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**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE
EUROPEAN PARLIAMENT AND THE ECONOMIC AND SOCIAL COMMITTEE**

**Tackling the corporation tax obstacles of small and medium-sized enterprises in the
Internal Market – outline of a possible Home State Taxation pilot scheme [...]**

Impact Assessment

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EXECUTIVE SUMMARY

Introduction

In its company tax Communications of 2001¹ and 2003² and its more recent tax and customs³ and modern small and medium-sized enterprises (SMEs)-policy⁴ Communications, the Commission, among other things, looked into the potential contribution of EU corporate tax policy for the achievement of the Lisbon goal and into the specific role of SMEs in this respect. It has been established that the cross-border economic activities of all businesses in the EU are hampered by various tax obstacles (such as increased compliance costs, lack of cross-border loss compensation, etc) and that, for various reasons, SMEs are hit particularly hard by them. Consequently, not least due to these tax obstacles, SME participation in the Internal Market is considerably lower than that of larger companies. This results in economic inefficiencies and consequently potential for economic growth and job creation is unrealised. This clearly jeopardises the achievement of the Lisbon objectives. As such appropriate action, to foster the cross-border expansion of SMEs should be taken particularly in the field of taxation.

Against this background, this Impact Assessment first provides information on the consultations carried out in the context of a Home State Taxation pilot project for SMEs. It then describes the problem to be addressed by policy action (i.e. the low participation of SMEs in the Internal Market due to company taxation obstacles) and the policy objectives of the measures under consideration. The Impact Assessment then analyses a variety of policy options and assesses their suitability for removing the tax barriers to the cross-border expansion of SMEs within the Internal Market. It also provides a qualitative and quantitative (as far as possible) assessment of the major economic, social and environmental effects of the Home State Taxation option. Finally, it sets out arrangements for the implementation of this approach and for its monitoring and evaluation.

Consultation of interested parties

The Company Tax Study of 2001⁵ identified one model for a common EU company tax base, "Home State Taxation" (HST), as a possible solution that would be particularly beneficial for cross-border activities by SMEs. The study floated the idea of launching in an initial phase a pilot scheme which would apply this approach to SMEs. This idea won support and the Commission services initiated a consultation process in order to consult interested parties on the issue. The consultation process included the organisation of a workshop, a public on-line consultation, bilateral meetings and the distribution of a questionnaire, all of them involving the relevant stakeholders (ie, business and accountancy/tax experts, national and European

¹ "Towards an Internal Market without tax obstacles - A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities" [COM(2001)582] of 23.10.2001.

² "An Internal Market without company tax obstacles – achievements, ongoing initiatives and remaining challenges" [COM(2003)726] of 24.11.2003.

³ "The Contribution of Taxation and Customs Policies to the Lisbon Strategy" [COM(2005)532] of 25.10.2005.

⁴ "Modern SME Policy for Growth and Employment" [COM(2005)551] of 10.11.2005.

⁵ "Company Taxation in the Internal Market" [SEC(2001)1681].

federations and organisations as well as some academics). Detailed reports on the outcome of these activities are publicly available⁶. Most interested parties considered that corporate taxation was an important obstacle to cross-border expansion of SMEs and acknowledged the potential of the HST approach to make a positive contribution here by helping and encouraging their economic activities in other Member States.

Economic importance of SMEs and their low participation in the Internal Market due to company taxation obstacles

SMEs (generally referred to as enterprises with less than 250 employees) make up a large part of Europe's economy. There are some 23 million of SMEs in the EU-25, accounting for 99.8% of all enterprises and providing around 66% of total private employment. The particular importance of SMEs as job creators is confirmed by their display of higher employment growth patterns than large-sized enterprises. Besides that, the empirical evidence strongly suggests that economic growth corresponds positively with an increased role for SMEs (especially due to the positive externalities that SMEs have on the economy as a whole). For these reasons SMEs are generally considered to play a pre-eminent role in EU economic and employment growth and social cohesion.

European SMEs develop their economic activities mainly in domestic national markets, thus their engagement in cross-border activities across the Internal Market effectively remains low. This is true for all forms of internationalisation, from the simple propensity to export or import from foreign suppliers to more complex forms of internationalisation. Notably, the establishment of a subsidiary, branch or joint venture abroad is only undertaken by 3% of EU-based SMEs. Statistical analysis based on a large dataset⁷ provides more insights into the main features of EU-based "international groups of SMEs"⁸: it shows an average number of 2.82 majority-owned subsidiaries per SME parent and it shows that neighbouring countries are the main destination of foreign investment of parent SMEs in form of foreign subsidiaries.

Given that, as shown in several studies, engaging in international activities has a positive impact on the competitiveness and performance of SMEs⁹ and that the present economic and business environment emphasizes the role of internationally oriented enterprises in the global economy, the problem of low participation of SMEs in the Internal Market, demonstrated by the statistics shown above, is considered real and concrete and has effects potential economic and social performance of the whole EU.

⁶ http://europa.eu.int/comm/taxation_customs/common/consultations/tax/article_384_en.htm and http://europa.eu.int/comm/taxation_customs/common/consultations/tax/article_1455_en.htm.

⁷ The AMADEUS data set contains standardized annual accounts of approximately 7 million companies in 38 countries, including the EU-25 Member States. AMADEUS also contains information on (domestic and cross-border) linkages between companies in its so-called "ownership" database, thus it is useful for cross-border company analysis.

⁸ For the purpose of this analysis an EU "international group of SMEs" exists when an SME parent company established in an EU Member State owns at least 50% of one or more SME-subsidiary companies located in other Member State/s.

⁹ European Commission (2003): "Internationalisation of SMEs", *Observatory of European SMEs* 2003/No.4, DG Enterprise Publications.

Particular indicators¹⁰ reveal that the participation of SMEs in the Internal Market is, among other things, hampered by company tax obstacles which companies face when undertaking cross-border activities. In that sense, there are two types of company tax barriers which are of special importance for international SMEs in the Internal Market. First, SMEs have particular difficulties in meeting the compliance costs resulting from the need to deal with up to 25 different taxation systems. Many studies suggest that compliance costs are regressive to size and put a disproportionately higher burden on SMEs (compared with larger companies)¹¹. Second, the limited availability or unavailability of a way to offset losses cross-border not only discourages the creation of an establishment abroad, but it also affects the conditions for new start-ups survival and limits the business' access to finance at an essential stage in a company's development life-cycle.

These specific cross-border tax obstacles, along with features of national tax systems that tend to favour domestic over foreign activities, lead SMEs often to refrain from cross-border trade and investments or to prefer purely domestic transactions, even when these are inferior in strict economic terms. When they do develop activities in other Member States, SMEs are systematically subject to higher compliance and finance costs than larger companies and therefore run a higher risk of business failure. In many other policy fields measures of harmonisation or mutual recognition have been taken to assist SMEs with cross-border activities. Taxation remains the single biggest obstacle to these activities which has so far not been addressed at EU level.

Policy objectives

Company tax obstacles to the Single Market can impede growth and employment and result in substantial negative economic consequences both for SMEs and for the EU that. Policy action in this area to remove such barriers is therefore urgently required. The general objectives of possible policies in this area should be to encourage and increase investment and cross-border expansion by SMEs in other Member States within an improved EU-wide tax environment and to minimise tax-induced efficiency losses in SMEs investment allocation choices (that is, to render the tax issue as neutral a factor as possible in SMEs' decisions on where to allocate their investments across the EU). The specific objectives of policy action include helping SMEs who wish to set up branch/subsidiary businesses in other Member States to replace or complement national production for export with localisation abroad. This would be a liberalisation policy within the framework of the freedom of establishment (art. 43 of the Treaty). The benefits of attaining these objectives can ultimately be expected to materialize, in sufficiently competitive markets, in further welfare gains to the consumers.

Options for tearing down the Internal Market company tax barriers for SMEs

Five policy options have been considered to addressing the above-described tax obstacles to the (economically desirable) increased participation of SMEs in the Internal Market, especially to favour the set up of establishments in other Member States,:

¹⁰ See the result of consultation of interested parties.

¹¹ European Commission (2004): "European Tax Survey", *Commission Staff Working Paper*, SEC(2004)1128/2.

- No policy change: General measures for tackling the tax obstacles faced by all companies, regardless of their size, are under way. It can therefore be argued that no specific action for the tax obstacles for SMEs is necessary. This approach has been followed so far and the result is that SMEs do not fully benefit from the Internal Market. Furthermore the pace of progress with these general measures is slow and their likely impact on SMEs is uncertain.

