EUROPE

// ZEWNEWS JULY/AUGUST 2019

Leibniz Association

ZEW

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PUBLISHER

ZEW – Leibniz Centre for European Economic Research
L 7,1 · 68161 Mannheim · www.zew.de
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Mannheim 2019

CbCR Makes Tax Havens and High-Tax Countries Less Attractive

Country-by-Country Reporting (CbCR) appears to effectively curb aggressive tax avoidance of multinational corporations and leads to a significant decrease in tax haven operations. The main beneficiaries of this development, however, are European low-tax countries, to which Germany does not belong. It is mainly these low-tax countries that attract real investment from multinationals following the CbCR mandate. These are the findings of empirical studies by ZEW, the University of Mannheim and Stanford University.

Ever since the OECD tackled the task of avoiding aggressive tax planning by multinational companies as part of the Base Erosion and Profit Shifting (BEPS) Action Plan, enhanced tax transparency has been a recurrent focus of political attention. With the introduction of the EU Directive 2016/881, the European Commission has finally adopted the OECD proposals for more transparency. It has made Country-by-Country Reporting mandatory for multinational companies with a consolidated turnover of at least 750 million euros per year, and which have either their headquarters or at least a subsidiary in the EU. Since 2016, CbCR has required affected companies to report to the competent national tax authorities on their overall activities (including subsidiaries, employees, profits, tax payments) on a country-by-country basis in a separate report. The aim of this increased tax transparency is above all to curb aggressive tax planning and to enable international tax authorities to better monitor transfer pricing strategies.

CbCR significantly reduced companies' presence in tax havens

As researchers from ZEW, the University of Mannheim and Stanford University show, the companies concerned have reacted to the mandatory CbCR on several levels. In their empirical analyses, the researchers compared the presence in tax havens and economic activity in EU Member States of companies above and below the 750 million euro threshold. The results show that companies affected by CbCR have significantly reduced their presence in tax havens. At the same time, the number of employees in the affected companies has grown significantly less than in the non-affected companies in the two years since the introduction of CbCR. In addition, the results suggest that affected companies are increasingly shifting their real investments to European low-tax countries. This is reflected in the lower income tax rates to which the companies concerned are exposed on average on the basis of their subsidiaries' investments and employee numbers. As a result, since 2016 tax payments appear to be increasingly due in countries where the tax rate in Europe is below the median.

Companies react to CbCR in ways not anticipated by the legislator

The empirical findings show for the first time the effectiveness of mandatory Country-by-Country Reporting. According to the authors of the study, this has important implications for tax policy. The greater tax transparency reduces aggressive forms of tax planning by means of tax havens. By relocating real investments, however, companies also seem to react in ways not anticipated by the legislator. It is expected that CbCR could lead to higher tax competition for corporate investment within Europe. In addition, lower growth rates indicate that multinationals perceive higher tax uncertainty.

To counteract the unintended developments, legislators and tax authorities would have to send a strong signal to multinational companies that greater tax transparency will not result in more aggressive tax audits.

Download the ZEW policy brief with the detailed results: *http://ftp.zew.de/pub/zew-docs/policybrief/en/pb05-19.pdf*

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CEE Countries Reject a Euro Transfer Union

From the point of view of Central and Eastern European (CEE) EU Member States, the attractiveness of the euro has declined significantly in recent years. If the eurozone were to move towards greater fiscal centralisation and solidarity, this would probably increase the scepticism of these countries about joining the single currency. Only a well-balanced reform package that credibly prevents the collectivisation of government debt could pave the way for an eastward expansion of the eurozone.

These are the findings of a recent study carried out by ZEW with the support of the Brigitte Strube Stiftung. The ZEW team has made an extensive screening of the economic situation of CEE Member States. Some of these countries are already in the process of overtaking Southern European countries in GDP per capita. In addition, most CEE members of the EU have comparatively low national debt levels and have been able to meet most of Europe's deficit limits in recent years.

The analysis was complemented by a survey in which more than 1,800 economists in CEE Member States as well as in Germany, France and Italy were asked about their reform preferences. With regard to the policy areas of defence, immigration and taxation, CEE respondents are more reluctant to grant the EU new competencies than those from Western Europe.

