Chapter 10
Assessing Corporate Tax Reform: Incomplete Information and Conflicting Interests

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I. Introduction

Legislation in the area of corporation income taxation is highly complicated and typically an experts’ area of law. The interests at stake can be high, with large corporate taxpayers owing amounts of € 100 mn and more per annum. Large taxpayers therefore have a clear incentive to develop political pressure for tax reform, both in terms of tax rate reduction and special tax incentives. At the same time, they also engage in international tax planning – relocation of taxable profits to lower-tax jurisdictions. Governments try to limit this behaviour by anti-avoidance rules, in themselves an important source of complexity of the law. Rigid enforcement of rules, however, creates risks in terms of regulatory competitiveness – a dominant issue in corporation tax policy throughout Europe. In fact, governments tend to pursue asymmetric policies – they try to discourage outward tax planning, but they also try to encourage inward tax planning and flows of real investment. This latter element of their policy is usually called tax competition. But national options to engage in tax competition are limited by an EU legal framework. This framework, consisting of heterogeneous elements, in effect provides a bias in national tax legislation – away from special tax incentives, towards general tax rate reductions.

It is against this background that national corporate tax policies develop their shape. With minor local variations, Member States are now all walking along the same road:

1. lower corporate tax rates
2. broader statutory definition of taxable profits
3. stricter anti-avoidance rules to regulate outward tax planning
4. fine-tuned special tax incentives to promote inward tax planning and foreign direct investment (FDI).

The first two measures can be seen as complements: rate reduction is paid for by using a more inclusive concept of profits for tax purposes. Measures 3 and 4 are both aimed at protecting and increasing the national tax base (the total amount of taxable profits), potentially at the expense of other countries’ tax revenues.

This chapter reflects on the most recent pieces of corporate tax legislation in the Netherlands. It introduced as per 2007 a sizeable reduction of the corporate tax rate (to 25.5%) and corresponding measures in the personal income tax, tighter rules for deduction of costs and losses, changes in existing anti-avoidance rules, and two special tax incentives: one for profits from research and development (R&D, effective tax rate 10%), and one for profits from intragroup financial services (effective tax rate 5%).

This package raises two types of questions, which will both be addressed. One is the balancing of interests in the legislative process: is this typically large firms’ policy? The second, more basic, question is how the aims of this legislation were chosen, or rather, how the process of choosing these aims was affected by the different interests at stake. Both questions, we will argue, touch upon the same problem: the strategic use of information in the process of choosing the purposes and instruments of corporate tax reform. Both the legislator and large firms have private information about the effects of alternative policy options, which they may use to affect the outcomes of the legislative process. The legislator – or at least the Ministry of Finance – has unique information about the tax base, and is able to monopolise budgetary estimates of alternative policy options. Corporations know better than the legislator how they will actually respond to lower rates, new tax incentives, tax planning opportunities etc. Jointly, they have some information about the overall impact of reform which they may not wish to discuss publicly. As we will argue, the economic literature suggests that measures as those undertaken in 2007 tend to create an inflow of ‘paper profits’ rather than real foreign direct investment. Lower rates and special incentives provide large multinational enterprises (MNE’s) with an incentive to report more of their worldwide taxable profits in the Netherlands.

1 In the Netherlands, as in many European countries, government is the main driver of (tax) legislation. Although the power to enact Acts of Parliament rests with the government and the States General jointly, in practice, most Acts of Parliament are the result of government initiatives. This also holds for tax legislation. Here, the State Secretary of Finance plays a pivotal role. In his capacity of co-legislator, he is responsible for initiating government tax policies. In practice, the State Secretary and his Ministry of Finance dominate the tax legislative process due to their lead on Parliament in terms of knowledge and technical skill.