- Simplification and EU-wide standardisation of company tax filing and bookkeeping rules for international transactions: this would constitute an enormous help for the businesses concerned and reduce their compliance costs. However, this approach falls short of addressing the cross-border company tax obstacles faced by SMEs in a comprehensive manner and could hardly be expected to have a noticeable remedial effect beyond individual cases. It would only address one aspect, of only one of the tax obstacles, that of disproportionate compliance costs (whilst the issue of cross-border loss-offset and the peculiarities of creating foreign establishments would not be addressed).

- Directive on cross-border loss-offset: this initiative would address one of the key issues hampering SMEs expansion in the Internal Market. However, it would do so only in a partial way, because it would still leave other issues such as disproportionate tax compliance costs untouched.

- Direct subsidies by Member States/State Aid: this option would address the tax obstacles for SMEs by using a non-tax instrument. For example, targeted subsidies could encourage cross-border expansion by SMEs. Such a solution would at best compensate for the tax obstacles but not resolve them and could raise 'state aid' or competition issues.

- Home State Taxation pilot project: Under a HST-regime, a SME that does business in more than one country could calculate its taxable profits in all countries according to the well-known tax rules in its 'home country'. The taxable income would then be apportioned between the countries according to some key (e.g. payroll, turnover or other) and each of the countries would apply its own tax rate to its share of the profit. The HST approach is based on the principle of mutual recognition and as such fully respects the principles of subsidiarity and proportionality. In the public consultation held on the pilot scheme idea (see above) a majority of contributions argued in favour of a real-life test approach for the pilot scheme and against a purely theoretical exercise or a limited application to a sample of 'model companies'. However the latter remain possible forms for a pilot.

Impact Assessment

A detailed economic impact assessment of the HST pilot project analyses the possible effects of this policy on various driving forces and economic agents:

- Foremost, the effect of the HST measures on SMEs is analysed:

* First of all, HST could benefit the SMEs that already have cross-border establishments in Member States other than that of the parent company. The benefits for these enterprises would include improved loss compensation and lower tax compliance costs:

a) As HST measures allow for a single system of loss compensation to all members of a given international group of SMEs (ie, the same system of loss compensation applicable to domestic group taxation), it should lead to a more efficient, non tax-biased, allocation of the resources from SMEs investments in the EU. However, international groups of SMEs with

parent companies established in countries that do not have appropriate group loss compensation rules in their domestic tax legislation (Belgium, Czech Republic, Estonia, Greece, Hungary, Lithuania and Slovakia) will not benefit from cross-border loss compensation possibilities under HST. A quantitative analysis of the loss compensation under HST estimates that the annual total amount that could be compensated cross-border for existing international groups of SMEs is in the order of three billion euros (resulting in estimated immediate savings in tax payments equal to around 860 million euros). This represents on average around 10% of the total losses of EU-based international SMEs groups. Around 30-40% of the existing international SMEs groups could benefit from these HST cross-border loss compensation possibilities.

b) The application of 'home state' tax rules to the foreign activities of a SME reduces tax-induced compliance costs for not having to deal with up to 25 different national tax systems. The direct cost savings from a HST simplification of the administrative burden for current international groups of SMEs is estimated, under conservative assumptions, to equal approximately 70 million euros per annum for the EU-25. These cost savings for existing international groups of SMEs can be tentatively estimated to increase EU GDP by twice this amount yearly in the long term.

* The effect of HST on new start-ups cross-border: the removal of tax barriers by HST measures may also affect the decision of companies to start new cross-border (activities i.e. new cross-border holdings in foreign subsidiaries, new or greater foreign direct investment, new foreign branches, etc). This applies both to companies already operating cross-border wishing to expand to other Member States. More importantly this also applies to companies operating hitherto only in a domestic context, insofar as their decision might be biased by tax considerations. The measures of the HST project could motivate these companies to go international, as the elimination of tax-barriers affects the trade-off between potential benefits and the costs of internationalisation that they face. The cross-border loss-offsetting tax regulation change and reduction of compliance costs should encourage companies to explore physical cross-border investments where companies had not considered these before and boost cross-border SMEs' chances of survival during the first years of business for . The question of how many extra companies are likely to expand cross-border as a result of a more straightforward administration system and the off-setting of losses from other Member States is difficult to answer a priori. Notwithstanding, the increased participation of SMEs in the Internal Market following a voluntary pilot scheme, that would bring about a change in their EU-wide company tax base and compliance costs, could be expected to be limited, because taxation is just one of the obstacles impeding cross-border expansion of SMEs.

- Then the transmission of the effects of improved cross-border establishments into the economic situation of host and home Member States are analysed. By increasing the openness of the Internal Market the HST scheme increases competition in host Member States. This should lead to global productivity gains and improvement in the allocation of resources, although it might also bring some crowding-out of local SMEs. Other effects of multinationals on local companies are predicted to be positive, such as the increase demand from local suppliers or the improved transfer of technology and know-how to local companies. The benefits for home Member States should include skill-upgrading and the use of new technologies after cross-border investments. In sufficiently competitive markets, the efficiency gains from increased competition will benefit consumers in the form of lower prices for products, improved quality and a greater variety of products. This sort of long-term,

dynamic effects are practically impossible to quantify, but they can be considered as the most important ones to the EU economy as a whole.

- The implementation of HST will also have implications for the Member States' national tax administrations. These will include higher spending on administration, control and coordination with other fiscal authorities costs and some revenue consequences following the possibility to offset losses cross-border and the apportioning of tax base results. Quantitative analysis shows the possible effects that apportionment based on factors such as 'payroll', 'turnover' or 'assets' may have on the distribution across the EU Member States of company tax bases of current international groups of SMEs. At any rate, given the proportions of enterprises and the proportions of taxation involved compared to total tax revenues of Member States¹² the tax revenue implications of the HST scheme should be very low and should not present insurmountable adverse consequences for any Member State. It is important to consider also that the net present value of tax revenues may even increase on the whole, via resulting future tax revenue increases, attributable to improved SME profits/survival and to the expected benefits to the EU economy as a whole.

The assessment has also analysed environmental and notably social aspects of HST, with the conclusion that a HST system would have positive social effects. These include higher employment and higher wages (following increased productivity), especially in host countries. A HST pilot project would have no major environmental impact.

The regional impact assessment suggests that it is reasonable to assume that many SMEs that decide to set up an establishment in another Member State will be located in border regions and will decide to create that establishment on the other side of the frontier. However, it might happen that HST measures also induce relatively more SMEs in remote regions when they need an extra-incentive, to engage in cross-border economic activity (as the propensity to cross-border operations is already higher in border regions). For those countries which do not operate any kind of domestic group loss-relief rules one essential feature of HST is not available and thus it can be expected that less SMEs in the countries concerned (see above) will participate.

As the HST pilot scheme would be voluntary for both Member States and interested companies, by definition, its actual impact would only be positive.

It is finally suggested that the pilot scheme is implemented via a multilateral agreement or, in bilateral relations, via a supplementing protocol to the applicable double-taxation treaty. The Commission and interested Member States may create a monitoring group for supervising the functioning of the pilot scheme, considering possible practical problems and assessing its success.

¹² Total corporate income tax yields represent 6.7% of total tax revenues for the EU-25 on average (European Commission (2005): "Structures of the taxation systems in the European Union", DG Taxation and Customs Union). The proportion of corporate income tax raised *from SMEs* and even more, from *international groups of SMEs* is much lower, tentatively estimated in the order of 0.066% of total tax revenues.

1. INTRODUCTION

At the Lisbon European Council of March 2000 the European Union committed itself "...to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion". This objective was reiterated by the Stockholm European Council of March 2001. Later, the European Council of March 2004 also reaffirmed the commitment of the Lisbon European Council and underlined the need to continue efforts to remove barriers to the Internal Market created through fiscal systems¹³. The Commission Communication to the Spring European Council COM(2005)24 and in particular its companion document SEC(2005)192, the Lisbon Action Plan have provided additional impetus for achieving the Lisbon objective, including in the tax field. Following that line of action, the recent Commission Communication COM(2005)532¹⁴ presents the ongoing and planned Community customs and tax measures, which are considered key in the attainment of the Lisbon objectives, by explaining "*these initiatives would help to renew growth and therefore create more and better jobs*". Further on, Commission Communication COM(2005)525¹⁵ emphasizes, in the context of the long-term sustainability of our social systems, that "*there is a need to look closely at making current tax systems perform better across the EU. A more co-ordinated approach at the EU level and more effective administrative co-operation between Member States could significantly improve the performance of tax systems. This could help to keep economic activity and 'mobile' assets (capital, companies) in the EU, while avoiding the risk of concentrating tax on less mobile bases like labour*".