With regard to euro reform ideas, in some areas there is more agreement with the German respondents than with those in Italy and France. Survey participants of the economically wealthier CEE countries (such as the Czech Republic and Poland) agree with their German colleagues in rejecting a relaxation of the Stability and Growth Pact. There is also broader consensus with Germany than with France and Italy on the question of dealing with highly indebted euro states.

Both German and CEE respondents support the implementation of an insolvency procedure for eurozone countries with a debt overhang. Stabilisation tools like a European unemployment insurance scheme for protecting the euro area against strong economic fluctuations are finding favour in CEE states.

From the perspective of CEE countries, the disadvantages of introducing the euro could outweigh the advantages. Given the much higher level of government debt in Western and Southern Europe, there seems to be great concern that joining the eurozone would entail incalculable financial risks. The authors of the study conclude that at least the wealthier CEE states will not join a union of joint liabilities and transfers. This makes well-balanced euro reforms that provide credible ways of dealing with heavily indebted Member States all the more important and necessarily includes an insolvency system for euro countries. A unilateral expansion of new transfer instruments without better debt rules will permanently prevent countries such as Poland, the Czech Republic and Hungary from introducing the euro and only allow the poorer EU states to join the eurozone.

The study is available to download at: *http://ftp.zew.de/pub/zew-docs/gutachten/ZEW_EMUReform_CEE_2019.pdf*

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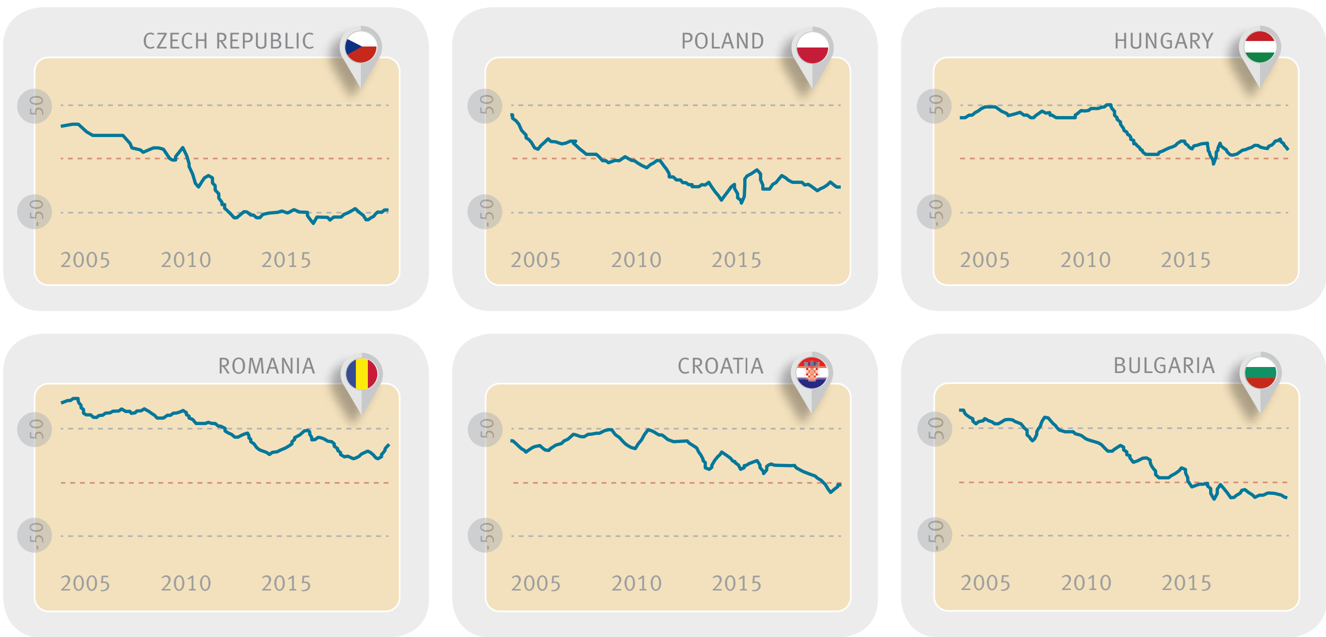
NET SUPPORT FOR THE SINGLE CURRENCY IN NON-EURO AREA COUNTRIES 1999 – 2018 (IN %)



Source: Eurobarometer surveys from March 1999 to March 2018

Slow Recoveries Through Fiscal Austerity

New insights from the FRAME project show that fiscal austerity slows down technology diffusion. Through its negative effect on technology diffusion, austerity has severe negative consequences for productivity and economic growth in the medium-run and can lead to slow recoveries.

