Prof.dr. Chr. Spengel

Thank you, Mr. president, for your nice words and thank you for inviting me to give a short presentation on the economic aspects of tax reforms in different countries. Two months after the soccer world championships it's not so hard for Dutch people to have a German speaker on a conference. In the end I will evaluate the Dutch tax reform proposals quite more positive than what is going on in Germany. My basic aim is first to highlight proposed aspects, the main big points, of the tax reforms in both countries and then make an evaluation from a more economic perspective. This is not just a perspective of both countries. It is embodied in an EU-wide comparison of effective tax burdens.

slide 2: Company tax reforms in the Netherlands and in Germany

slide 3: Highlights of proposed tax reforms

In order to evaluate tax reform proposals or tax systems in general we need some measures. There are different measures for highlighting different aspects of tax reforms. This will be some theory in my presentation. Then I will rush to the evaluation of the impact of the different reform proposals, on the attraction of direct investment and the stimulation of the domestic investment climate. Finally I will draw some conclusions.

If we compare the reform proposals in both countries, we find that there is a similar intention and a common principle. The economic intention is to stimulate the investment climate. I think this is a general intention of many tax reforms. The principle is to reduce the tax rate and to broaden the tax base. But we will see that there is only one principle in common. That is the reduction of the tax rate. I think you all know better what is going on in your country: the proposed reduction of the corporation tax rate of a bit above 25%. Then there should be some cut-backs of depreciation allowances on certain business assets. The second element would be a limitation of the loss-compensation. There are other elements, which I cannot consider here, so there is some incentive for R and D-investment, the royalty box and some proposed changes with respect to group financing. On the shareholder level is a minor measure for domestic investment. The withholding tax should be reduced.

In Germany we are not so far as you are in the Netherlands, but we are still discussing. There is a consensus only with respect to reduce the corporation tax and the corporation tax rate or the nominal tax rate, which includes trade tax in Germany. It is now a bit below 40%. The government has announced the intention to reduce this rate just below 30%. This should be done by reducing our corporation tax rate of 25% by one half to 12,5%. If we add the trade tax we end up at 30%. What is not clear, I have to admit, is how the tax base should be broadened. There is one principle. The tax reform should not cost more than five billion euros, but if you reduce the tax rate by about eight percent points it will cost about fifteen billion euros. So we have to make up our minds how to refinance ten billion.

The proposals go into different directions compared to the Netherlands. We do not want to make any changes in tax accounting. We want to broaden the tax base by disallowing certain deductible expenses from both the corporation tax and the trade tax. What would be likely is to disallow the deductibility on interest payments by 50%, but there could be even more severe measures. We don't know. Also in discussion is a major change in shareholder taxation. We have a shareholder-relief system on dividend income. One half is exempt of the dividend income from the personal income tax. We want to abolish this exemption system and introduce a final withholding tax, which should be similar to the tax rate on corporations, about 30%, and cover all categories of capital income.

slides 4 and 5: Economic criteria to assess tax systems

You see there is a common principle, but the measures are very different, which will have an impact on the evaluation. In order to briefly provide you an understanding of the assessment on tax reforms it is necessary to show you one slide of different measures of effective tax burdens, since really every day in the newspapers you get presented measures which use different models. It is very hard to understand what the background of these models is. So if you want to enhance or to stimulate the investment climate this is always twofold. The stimulation could be to attract direct investments from multinationals. The effort can also be to increase the level of domestic investments, which is something different in reality. There are different measures. On the one hand we have the costs of capital and the related effective marginal tax rate (EMTR). On the other hand there is the effective average tax rate (EATR). For the stimulation of the level of investments it is relevant to affect the cost of capital.

What is the cost of capital? This is the minimum return of investment it must yield before any taxes, so that the project net of taxes is just worth while for the investor. To make a simple assumption: you can invest private money in the banking sector and you receive an interest of 5%. When will you invest money in a corporation? If you receive the same net income. If you want an interest rate of 5% and you have a definite corporation tax rate of 25%, the corporation must earn 6,67% to pay 5% after taxes. The theory says that a tax reform which increases the cost of capital and increases definite company taxes has a negative impact on the level of domestic investment, because investment must earn more money before taxes in order to become worth while. This is clear. The reality is that you must earn more than the cost of capital. Otherwise there is a bad incentive for investments. The effective marginal tax rate links this measure with a percentage. It is very easy. If you divide the difference with the market interest rate by the cost of capital you end up by a 25% definite tax rate.

Cross-border investments or investments by multinationals directing investments have something different in common. They are very profitable investments. They earn more than the market interest rate, so they earn real profits, stemming from intangible goods. We call them firm specific rents. There is a different idea. They really make a profit above the market interest rate and these profits are taxed and afterwards distributed to the shareholders. For a tax reform it is relevant to increase net profits, in order to decrease the effective average tax rate on profitable investments.