Thus, it is now acknowledged that achieving the Lisbon objective requires new impetus and the Commission has made this issue one of its priorities. As small and medium-sized enterprises (SMEs) play a pre-eminent role in the economic development of the European Union and are generally considered to be one of the most important growth and employment creators, their importance for attaining this goal can hardly be overestimated. Accordingly, appropriate action for fostering the cross-border expansion of SMEs has already been called for in the multi-annual programme for enterprise and entrepreneurship, and in particular for SMEs (2001-2005)¹⁶ and in the Commission Communication "Action Plan: The European Agenda for Entrepreneurship"¹⁷. The conclusions of the Presidency of the European Council of 23 March 2005 repeatedly highlight the important role of SMEs and call for broad policy actions in favour of SMEs¹⁸. In turn, in its recent Communication COM(2005)551¹⁹, the Commission proposes "*a new start for a more pragmatic, comprehensive and inclusive EU policy in favour of SMEs*" to be implemented in closed partnership with Member States. Among other SME-friendly measures, this new policy framework stresses the importance of specific tax policies targeted at improving SMEs' access to markets and their growth potential (for example, a pilot project on Home State Taxation and a VAT One-Stop Shop system).

¹³ Presidency Conclusions of the Brussels European Council of 25 and 26 March 2004, para. 6 ff and 22.

¹⁴ "The Contribution of Taxation and Customs Policies to the Lisbon Strategy", COM(2005)532 of 25.10.2005.

¹⁵ "European values in the globalised world", COM(2005)525 of 3.11.2005.

¹⁶ Council decision 2000/819/EC of 20.12.2000.

¹⁷ COM(2004)70 of 11.02.2004.

¹⁸ Presidency Conclusions of the Brussels European Council of 22 and 23 March 2005, e.g. in para. 25.

¹⁹ "Modern SME Policy for Growth and Employment", COM(2005)551 of 10.11.2005.

In its company tax Communications of 2001²⁰ and 2003²¹ the Commission, looked into the potential contribution of EU corporate tax policy to the achievement of the Lisbon goal and into the specific role of SMEs in this respect. It was shown that the cross-border economic activities of all businesses in the EU are hampered by various tax obstacles but that, for various reasons, SMEs are hit particularly hard by these obstacles. Consequently, not least due to these tax obstacles, SME participation in the Internal Market is considerably lower than for larger companies. This results in economic inefficiencies and a foregone potential of economic growth and job creation which clearly jeopardises also the achievement of the Lisbon objective.

Under the concept of Home State Taxation (HST) the profits of a company or a group of companies active in more than one Member State are computed according to the rules of one company tax system only, that is the system of the Home State of the parent company or head office of the group. This system seemed to hold the most promise for tackling the tax problems that hamper SMEs most when expanding cross-border and that the concept could therefore be usefully tested in a pilot scheme. The European Parliament supported the idea of HST and invited the Commission to take this concept forward²².

Against this background, this Impact Assessment first provides information on the consultations carried out in the context of a Home State Taxation pilot project for SMEs. It then describes the problem to be addressed (low participation of SMEs in the Internal Market due to company taxation obstacles, which restrict the growth and employment potential of SMEs) and the policy objectives intended by the measures under consideration. It then analyses a variety of policy options and assesses their suitability for removing the company tax barriers to the cross-border expansion of SMEs within the Internal Market. It also provides a qualitative and quantitative (as far as possible) assessment of the major economic, social and environmental effects of the HST pilot project. Finally, it sets out arrangements for the implementation of the HST pilot project and its monitoring and evaluation.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

The Commission in its October 2001 company tax Communication²³ identified several steps which could be taken to remove individual tax obstacles to cross-border trade in the Internal Market and concluded that in the longer term Member States should agree to allow EU companies to use a single consolidated base for computing tax on their EU-wide profits. The Commission considers that the existence of (now) twenty-five separate sets of tax rules for calculating the taxable base within the Internal Market, creates excessive compliance costs and, causes numerous other problems such as the absence of relief for losses in cross-border situations, transfer pricing and double taxation. Home State Taxation was one of the policy options to achieve a single tax base presented in the Commission Communication. Following the discussion of the Communication in the relevant groups and at a conference held in

²⁰ "Towards an Internal Market without tax obstacles - A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities" [COM(2001)582] of 23.10.2001.

²¹ "An Internal Market without company tax obstacles – achievements, ongoing initiatives and remaining challenges" [COM(2003)726] of 24.11.2003.

²² Report on the Commission Communication to the Council, the European Parliament and the Economic and Social Committee on "Tax policy in the European Union–Priorities for the years ahead" (COM(2001) 260 – C5-0597/2001 – 2001/2248(COS)).

²³ [COM(2001)582].

Brussels in April 2002²⁴, the Commission services organised a workshop with all relevant business and accountancy/tax advisor federations, tax experts and other interested parties which took place on 17 December 2002 in order **to consult on the idea of a Home State Taxation pilot scheme for SMEs**. The workshop gave support to the Commission project (a summary report is available at the Commission's website²⁵).

On that basis, the Commission services launched a public on-line consultation in February 2003. The consultation period officially ended on 30 April 2003 but responses were still informally accepted up to the end of May 2003. The consultation paper was first distributed to the participants of the workshop of 17 December 2002 and prior to the on-line publication further disseminated on request. Full information on the consultation (document, summary report, etc) is available at the Commission's website²⁶ and individual contributions can be made available upon request.

In the consultation, twenty-four external contributions were received from a variety of national and European federations and organisations as well as some individuals. Almost all contributions were supportive of a HST pilot. Most federations and academics were willing to co-operate on the pilot scheme and most contributors said that their views were subject to a further assessment of the final design of the scheme. The efficiency and simplification gains, which the pilot scheme would bring about for SMEs, were generally acknowledged but many contributions also pointed out that it was too early for a final assessment of these. Moreover, many contributions highlighted the risk of potential discrimination and/or competition problems of the pilot scheme and some even referred to possible constitutional problems in specific Member States. However, it was also frequently maintained that a pilot scheme, which was available to SMEs under a specific definition on an optional basis, could avoid such problems. Most contributions argued in favour of a real-life test approach for the pilot scheme although some considered theoretical simulations on the economic effects could be a useful first step or 'backup'. A few contributions suggested that the pilot scheme should be run as a theoretical simulation only. The view that the existing EU definition of SMEs should be used for the purpose of the pilot scheme was overwhelmingly supported. A majority of contributions considered a relatively long or indefinite period as reasonable for defining the time limit of the scheme (e.g. at least 5 years) and refused other types of limitations (e.g. the exclusion of specific sectors). Some form of EU framework for the pilot scheme was generally welcomed but most contributions remained relatively vague on this point. Some expressed firmer opinions on the details and precise legal form of this framework but these were divided. Almost all contributions maintained that the pilot scheme would be of merit even if not all Member States participated. This should be possible. A majority of respondents wanted to include partnerships in the scheme but considered VAT as too different a tax for inclusion in the scope of the pilot project. On the other technicalities of the possible pilot scheme, a variety of - sometimes conflicting, sometimes complementing - views were presented. These concerned questions like

- whether or not participating enterprises should file a pro-forma tax declaration in the country of activity;
- whether or not local profit taxes should be included in the scope of the scheme;

²⁴ For further information see

http://europa.eu.int/comm/taxation_customs/taxation/company_tax/conference.htm

²⁵ http://europa.eu.int/comm/taxation_customs/common/consultations/tax/article_384_en.htm

²⁶ http://europa.eu.int/comm/taxation_customs/common/consultations/tax/article_384_en.htm

- which factors should be used for the formula needed for dividing the tax base between participating Member States;
- whether or not existing national tax incentives for SMEs are important for the pilot scheme; etc.

Throughout 2002 and 2003, various contacts were established with appropriate European and national associations representing SMEs and other relevant stakeholders. Bilateral meetings were organised in order to follow up specific issues and participation in conferences and workshops was ensured in order to raise awareness of the project and the consultation process. In July 2003, the Commission published and distributed, inter alia with the help of the relevant EU federations an "Outline of a possible experimental application of Home State Taxation to small and medium-sized enterprises" and a "Questionnaire on corporate tax as barrier to EU expansion of small and medium-sized enterprises" and called upon interested stakeholders to complete and return the questionnaire in an anonymous form.

The questionnaire was intended to collect some useful information for this pilot project from the EU SME community. There was no intention to draw an EU representative sample in order to conduct a statistical analysis. It should also be noted that numerous replies were incomplete which explains that in the presentation of the results below some figures might at first sight appear to be inconsistent. Moreover, the geographical spread of replies is very uneven. Still the Commission services consider that the replies received in response to the questionnaire provided useful insights also into some of the effects of the scheme. The main results can be summarised as follows:

- 177 replies were received in response to the questionnaire: 152 from Germany; 8 from Poland; 6 from Austria; 2 respectively from Belgium, the Czech Republic and Italy and 1 respectively from Denmark, France, Slovakia, the United Kingdom and from an unspecified third country.
- 49 replies were given by businesses run as partnership and 128 by business run as incorporated companies.
- 49 replies considered that the different existing business tax laws and arrangements within the Internal Market discourage businesses from expanding to another Member State while 128 replies were not of this opinion.
- Asked, if, when it was made possible to use their domestic business tax rules to work out the taxable profits for all European Union countries where they do business, using their own language then file all the calculations only with their 'home' tax authorities, they would consider creating a new, or expanding an existing, establishment in one or more EU states, 89 businesses replied positively and 87 negatively.
- 92 of the respondents were interested in participating in a five years pilot scheme as described while 84 respondents were not.

