversed by national tax policy – without any need for EU-wide tax harmonisation – by substituting "all compensation of capital", a clearly defined and easily measurable quantity for the present tax base "taxable profit", which – as shown above – is more and more subject to tax strategies that in many cases reduce it to a very small fraction of the actual earnings.

Total compensation of capital consists essentially of three components:

- compensation for the use of equity: profit to owners
- compensation for the use of outside capital: interest to creditors
- compensation for the use of outside rights and knowledge: licence fees to patent holders etc.

We propose a general tax on compensation of capital (CCT):

- *common tax base*: all compensation of capital, e.g. interest paid to creditors, both domestic and foreign, paid licence fees, paid royalties etc. as well as the remaining profit;
- *tax rate*: may differ between countries;
- *taxation*: irrespective of the formal tax residence of the beneficiaries of all capital compensation;
- *collection of tax*: at the site of the enterprise where the compensation of capital is produced.

Irrespective of the tax residence of the beneficiaries this tax on all compensation of capital could reliably be collected at low compliance cost at the site of each enterprise.

The compensation of employees (i.e. wages and salaries) would continue to be taxed only under the personal income tax regime as practised successfully anyway in most countries.

Thus the results of all economic activities are taxed in the country of production irrespective of the nominal tax residence of the enterprise or its parent company or the beneficiaries of distributed surplus.[11] After all it is this country that needs the revenue to develop and maintain an infrastructure – from education to traffic systems, from water supply to public security and a fair legal system – as the necessary prerequisites of any economic results.

The Role of Financial Instruments

Payments for financial services, including payments for derivatives and similar financial products which are increasingly used to replace the traditional financing through bank loans, should be treated like interest payments and hence be taxed at source, i.e. at the business entity using the service or instrument. Likewise payments for immaterial goods utilised in a given country should also be subject to the source tax in this country. Complicated supranational control systems for the taxation of the trade with financial services and other immaterial goods can thus be avoided.

New Tax Reform Proposals in the USA

The "Growth and Investment Tax Plan" of the US President's Advisory Panel on Federal Tax Reform of 11/2005[12] resembles our proposal in almost all respects:

- uniform taxation of all capital returns produced in the USA, i.e. interest payments to creditors, licence fees and the like shall no longer be deductible for tax purposes;
- a low flat tax rate of 30% on this broadened tax base;
- abolition of the "world income principle"; this would end a type of tax evasion which also affects EU

[10] A Common Consolidated EU Tax base, Commission Non-Paper, 7 July 2004, http://europa.eu.int/comm/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm.

[11] Similar to "trade tax" or "business tax", which already exists in several countries.

[12] The US President's Advisory Panel on Federal Tax Reform: The "Growth and Investment Tax Plan", November 2005, http://www.taxreformpanel.gov/final-report/.

countries like Germany: the deductibility of worldwide costs even though only a vanishing fraction of the proceeds obtained abroad is actually taxed in the home country.

An Initiative

In principle the taxation-at-source measures outlined above could be enacted through national legislation in any country that is suffering from the present unfair tax practices. However, in order to be efficient and to avoid new escapist strategies on the part of global business this legislation ought to be coordinated among a large group of major industrial nations, possibly under the auspices of supranational bodies such as the EU and OECD. The following outlines the measures that could lead to a general taxation of capital compensation at the site of value production.

The initiative would consist in the following agreement among a group of member states: within the action group *all* capital compensation is subject to a tax to be paid in *that* country in which the corresponding production of goods and services takes place. This corresponds to the principle: taxation at the residence of production. The group members agree to a tax on all compensation of capital, to be levied only once and for all in the country in which the compensation has been produced.

A member state of the action group will, according to the new agreement, receive revenues from all capital compensation (interest paid, licence fees paid and remaining profits) produced within its borders. It may continue to levy taxes on its own tax residents for capital income obtained in third countries according to the present residence principle. Tax havens outside the action group lose importance because all capital compensation produced within action group countries is now taxed there.

The existing, and still growing, problems with the taxation of multinational enterprises are due to a number of factors: their flexibility regarding the assignment of profits to individual subsidiaries in different countries, their use of hybrid financing, the difficulty of controlling the adequacy of transfer pricing and the treatment of royalties etc. At least for that portion of multinational transactions that takes place *within* the action group of member states, these problems would be considerably reduced.

It must be emphasised that the proposed tax on compensation of capital is an enterprise tax to be collected by the country of production; its tax base is only income from the deployment of capital and has nothing to do with that of the well-known tax on value added (VAT) which is essentially a sales tax, includes the cost of deployed labour in its base and is collected in the country of consumption. Therefore the proposed tax is not covered by the prohibition in Art. 33 of the Sixth Directive.[13]

Competitiveness of the Action Group Countries

Ceteris paribus, capital goes to the place where the return after tax is the highest. After the action group agreement the following movements might be predicted.

- *Real Investments*. The proposed tax might reduce the yield after taxes for those investors presently using tax havens, at least in the first stage. However, if the additional revenue is used appropriately, e.g. to decrease the cost of labour, net profits may even increase, in particular in labour-intensive sectors and certainly for investors who have not made use of tax havens.
- *Financial investments and loans*. Presently, returns paid to tax foreigners are often treated more favourably than those paid to tax residents. A levelling of this difference within the action group is a step towards the single market. In addition, the increased tax revenue might be used to reduce the general tax rate, increasing the net yield of investments from action group countries.
- Many so-called "foreign financial investments and loans" in fact constitute domestic capital that is only managed abroad to avoid taxes. The uniform taxation of all capital income, wherever the beneficiary may reside, makes such costly financial constructions unattractive, thereby improving the overall competitiveness of the countries of the action group.

Altogether the measures of the action group should be enacted in such a way as to constitute an automatism, a drive inherent in the system that invites affiliation. The action group countries might even establish tax havens for the management of capital returns from third countries including member states, thus creating an additional incentive for these countries to join the agreement. Once all, or most, EU member states have joined the action group, the group agreement principle could become a common EU principle.

[13] The Italian regional trade tax IRAP which taxes all value added at the enterprise has been brought to the European Court of Justice, ECJ C-475/03; opinion statement of AdvGen Stix-Hackl of March 14, 2006; the judgement is expected later in 2006.