Before presenting you some results I want to show you that attracting the level of domestic investment or multinational direct investment we have to influence different elements of the tax codes. An investment which is just worth while is just earning the cost of capital. You know as a tax practioner that all costs of capital, like interest costs or depreciation, can be deducted from the tax base. So you can deduct for marginal investments or costs. What is relevant for the tax burden is the tax base and maybe non-profit taxes. But if you earn more, if your cost of capital is 5% and you earn 20%, the difference, 15%, is just taxed by the nominal tax rate. So to attract multinational investment it is even more relevant to have a look at the nominal tax rate. When we calculate effective tax rates, we have to bear in mind that it's not sufficient just to look at the nominal tax rate. We really have to include the most relevant aspects of tax codes, like different categories of taxes, various elements of the tax basis, the nominal tax rates and also the corporation tax-system. We have to ingress in models of relevant economic parameters, like different kinds of investment or the distinction between the corporate and the shareholder level.

slide 6: The Devereux Griffith Model

There is a common model. I have realised that many ministries of finance, as the Dutch one and the German one, present figures developed by this model, made by two British researchers, the Devereux-Griffith Model. This model takes into account five different assets for corporations, buildings, intangibles, machinery, financial assets and stocks. At the shareholders side we distinguish different forms of financing and investments. A shareholder can insert new equity capital and receive in return a dividend or he can grant a loan and receive an interest. The corporation can retake profits and the benefit will be an increased capital gain when disposing of the shares. By doing so we can include a lot of aspects of the tax codes. If you think of the tax base you can include depreciation on buildings, intangibles and machinery and stock evaluation. On the shareholders side you can think of the interest deductibility, the corporation income taxes, the dividend taxation and capital gains taxations. It is a very simple model, but we include a lot of elements of the tax receipts. We have fifteen different cases. In the following I combine these cases and show you a kind of weighted average tax burden on these investments. For the Netherlands I have included the corporation tax, the real estate tax on buildings and all the deprecation allowances. On the shareholder level I include the relevant measures. For Germany I include the same taxes, plus our nice trade tax on income. Now we will see how the reforms affect the different measures.

<u>Slide 7: Impact on direct investment/Effective average tax rates (EATR)-Corporate level (EU 2006)</u>

Let us look at the present situation. We talk about the effective average tax rates. We have a profitable investment at the level of the corporation and this is the portion which is taken away by tax. As you can see we have a wide range of effective tax burdens in the EU, from approximately 10% in Cyprus to 36% in Spain, so the range is 26% and the average is about 24%. We can also see that there is a great variation among regions. 9 Out of 10 of the top ten countries are accession countries, with the exception of Ireland, which takes the third position. The Netherlands are right now slightly above average and Germany is a high tax country. The difference between the two countries amounts to approximately 8 percentage points. Before we see the effect on the results the question is what has the major impact on the effective average tax burden. It could be the tax base, the number of taxes or the tax rate. As I told you from theory we expect that the nominal tax rate has the major impact.

<u>Slide 8: Impact on direct investment/Comparison EATR vs. Statutory tax rate - Corporate level (EU 2006)</u>

In slide 8 we compare the effective average tax rates, the red bars, with the nominal tax rates on corporate income. We can see that with the exception of Ireland, Cyprus and France the statutory tax rate is slightly above the EATR. This is clear as we have some incentives in the tax base to reduce the effective tax burden below the nominal tax rate. It is very interesting to note that the pattern of the ranking of the 25 countries with respect to the nominal tax rates is quite similar to the pattern with respect to the effective tax rates. As I told you there are only three deviations. One of them is France and we all know that this country has a portion of non-profit taxes - think of the taxe professionnel - which is not included in the nominal tax rate.

<u>Slide 9: Impact on direct investment/Impact of tax reforms 2007/08 on EATR-Corporate level (EU 2006)</u>

When the reforms would become effective I had to make assumptions for both countries. For the Netherlands it is not clear, if we think of an industrial company, whether we will have a limitation of the depreciation on real property or not. The rules distinguish between portfolio investments. The first bar takes into account amortization of real property and the second does not. In the optimistic situation the tax burden will be reduced by some 5 percentage points and the Netherlands would approach the average. The German tax reform would improve the country ranking and reduce the tax burden by even 7 percentage points. The reason is clear: we would have a higher tax rate reduction. Of course we have to bear in mind that both countries cannot take full advantage of the tax rate reduction, since we have some compensating elements in the tax base. I mention the depreciation allowances in the Netherlands and the limitation of interest deductibility in Germany. We have to realise, however, that the difference between both countries would decrease, so we have right now 8 percentage points en we will end up below 5 percentage points. Anyway, it would be important for the two countries to move if the other one moves, otherwise we lose advantage.

Slide 10: Impact on direct investment/EATR- Corporate level (EU-15 2001, EU-Accession 2004)

To give you an impression of tax competition during the last five years I refer to the situation of five years ago. There is a discussion in Europe about the question whether there is a race to the bottom or a race to the average. Five years ago there was a similar pattern. As you can see we had in 2001 a similar range of effective tax burdens, from 10% (Ireland) to 36% (Germany). In 2001 nine accession countries were among the top ten and seven countries, among others Germany and the Netherlands, were in the highest top ten. We have of course a tax rate reduction. The average tax burden five years ago was 2 percentage points higher. I fail to notice a race to the bottom. To make it more general I show you a last slide on the effective average tax rate, which is important for multinationals.