A detailed summary of the replies is available on the Commission website²⁷. The Commission services are mindful of the fact that these results are subject to methodological reservations and do not meet statistical standards of representativeness. On the basis of the replies given to the questionnaire it was nonetheless possible to conclude that

- around one-third of the SMEs in the EU consider corporate taxation as an important obstacle to cross-border expansion;
- around one-half of the SMEs in the EU acknowledge the potential and the positive contribution of the Home State Taxation approach for helping and encouraging their economic activities in other Member States;
- around one-half of the SMEs in the EU show, at least in principle, interest to take part in an appropriately designed pilot scheme;
- the interest to take part in the pilot scheme is, in relative terms, highest among medium-sized enterprises.

3. PROBLEM DEFINITION: THE ECONOMIC IMPORTANCE OF SMEs AND THEIR LOW PARTICIPATION IN THE INTERNAL MARKET DUE TO COMPANY TAXATION OBSTACLES

In order to assess the effects of company tax obstacles to SMEs participation in the Internal Market it is first necessary to understand the importance of SMEs for the EU economy.

3.1. Economic importance of small and medium-sized enterprises in the EU

At EU level, SMEs are generally referred to as enterprises with less than 250 employees²⁸. Enterprises which are part of a larger grouping and could therefore benefit from a stronger economic backing than genuine SMEs, do not fall within the scope of this definition.

The importance of SMEs in driving the European Union's economy can be hardly overemphasized as they make up a large part of Europe's economy. There are some 23 million of SMEs in the EU-25, accounting for 99.8% of all enterprises. As shown in figure 1 below, nearly the totality of SMEs in the EU-25 are micro enterprises (employing less than 10 employees) as they represented 91.3% of the total number of enterprises in 2001. SMEs provide jobs for around 105 million people²⁹, which represents around 66% of total private

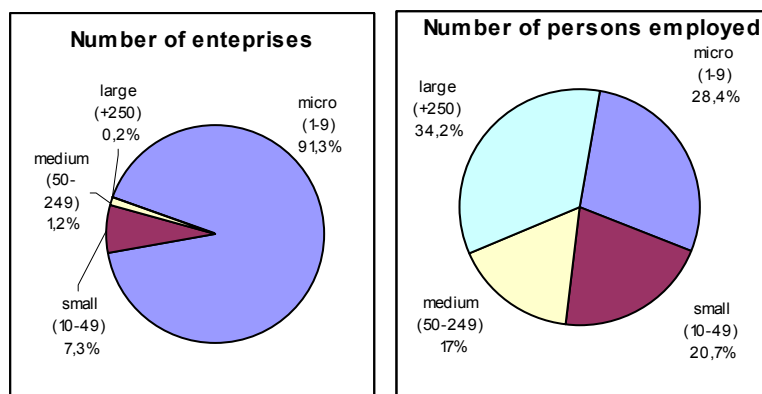
²⁷ http://europa.eu.int/comm/taxation_customs/common/consultations/tax/article_1455_en.htm

²⁸ See Commission Recommendation 2003/361/EC concerning the definition of micro, small and medium-sized enterprises, OJ L 124 of 20.5.2003, p.36-41. It distinguishes the following categories:
- medium-sized enterprises [headcount <250 and turnover ≤€50 million and/or balance sheet total ≤€ 43 million].
- small enterprises [headcount < 50 and turnover ≤ € 10 million and / or balance sheet total ≤ € 10 million].
- micro enterprises [headcount < 10 and turnover ≤ € 2 million and / or balance sheet total ≤ € 2 million].

²⁹ Calculated from the information reported on European Commission (2003): "SMEs in Europe 2003", *Observatory of European SMEs* 2003/No. 7, DG Enterprise Publications and European Commission (2003): "The impact of EU enlargement on European SMEs", *Observatory of European SMEs* 2003/No.6, DG Enterprise Publications. This data and other data mentioned in this impact assessment

employment in EU-25, as shown in figure 1. In turn, large scaled enterprises (LSEs), defined as having more than 250 employees, represent only 0.2% of the total number of enterprises but 34.2% of the total employment in the EU-25.

Figure 1: Breakdown of main indicators in the EU-25's business economy by enterprise size class, 2001, % share of total



Source: *Structural Business Statistics*, Eurostat (estimates based on incomplete country data).

Further analysis confirms the particular importance of smaller enterprises and micro-enterprises as job creators. There is evidence of the differing employment growth patterns of the various size-classes³⁰, indicating that SMEs consistently display higher employment growth than LSEs, and that the difference is mainly due to micro and small enterprises. The early 1990s recession dip in employment, for example, was less severe in micro and small enterprises and their recovery, in terms of employment total, was swifter. Micro and small enterprises have recovered to employment levels higher than in 1988, whereas by 2001, medium and large enterprises were still below this level. Based on these facts SMEs are generally considered to be a key driver in EU employment levels, and are considered to provide greater employment growth than large-sized enterprises³¹. This is all the more likely since smaller enterprises account for a greater role in labour intensive sectors than do larger enterprises³². For example, SMEs contribute up to 80% of employment in some industrial sectors, such as textiles, construction or furniture³³.

On top of that, based on an extensive literature study, the above-mentioned report "*SMEs in Europe 2003*" claims that SMEs serve as an engine of economic growth. The empirical evidence strongly suggests that economic growth is positively correlated with an increased

based on the *Observatory of European SMEs* reports, is primarily drawn from Eurostat's SMEs database and an European Network for SME Research (ENSR) survey among over 7 600 SMEs in Europe, compiled by the Commission.

³⁰ Evidence for the Europe-19 countries (ie EU-15 countries plus Iceland, Liechtenstein, Norway and Switzerland) shown in European Commission (2002): "SMEs in Europe, including a first glance at EU candidate countries", *Observatory of European SMEs* 2002/No.2, DG Enterprise Publications.

³¹ "Small and medium-sized enterprises – A dynamic source of employment, growth and competitiveness in the European Union", report presented by the European Commission for the Madrid European Council, December 1995 [CSE(95)2087], p.3.

³² European Commission (2003): "SMEs in Europe 2003", *Observatory of European SMEs* 2003/No.7, p. 26, DG Enterprise Publications.

³³ "Modern SME Policy for Growth and Employment", COM(2005)551.

role of SMEs, specially due to the three types of positive externalities that SMEs have on the economy as a whole: (i) SMEs serve as vehicles for knowledge spillovers, which may become accessible and commercialised by large enterprises through technology transfer or acquisition; (ii) SMEs increase the amount of competition in the input market, particularly in terms of the competition for new ideas and human capital embodied in knowledge workers; (iii) SMEs increase diversity in the market, which can spill over to generate productivity increases in existing enterprises. An important implication of the external impact of SMEs is that their contribution to growth is not restricted to the SME sector of the economy, but rather spills over to impact on non-SME enterprises.

In addition, with the indirect impact through taxation of their generated profits and wages, European SMEs are a fundamental pillar of the European welfare state and contribute to economic and social cohesion.

Based on these facts it is not surprising that **SMEs are generally considered to be a key driver in EU economic and employment growth and social cohesion**. Thus, fostering the development of SMEs can be expected to have greater and more immediate economic and social effects than in other company size classes. These facts increase the relative economic importance of the barriers that these businesses face in their cross-border activities.

3.2. Participation of SMEs in the Internal Market and internationalisation strategies

Despite their economic importance, SMEs participation in the Internal Market effectively remains low, both in absolute terms and relative to that of larger companies. For instance, the propensity to export (percentage of enterprise's turnover abroad) varies strongly with enterprise size: it is 23 % in LSEs as against 12 % in SMEs, and within SMEs, only 7 % in micro enterprises³⁴. The larger the enterprise, the larger (in a physical sense) the market area tends to be. As it can be seen from figure 2³⁵, size still matters, since the importance of company size clearly influences the extent and forms of internationalisation.

Micro enterprises are significantly less internationalised than small or medium-sized enterprises. While 64% of micro enterprises are non-internationalised, this is only true for 35% of medium enterprises. The size difference is particularly marked when analysing the share of SMEs with more complex forms of internationalisation such as a subsidiary, branch or joint venture abroad or a combination of more than one form of internationalisation. Thus, the size of the enterprise seems to have a significant impact on the possibilities or choice of internationalisation. Smaller companies create subsidiaries abroad less frequently.