Sovereign bond yields and public debt levels skyrocketed during the Great Recession and the European Debt Crisis. Several European countries such as Spain, Portugal, and Greece implemented austerity programmes to cope with the government-debt crisis in the aftermath of the Great Recession. They increased taxes on consumption, labour and capital, and reduced government expenditures. The overall tax burden as a share of GDP in Spain, Portugal and Greece increased markedly from 2009 to 2015. It was between four and six percentage points higher in 2015 than it was in 2009. Spain, for example, increased the VAT rate from 18 per cent to 21 per cent in 2012. The top rate on personal income was increased from 43 per cent in 2010 to 52 per cent in 2012.

While tax revenues were raised, government consumption was cut. In 2013, Spanish government consumption relative to gross domestic product was nearly four per cent lower than in 2009. Portuguese government consumption expenditures relative to GDP were down by more than ten per cent and Greece cut government consumption relative to GDP by as much as 12 per cent. In 2013, the unemployment rate in Spain exceeded 25 per cent and real GDP per capita was more than six per cent below its 2009 level.

Strong adverse effects on productivity, output and consumption

How do austerity measures affect technology adoption and what are the implications for productivity and income growth? These questions are at the core of the Horizon 2020 research project FRAME. As part of FRAME, Bianchi, Comin, Kung and Jung have investigated this question focussing on the case of Spain during the Great Recession. Their model endogenously accounts for the connectedness of Spain with other European economies through the trade of goods and financial assets. The study finds support for strong adverse effects of austerity programmes on productivity, output and consumption. Because tax rates are increased to consolidate the government's budget, investment decisions are distorted.

In particular, fiscal austerity deters both investment in capital and in the adoption of new technologies. This reduces the speed of technology diffusion and leads to a slower recovery. Fifteen years after the beginning of the Spanish debt crisis, both the technology adoption rate, output and consumption are still more than two per cent lower when austerity measures are implemented compared to a situation without austerity measures in which fiscal policy continues to operate the fiscal rules estimated for pre-recession times. These findings suggest that the austerity measures taken in the eurozone have contributed to the slow recoveries that were observed. They may be one explanation for the very different experiences in the US and in most of Europe after the Great Recession. Fiscal policy was much less austere in the US than in the EU. In turn, the recovery was faster in the US than in many European countries: In 2017, real GDP per capita in the US was already 6.7 per cent higher than ten years before while Spanish real GDP per capita had merely returned to its pre-crisis level.

The exact design of austerity programmes greatly affects their consequences. There is evidence that expenditure-based consolidations have much higher output costs than tax-based measures. Among tax-based measures, Bianchi et al. find large differences regarding the consequences for growth depending on which types of taxes are used to increase revenues. According to their simulations, the adverse effects of labour tax raises on GDP and consumption are especially strong. Raising capital taxes is the preferred means of fiscal consolidation. For the Spanish case, an austerity programme that relies solely on higher capital taxes to stabilize debt leads to a trough response of output of minus three per cent ten years after the shock. The recession is much deeper and the recovery slower when only the labour tax is used to stabilize debt. For this scenario, the model in Bianchi, Comin, et al. predicts output to be ten per cent below trend ten years after the shock.

These findings have important implications for policy. First, besides consequences for demand in the short run, negative medium-run effects of austerity measures can be very large and should be taken into account when deciding on such policies. Austerity is only advisable if it can reduce interest rate spreads quickly, which is unlikely for countries in severe financial distress. Second, if austerity measures are implemented, they should be accompanied by policies that support innovation and thereby limit the negative effects on technology adoption. This includes innovation subsidies but also policies aimed at alleviating credit constraints of firms.

The article is based on a ZEW policy brief. The complete paper is available to download at: *www.zew.de/PU80741-1*

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FRAME stands for Framework for the Analysis of Research and Adoption Activities and their Macroeconomic Effects. FRAME has received funding from the European Union's Horizon 2020 research and innovation programme. The multi-partner project was coordinated by ZEW and ran from April 2017 to March 2019. FRAME investigated which factors ease the diffusion of knowledge from the public domain across all economic agents to innovate and sustain economic growth at the European level. This video provides a clearer idea of the project: *https://bit.ly/2YLtsgk*