Slide 11: Impact on direct investment/EATR - Corporate level (EU and Switzerland, different years)

I made a division for three European regions, the Netherlands and Germany. I divided the 25 EU-countries into the accession countries (the red bars), the former EU 15 (the dark blue bars) and I included Switzerland, with its 12 cantons (the pink bars), the Netherlands and Germany. As you can see the 12 cantons of Switzerland are on an average quite similar to the accession countries. If I compare the various periods I realize that there is action among accession countries, in Switzerland, but also among the former EU 15. So there is tax competition but no race to the bottom. In my opinion there is also no race to the average, because the average decreases in the course of the years. All countries are active.

If I take a look at the situation for the Netherlands I think one thing is important with your reform. Rankings are important for multinationals. It would be the first time for the Netherlands to rank below the average of the former 15 member states. The Netherlands would be in the third position of the former EU 15, after Austria and Ireland. Germany remains above the average and a high tax country for the old member states.

Slide 12: Impact on domestic investment climate? Changes (2006/2007) in cost of capital caused by the Dutch tax reform - Level of qualified shareholder

This slide shows the impact on the domestic investment climate. The model has five different assets, viz. buildings, intangibles, machinery, financial assets and inventories. We can distinguish three different forms of financing, viz. retained earnings, new equity and debt financing. In this way we can calculate a weighed average. If we want to draw any conclusions on the impact of the domestic investment climate, the theory tells us we have to look at the cost of capital and we have to include the shareholder level. This is important, as the domestic shareholder decides whether to invest or to save money on a bank account. What you see here are the changes in the cost of capital from 2006 to 2007 if the reform would become effective. The red bar shows that overall the impact is positive, because the cost of capital would be reduced by 0,2 percentage points. This is a lot when you think of a rate of interest of 5%. The reason for this reduction is that the Dutch tax reform puts an incentive on equity financing, because you would reduce the effective corporate tax burden by reducing the corporate tax rate by 4 or even 5 percentage points. This is a definite burden and reduces equity financing and produces a positive impact to inject more equity in companies. This is extremely relevant if you think of start-ups which need fresh equity. Why does that financing increase? It is clear that if you reduce the corporate tax rate your tax savings from deducting interest from the corporate tax base will be less. Apart from theory you can understand the result. For the investment the impact is also positive, with the exception of buildings. If the cutback of the depreciation of buildings will become effective there will be a negative incentive to invest in buildings. In my opinion this does not hold however for industrialized companies, which have buildings on the assets side and not on the portfolio side. I am not an expert in the Dutch reform. I just made up my mind.

<u>Slide 13: Impact on domestic investment climate/Changes (2006/2008) in cost of capital caused by the German tax reform</u>

What happens in Germany makes a big difference, as shows slide 13 on the impact on the domestic investment climate in Germany. If we look at the results the overall cost of capital would increase by almost 1 percentage point, which amounts to 20%. The reason is that Germany intends to introduce a final withholding tax on capital income. A final withholding tax effects all types of capital income, private income or income paid by corporations. So the first question is: why do the cost of capital for that financing increase. The increase since the interest deductibility would be limited to one half. This is the major reason. The second reason is even more severe. Why do we have increased cost of capital on equity financing? The reason is that the tax burden on equity financing will not be reduced by the reform. Right now we pay a 40% corporate tax and we get a dividend of 60, which is taxed by one half, so 30 are taxable by a personal income tax of 40%, which boils down to about 12. If we add this to the 40% corporate tax we have a nominal tax burden of 52. If we had a withholding tax of 30% and paid a corporate tax of 30% we would get a dividend of 70. 30% of 70 are 21 and so we end up at 51%, which is comparable to 52. If we compare however this 51 to 30% for the interest income, we have a clear disadvantage of equity finance, because we have more incentives to invest our money on the capital market. This is a big mistake of the German politicians. I have not a positive message for our government.

I conclude. Referring to current EU-ranking of company tax burdens Germany is a high tax country for companies, while the Netherlands slightly range above the EU-average.

The proposed company tax reforms in the Netherlands and Germany have the same intention and follow a similar pattern. The have different effects, however.

Referring to the EATR both the Dutch and the German reform proposals enhance the attractiveness of the countries for the location of direct investment. There are different effects, however, in the ranking. The Netherlands will obviously become one of the lowest countries among the old member states, while Germany will range above the EU-average. It gains percentage points in comparison with the Netherlands, however.

In my opinion the Dutch tax reform is a good one and the German tax reform will fail to achieve its goal. It will fail to enhance the domestic investment climate. If you do not allow to deduct interest in an international sense from your domestic tax base you end up in double taxation, which is negative for direct investment.

Thank you very much for your patience. *(Applaus)*