Figure 3 below indicates the percentage of SMEs with subsidiaries, branches and/or joint ventures abroad by size of enterprise³⁶. Again it can be seen that whilst only around 2% of micro SMEs engage in this type of more complex form of internationalisation (foreign

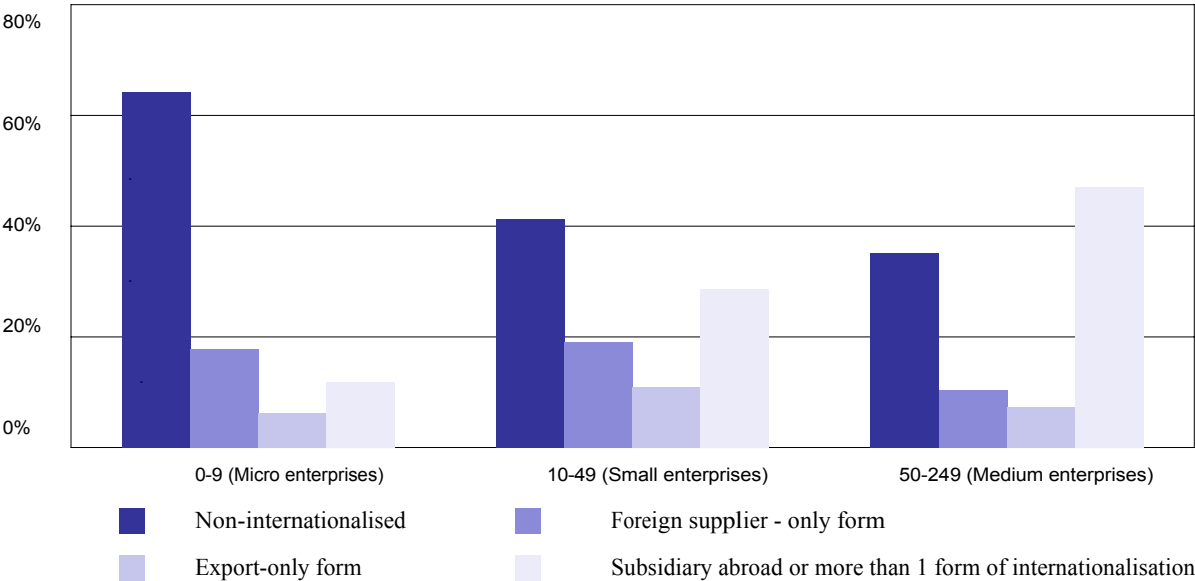
³⁴ European Commission (2003): "Highlights from the 2003 Observatory", *Observatory of European SMEs* 2003/No.8, DG Enterprise Publications.

³⁵ From European Commission (2003): "Internationalisation of SMEs", *Observatory of European SMEs* 2003/No.4, DG Enterprise Publications. The results are based on the 2003 European Network for SME Research (ENSR) Enterprise survey, among 7 837 SMEs in Europe-19 countries.

³⁶ From European Commission (2002): "Highlights from the 2002 survey", *Observatory of European SMEs* 2002/No. 8, DG Enterprise Publications. The results are based on the 2002 ENSR Survey on 7669 SMEs in Europe-19 countries.

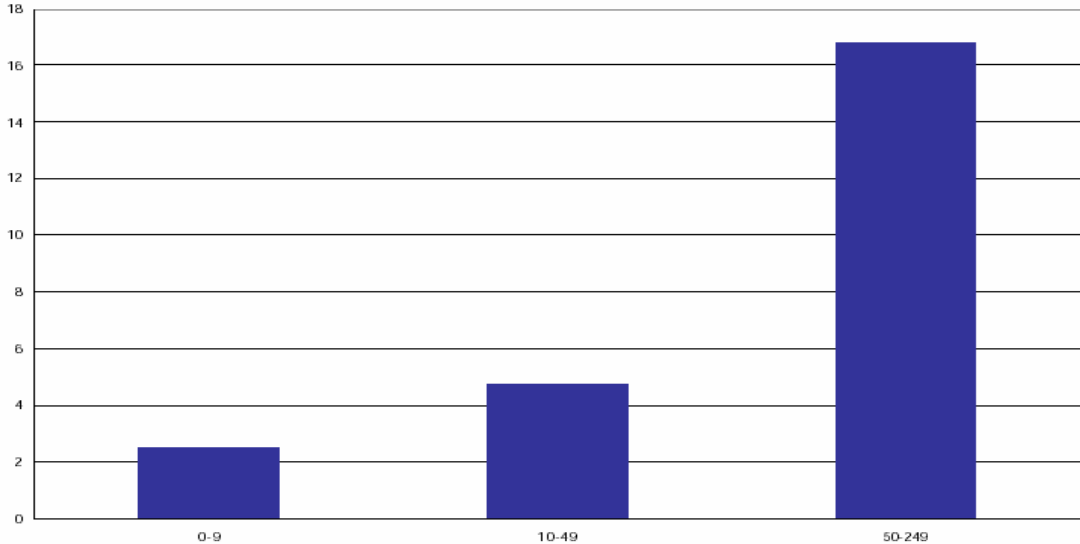
investments), the percentage for medium-sized enterprises is much higher since it amounts to 17%, but medium-sized enterprises account only for 1.2% of the total number of enterprises as shown in figure 1 above.

Figure 2: Frequency of internationalisation by size of enterprise



Source: ENSR Enterprise Survey, 2003.

Figure 3: Percentage of SMEs with subsidiaries/branches/joint ventures located abroad, by size of enterprise



Source: Weighted data 2002 ENSR Survey on SMEs.

This essential picture can be developed further to give some insight into the characteristics of SMEs with subsidiaries/branches/joint ventures located abroad. The ENSR Survey 2002³⁷ shows the proportion of SMEs in the Europe-19 countries that have subsidiaries/branches/joint ventures located abroad *by country*. Typically the proportion is very low, ranging from 1% to only 7%, with the exception of Luxembourg (10%)³⁸. This higher figure is not surprising given the size of the country and the minimal effort required for any enterprise to expand cross-border compared with the effort needed for the typical SME in the other Member States, not least because of the absence of language barriers. The typical figure for the Europe-19 countries is around 3%, with France, Italy and Portugal only having 1% of their enterprises with subsidiaries/branches/joint ventures located abroad. Although there are no comparable data for the ten 'new' Member States of the EU to our knowledge, it seems reasonable to assume that the relevant proportions are as low or even lower for international groups of SMEs with parent companies based in these countries.

Further on, from table 1 it can be shown that the percentage of SMEs having subsidiaries, branches or joint ventures located abroad is twice as high for young enterprises (less than 5 years) as for the oldest ones (more than 10 years).

Table 1: Subsidiaries/branches/joint ventures located abroad (% of SMEs) by age of enterprise

	<=5 years	6-10 years	>10 years	Total
Yes	4%	3%	2%	3%
No	96%	97%	98%	97%

Source: Weighted data ENSR Survey 2002 among 7669 SMEs in Europe-19 countries

The **picture of the main characteristics of existing EU-based international groups of SMEs**³⁹ can be rendered in greater detail using an exercise based on the AMADEUS database⁴⁰. Some basic results from this investigation have been compiled and reported in Tables 2, 3 and 4 below. The main insights from these data can be summarised as follows:

- Table 2 shows that the database provides information on about 7145 international groups of SMEs, that is, 7145 SMEs parent companies (established in up to 23 EU

³⁷ European Commission (2002): "Highlights from the 2002 survey", *Observatory of European SMEs* 2002/No. 8, DG Enterprise Publications.

³⁸ The survey gives the following percentages of SMEs with subsidiaries/branches/joint ventures located abroad by country for the Europe-19 countries: Austria 7%, Belgium 2%, Denmark 4%, France 1%, Finland 5%, Germany 3%, Greece 1%, Ireland 4%, Italy 1%, Luxembourg 10%, Netherlands 4%, Portugal 1%, Spain 4%, Sweden 4%, UK 5%, Iceland 10%, Liechtenstein 6%, Norway 7%, Switzerland 3%.

³⁹ For the purpose of this analysis an EU "international group of SMEs" exists when an SME parent company established in an EU Member State owns at least 50% of one or more SME-subsidiary companies located in other Member State/s. Subsidiaries located outside the EU borders are not taken into account in the analysis.

⁴⁰ The AMADEUS data set contains standardized annual accounts of approximately 7 million companies in 38 countries, including the EU-25 Member States (the July 2005 version of this dataset is used in this analysis). AMADEUS also contains information on (domestic and cross-border) linkages between companies in its so-called "ownership" database. These features imply that this dataset is useful for cross-border company analysis. It doesn't prevent from raising, however, the difficult question of how representative the results of such an analysis are for the total actual population of companies with cross-border linkages in the EU, since data collection reported in this dataset sometimes differs between countries and depends on the institutional settings in each country.

MS) which have at least one majority-owned subsidiary in a Member State other than the parent's one. Subsidiaries have to be owned at least 50% by the SME parent (second or further levels of ownership are allowed as long as indirect ownership is beyond the 50% threshold) and have to fulfil also the SMEs criteria to be considered as part of the SME international group. The table shows that there are 20134 such qualifying subsidiaries in the EU for the 7145 SMEs parent companies, thus a total of 27279 companies are under analysis.

Table 2. Some basic insights about international groups of SMEs from the AMADEUS database

	Number of SMEs observed by MS	Number of SMEs parent cos. in each MS	Total number of subsidiaries (>50%) of the SMEs parent cos. located in each MS	Total number of cos. (parents + subs)	Average nr of subs. /SME parent co.	Number of domestic subsidiaries (>50%)	Average nr of domestic subs./SME parent co.	Number of subsidiaries abroad (>50%)	Average nr of subsidiaries abroad/SME parent co.	Assumed True Weight
AT	107	12	49	61	4,08	28	2,33	21	1,75	0,0223
BE	145645	1502	3477	4979	2,31	789	0,53	2688	1,79	0,0185
CY	25	2	2	4	1,00	0	0,00	2	1,00	0,0023
CZ	5430	16	44	60	2,75	11	0,69	33	2,06	0,0185
DK	32018	426	1065	1491	2,50	301	0,71	764	1,79	0,0160
EE	30835	42	58	100	1,38	13	0,31	45	1,07	0,0023
FI	26196	62	130	192	2,10	39	0,63	91	1,47	0,0089
FR	434127	959	2568	3527	2,68	936	0,98	1632	1,70	0,1079
DE	2887	41	82	123	2,00	28	0,68	54	1,32	0,2241
EL	7137	10	28	38	2,80	10	1,00	18	1,80	0,0115
HU	5061	3	4	7	1,33	1	0,33	3	1,00	0,0185
IE	52662	345	830	1175	2,41	182	0,53	648	1,88	0,0089
IT	83330	338	544	882	1,61	84	0,25	460	1,36	0,1252
LV	1599	3	3	6	1,00	0	0,00	3	1,00	0,0023
LT	701	3	7	10	2,33	1	0,33	6	2,00	0,0046
LU	368	1	1	2	1,00	0	0,00	1	1,00	0,0026
NL	101526	846	3152	3998	3,73	1665	1,97	1487	1,76	0,0332
MA	73	0	0	0	0	0	0	0	0	0,0000
PL	7058	9	11	20	1,22	0	0,00	11	1,22	0,0507
PT	10409	23	71	94	3,09	38	1,65	33	1,43	0,0287
SK	698	0	0	0	0	0	0	0	0	0,0069
SI	1266	0	0	0	0	0	0	0	0	0,0069
ES	378038	793	1984	2777	2,50	888	1,12	1096	1,38	0,1117
SE	80928	884	2840	3724	3,21	1101	1,25	1739	1,97	0,0198
UK	554778	825	3184	4009	3,86	2009	2,44	1175	1,42	0,1475
Total	1962902	7145	20134	27279	2,82	8124	1,14	12010	1,68	100,00%

Table 3. Distribution of subsidiaries of international groups of SMEs by Member State

Nr of subsidiaries (>50% owned) (of SMEs parent cos) in each MS: Nr of SMEs parent cos in each MS:																											Total number of subsidiaries (>50% owned) of SMEs parent cos.
	AT	BE	CY	CZ	DK	EE	FI	FR	DE	EL	HU	IE	IT	LV	LT	LU	NL	MA	PL	PT	SK	SI	ES	SE	UK		
AT	12	28		1				2	12		1					1							1		3	49	
BE	1502	13	789	2	34	6	2	4	693	203	9	26	8	84	2	2	107	1053	3	65	15	21	2	100	83	151	3477
CY	2								1																1	2	
CZ	16	1		1	11				8								2		4		16				1	44	
DK	426	2	11	2	3	301	6	37	51	170	2	7	2	30	18	9	9	64		24	3	4		54	130	126	1065
EE	42				1	13								35	9												58
FI	62	1			2	27	39	1	11		2			9	5		4		6					5	18	130	
FR	959	14	149	1	34	8	1	7	936	355	12	25	6	118		3	38	58	2	67	31	7		239	13	444	2568
DE	41	7		2				6	28		2		5	1	1		9		2				2		17	82	
EL	10	1		3							10		1												13	28	
HU	3								2		1								1							4	
IE	345	1	1		3	1	1	2	21			182					16		3				18		581	830	
IT	338	11	8		1	1	1	1	137	101	1	4	1	84		1	2	20		13		1	39	1	116	544	
LV	3						2																			3	
LT	3						2								2	1								2		7	
LU	1								1																	1	
NL	846	24	146	3	23	26	1	2	100	588	2	22	9	22	2		2	1665		37	8	3		76	7	384	3152
MA	0																									0	
PL	9	2							1	7															1	11	
PT	23								4	4								2			38			14		9	71
SK	0																									0	
SI	0																									0	
ES	793	1	24	1	14	5			253	93	12	15	7	83	1	1	7	52		22	342	4	1	888	3	155	1984
SE	884	15	36	4	26	233	72	268	95	225	4	18	7	28	45	27	10	157		120	9	3	6	46	1101	285	2840
UK	825	19	8	8	4	44	3	5	163	403	5	7	89	21	4		3	249	1	32	5		1	93	8	2009	3184
Total	7145	140	1172	25	153	630	131	364	2444	2233	57	130	312	475	119	60	178	3352	6	396	451	58	11	1570	1353	4314	20134

Table 4. Subsidiaries of domestic and foreign SMEs parents in each Member State

	AT	BE	CY	CZ	DK	EE	FI	FR	DE	EL	HU	IE	IT	LV	LT	LU	NL	MA	PL	PT	SK	SI	ES	SE	UK	Total q.s.
Total Nr of subsidiaries (>50% owned) in MS	140	1172	25	153	630	131	364	2444	2233	57	130	312	475	119	60	178	3352	6	396	451	58	11	1570	1353	4314	20134
Subsidiaries owned by domestic parent cos.	28	789	0	11	301	13	39	936	28	10	1	182	84	0	1	0	1665	0	0	38	0	0	888	1101	2009	8124
Subsidiaries owned by foreign parent cos	112	383	25	142	329	118	325	1508	2205	47	129	130	391	119	59	178	1687	6	396	413	58	11	682	252	2305	12010
% subs majority owned by foreign parent cos.	0,93	3,19	0,21	1,18	2,74	0,98	2,71	12,56	18,36	0,39	1,07	1,08	3,26	0,99	0,49	1,48	14,05	0,05	3,30	3,44	0,48	0,09	5,68	2,10	19,19	100
Weighted % subs majority owned by foreign parent cos.	4,35	2,19	0,46	1,51	1,15	0,79	0,67	12,45	20,38	0,32	1,57	1,37	4,14	1,00	0,64	0,59	9,82	0,03	3,45	3,70	1,42	0,06	6,66	0,95	20,34	100

Table 2 also shows in the first column that nearly data for 2 millions SMEs is recorded in the database. As only 7145 are found to be parent companies with cross-border subsidiaries (i.e. 0.37%), this may seem to contrast with the *Observatory of SMEs* figure that 3% of SMEs have cross-border subsidiaries, permanent establishments or branches and lead to misleading conclusions of non-representativity of the database. However this may not be the case and the database information is still representative, since the lower observed percentage of SMEs with subsidiaries abroad could be due to the fact that the 3% figure, in addition to subsidiaries, includes also branches and permanent establishments (which are normally much more numerous than subsidiaries) and also to the fact that the threshold fixed to define international groups of SMEs -50% ownership threshold- excludes many of the “subsidiaries abroad” reported in the Observatory figure.

- The analysis of SMEs international groups drawn from this database shows an **average number of 2.82 subsidiaries (>50% owned) per SME parent in the EU, out of which, 1.14 are domestic subsidiaries and 1.68 are foreign subsidiaries in a different EU Member State to their parent.**
- Although not presented in the tables, other analysis have been carried out showing that around 20% of the subsidiaries of the EU-based international groups of SMEs are owned in second or further levels of ownership (ie sub-subsidiaries, etc) for the sample under consideration. Also, group members of this sample of international groups of SMEs have an average of 28 employees per company within the group.
- Tables 3 and 4 in turn show the sample distribution of the subsidiaries of international groups of SMEs by Member State. Thus, the number of domestic and foreign majority-owned subsidiaries (by MS of location) owned by the SME parent companies based in a given MS is presented within Table 3 by rows. The number of subsidiaries established in a given MS (>50%-owned by domestic or foreign parents) is presented in Table 4. Table 3 confirms that in most cases, **neighbouring countries are the main destination of foreign investment of parent SMEs in form of foreign subsidiaries.** For example, this trend can be seen in the destination of foreign subsidiaries of Nordic countries-SMEs parents (preferably across Sweden, Denmark or Finland), central Europe countries' SMEs parents (for instance SMEs parents in the Netherlands, Belgium, France, etc establish their foreign subsidiaries mainly in the neighbouring countries) or southern countries (for example, cross-border subsidiaries are frequent across Spain and Portugal). On the other hand, Table 4 presents the subsidiaries (foreign or domestically-owned) established in each MS of the EU-25. It shows that **UK, Germany and France are the EU countries that receive higher percentages of cross-border investments** in the total sample of EU international SMEs parent companies: around 20% of total majority-owned foreign subsidiaries (ie. owned

by a parent company set in a country other than that of the subsidiary) are established in the first two countries and around 12% in France⁴¹.

All in all, the previous analysis has provided a rather thorough picture of the main features characterising existing EU-based international groups of SMEs with subsidiaries in Member States other than the parent companies' ones.

3.3. The benefits of SMEs internationalisation

The statistics shown above demonstrate that **the problem of low participation of SMEs in the Internal Market is real and concrete**. Moreover, it is shown that in particular smaller and younger enterprises (which are the main employment creators) need further help and encouragement for expanding across borders and exploiting business opportunities in other Member States.

Why should the low participation of SMEs in the Internal Market be a problem? Firstly, as indicated by several international studies as well as the ENSR 2003 Enterprise Survey, **engaging in international activities has a positive impact on the competitiveness and performance of SMEs** and thereby on economic growth and social welfare in the EU. The above-mentioned "*Internationalisation of SMEs*" report investigates in detail how internationalisation affects SMEs competitiveness and shows that internationalised SMEs perform overall better compared to domestic SMEs. Moreover, the more complex forms of internationalisation (ie, the establishment of cross-border subsidiaries) are perceived to have a greater effect on the SMEs' competitiveness.

For example, it shows the effect of foreign subsidiaries on turnover (by enterprise size): Among micro enterprises with subsidiaries abroad, 50% register a positive (or strongly positive) effect on their turnover. For medium-sized enterprises the figure goes up to 68%. Roughly between a quarter and a third of the SMEs register no effect. Very few register a negative effect.

⁴¹ At this point, some concerns of sampling bias could arise: ie, in the sample of international groups of SMEs analysed, groups with parent companies in some particular countries are over-represented whilst others are under-represented with respect to the actual *unknown true* distribution of international groups of SMEs across countries. To take account of that fact, the results in different parts of the analysis based on this database are weighted by a factor that aims at replicating the *assumed true* distribution of international groups of SMEs. In that sense, parent companies of international groups of SMEs are meant to follow the same distribution across the EU-25 countries as the total number of SMEs by countries. That assumed *true weighting* is obtained from the "SMEs in Europe 2003" report of the *Observatory of European SMEs 2003* (together with some further calculations for the weighting of total SMEs across the 10 'new' Member States, which are weighted according to the distribution of aggregated GDP among them), and is given in the last column of table 2 above. By making the different results weight by country according to this assumed true weighting (instead of according to the random weight of the initial sample distribution), the representativity of the sampling results is statistically higher, as they would replicate the distribution of the corresponding results of the true population by country. For example, this technique has been applied to weight the number of foreign subsidiaries of parent companies in the different MS and the result is shown in the last row of table 4.

The positive effect of internationalisation is further supported by comparing the turnover of internationalised SMEs *versus* non-internationalised SMEs. The report shows that non-internationalised SMEs were more likely to experience a decrease in turnover from 2001 to 2002. Similarly, both SMEs with a foreign supplier and those with more complex international activities experienced increases in turnover more frequently than the non-internationalised equivalents. It appears that SMEs with international activities are more likely to see constant or increased turnover rather than decreased turnover, compared with SMEs that only undertake domestic activities.

The report claims that in addition to quantifiable effects on sales (turnover) international activities can also have an indirect positive impacts on the competitiveness of SMEs in a way that is less easy to measure. The SMEs may for instance improve their cost-efficiency by outsourcing abroad or may develop their know-how and technology competencies. Also, initiating foreign investment or collaboration with partners in other countries may offer new challenges and opportunities to the employees or improve the SMEs' scope of recruitment and their ability to maintain highly skilled employees.

Eventually, foreign direct investments and cross border clustering represent viable ways to facilitate exchanges of knowledge and technology and to strengthen international business strategies of SMEs, resulting in overall better performance. And the tax factor should not be an obstacle to develop such potentiality of growth and improved performance of one of the Internal Market's leading economic agents.

Besides these arguments, the importance of cross-border start-ups by SMEs for the EU economy should also take into account **a contextual consideration**. It is indisputable that at the moment the current business environment is more favourable for SMEs engaging in cross-border investments than two decades ago. The technologies for communication and management have improved, managers are better educated and more aware of globalizing business, access to information and communication has improved as well as the facilities for managing geographically scattered production. Furthermore, the use of the worldwide web is continuously growing, more efficient, low-priced types of transportation for both goods and personnel have emerged and in general tendencies for increasing specialisation globally are likely to push more SMEs into international business (specially in small open economies). Thus, the importance of cross-border ownership of assets and cross-border establishments continues to increase, mirroring the substantial role of internationally oriented enterprises in the global economy. These considerations support the idea that the present economic and business context in the EU should be supportive of the internationalisation of SMEs by the emergence of horizontal/vertical SMEs' multinationals. Certainly, tax factors should not be allowed to obstruct this trend.

3.4. Company tax obstacles in the Internal Market and their relevance for SMEs

Intense research by the Commission services⁴² and independent research institutes⁴³ over the last years have again confirmed that, despite the positive effect on enterprises' performance as described above, the cross-border economic activities of businesses in the EU, are seriously hampered by numerous and varied company tax obstacles. Given progress in many other policy fields where measures of harmonisation or mutual recognition have been taken, the relative importance of these tax obstacles has increased over recent years and now constitutes one of the single biggest problems in the completion of the Internal Market and the fulfilment of its economic potential. The European Commission is therefore currently working on the implementation of a "two-track strategy" which contains both short-term measures that are targeted at resolving specific obstacles to cross-border economic activities in the Internal Market and longer-term comprehensive solutions⁴⁴.

In the Commission services' analysis, particular attention was also paid to the specific situation of SMEs⁴⁵. Generally, the tax obstacles to cross-border economic activity are identical for small and medium-sized enterprises and larger companies. The impact of many obstacles on SMEs is however stronger as they have, simply due to their smaller size, less economic and human resources and tax expertise available. In other words, the limited size of the business inherently limits the possibilities to avoid some tax obstacles. It was nevertheless established that there are two areas which are of additional, particular importance for SMEs⁴⁶.

First, **SMEs have particular difficulties in meeting the compliance costs resulting from the need to deal with up to 25 different taxation systems**. This finding is strongly supported by tax practitioners and business federations which represent SMEs' interests⁴⁷. According to UEAPME, the European Association of Craft, Small and Medium-sized Enterprises, "tax related compliance costs for small businesses are up to 100 times higher than for large companies"⁴⁸.

⁴² Commission staff working paper "Company Taxation in the Internal Market" [SEC(2001)1682].

⁴³ See for instance: Centre for European Policy Studies, "EU Corporate Tax Reform", Report November 2001 and "An EU Company without an EU Tax? A Corporate Tax Action Plan for Advancing the Lisbon Process", Report April 2002, both with further references.

⁴⁴ For details see the above-mentioned Commission Communications [COM(2001)582], [COM(2003)726] and [COM(2005)532].

⁴⁵ Part III, ch. 8 and part IV, B, ch. 11 of the study [SEC(2001)1682].

⁴⁶ This conclusion by the Commission is also supported by the literature, see for instance: Chittenden F., Michaelas N. & Poutziouris P. (2000) 'Small Business Taxation: An Agenda for Growth', Executive Development Centre, Manchester Business School and NatWest Bank PLC, p.2.

⁴⁷ See for instance the replies given to the Commission consultation in 2003 and a questionnaire launched in 2004 (Section 2 above).

⁴⁸ Press release dated 11.06.2004.

This finding is also endorsed by scientific and quantitative evidence. In addition to the available studies suggesting that compliance costs are regressive to size and put a disproportionately higher⁴⁹ or even prohibitively high burden on small and medium-sized enterprises compared to bigger companies⁵⁰ the recent *European Tax Survey*⁵¹ which was obtained from the Commission's European Business Test Panel has, albeit admittedly not in all respects in a statistically reliable way, confirmed the importance of tax-induced compliance costs for SMEs. In particular, it revealed that compliance costs relative to sales are larger for SMEs than for large companies. For instance, econometric regressions provided significant and recurrent evidence that total, VAT and company taxation compliance costs increase with company size but impose a higher relative burden on smaller companies. Moreover, it was established that cross-border activity leads to higher compliance costs for companies. Based on the econometric analysis carried out it was demonstrated that compliance costs are higher for companies with at least one subsidiary in another EU Member State compared to companies without subsidiaries in another Member State and that they increase with the number of subsidiaries abroad.

Second, among the other more specific tax obstacles to cross-border economic activity in the Internal Market, **the cross-border offsetting of losses has been identified as the most important one from the perspective of SMEs.** Losses often occur at the beginning of an activity in a foreign country, i.e., precisely when these activities are typically still run in a smaller enterprise. Bigger companies are usually in a position to make sure that all losses are eventually offset against profits, e.g. by using appropriate transfer pricing strategies. SMEs usually do not have this possibility. Moreover, given their usually limited capital cover, it is particularly important for small businesses to be able to carry back losses.

Obviously, SMEs also face specific cross-border problems relating to taxes other than company taxation. For instance, the transfer of SMEs, often family businesses, entails a number of tax problems that are often more difficult and onerous than for big publicly quoted companies. Cash-effective gift and inheritance taxes are an important example in this respect. The Commission has repeatedly referred to these issues and presented

⁴⁹ See, for instance: Cressy, R. (2000): 'Tax, Assistance, Compliance & the Performance of the Smaller Business', A Research Report to the Federation of Small Businesses; and: Chittenden F., Michaelas N. & Poutziouris P. (2000): 'Small Business Taxation: An Agenda for Growth', Executive Development Centre, Manchester Business School and NatWest Bank PLC.

⁵⁰ See Annex 2 of the Commission services study [SEC(2001)1682] with further references to Pope, J. (1994): 'Compliance costs of taxation: Policy implications', *Australian Tax Forum*, Vol. 11, pp. 85-121; Turner, R. (1996): 'Study on transfer pricing', *Working Paper*, 96-10, prepared for the Technical Committee on Business Taxation, Toronto, December 1996; Erard, B. (1997): 'The income tax compliance burden on small and medium-sized Canadian business', *Working Paper*, 97-12, Department of Economics, Carleton University, prepared for the Technical Committee on Business Taxation; Plamandon and Associates Inc. (1996): 'Compliance issues: Small business and the corporate income tax system', *Working Paper*, 96-9, prepared for the Technical Committee on Business Taxation.

⁵¹ Commission Staff Working Paper SEC(2004)1128.

recommendations on tax problems concerning the transfer of SMEs⁵² and a Communication on the general improvement of the tax environment of SMEs⁵³. Most of the recommendations concern tax problems relating to the legal status of sole proprietorships and partnerships, in particular on the succession of SMEs. The Commission services will soon publish a Communication with updated information regarding the transfer of enterprises and related tax problems in order to prepare the ground for new initiatives in this field. Finally, there are currently a variety of measures under way in order to address the particular problems of SMEs in the area of value-added tax. In particular, the Commission initiative on the 'one-stop-shop' concept will make it much easier for SMEs to expand in the Internal Market as they will be able to deal with their VAT obligations at one single point of registration only⁵⁴. It follows that **from a SME perspective company taxation remains the single biggest Internal Market tax problem which is so far not being addressed at EU level.**

3.5. Evaluation of the effects of the company tax obstacles

Given the lack of data on SMEs as regards their taxation as well as the limitations of economic modelling, providing a reliable global estimate of the effects of company tax obstacles to SME participation in the Internal Market is difficult. There are nevertheless numerous qualitative and quantitative indicators revealing that the low participation of SMEs in the Internal Market is among other things caused by the tax obstacles which these companies face in the Internal Market. For instance, the replies by interested stakeholders to a "Questionnaire on corporate tax as barrier to EU expansion of SMEs" published by the Commission services in July 2004 among other things revealed that around one-third of the SMEs in the EU consider **corporate taxation as an important obstacle to cross-border expansion**⁵⁵.

Moreover, the often specific nature of the business activities of SMEs means that they are particularly susceptible to certain cross-border tax obstacles (in particular technology-driven start-up companies). For instance, the limited availability or the unavailability of a

⁵² Commission Recommendation of 25.05.1994 concerning the taxation of small and medium-sized enterprises, OJ L 177, p.1-19; Commission Recommendation of 27.07.1994 concerning the taxation of small and medium-sized enterprises, OJ L 385, p.14-17; Communication on the Commission Recommendation of 7.12.1994 on the transfer of small and medium-sized enterprises, OJ C 400, p.1-9.

⁵³ Commission Communication to the Council and to Parliament on "The improvement of the tax environment of small and medium-sized enterprises", COM(1994)206, OJ C187, p.5-10.

⁵⁴ Proposal for a Council Directive amending Directive 77/388/EEC with a view to simplifying value-added tax obligations; Proposal for a Council Directive laying down detailed rules for the refund of value added tax, provided for in Directive 77/388/EEC, to taxable persons not established in the territory of the country but established in another Member State; Proposal for a Council Regulation amending Regulation (EC) No 1798/2003 as regards the introduction of administrative cooperation arrangements in the context of the one-stop scheme and the refund procedure for value added tax [COM(2004)728].

⁵⁵ For more information on the questionnaire and the replies see above chapter 2 "Procedural issues and consultation of interested parties".

means to offset losses in start-up companies in other Member States not only, as mentioned above, discourages the creation of an establishment abroad, but it also limits the business' access to finance at an essential stage in a company's development life-cycle, which is frequently subject to supply-side constraints imposed by risk-averse financial provision from banks and other financial institutions. This negatively affects the conditions for the survival and the development or cross-border expansion of SMEs. Moreover, due to the smaller business size, high compliance costs are particularly relevant for SMEs and clearly deter many from cross-border expansion.

Furthermore, some features of tax systems tend to favour domestic over foreign activities. For instance, in the domestic context most Member States apply special tax arrangements (fiscal incentives or tax breaks) for self-employed and SMEs that need to be taken into account⁵⁶. These arrangements, which are however usually not geared at cross-border economic activities and the related tax issues, essentially concern the determination of the tax base, flat-rate arrangements and other simplified methods of profit determination. Some Member States also grant specific lower rates. The combination of both effects - the particular importance of cross-border obstacles for SMEs and relief for domestic tax problems - may even increase the hurdle for starting cross-border business for SMEs. Based on an initial qualitative assessment the effects of the tax obstacles can therefore safely be expected to be considerable, with economically relevant impacts.

The consequences of the company tax obstacles and their interplay with other tax and non-tax factors are thus reflected in the above-mentioned statistics on the relatively low participation of SMEs in the Internal Market and supported by economic research. In other words, because of the company tax barriers to cross-border EU activity and in particular the problems to compensate for foreign start-up losses and even more so the disproportionately high compliance burdens, SMEs;

- often refrain from cross-border trade and investments as they are inhibited by the tax problems; or
- prefer purely domestic transactions even when these are inferior in strict economic terms.

When they nevertheless develop activities in other Member States, SMEs are systematically subject to higher compliance and finance costs than larger companies and therefore

- run a higher risk of business failure (altogether and/or of the newly created foreign establishment).

⁵⁶ For a broad overview and an assessment see for instance OECD, Directorate for Science, Technology and Industry, STI Working Paper 2002/9 "Taxation, SMEs and Entrepreneurship" by Duanjie Chen, Frank C. Lee and Jack Mintz.

Given the overall importance of SMEs as key driver in economic growth their reluctance to Internal Market participation and their poor survival rate is not only very costly to the individual business owner/entrepreneur⁵⁷ - it also adversely affects the overall economy in terms of productivity and job creation to maintain low unemployment levels, or tax revenue creation to support public services, both factors being essential to achieve the final goal of social cohesion stated in the Lisbon Council conclusions.

4. POLICY OBJECTIVES

The tax barriers faced by SMEs when they undertake international expansion as described above, can be defined as cost-increasing barriers resulting in market-entry restrictions. The removal of such barriers is a liberalisation policy to be analysed within the framework of the **freedom of establishment**, according to the art. 43 of the Treaty. The manifold, substantial negative economic consequences for SMEs and for the EU that company tax obstacles induce, impeding further potential for growth and employment, calls for policy action in this area to remove such barriers.

The cross-border-specific company tax obstacles mentioned above lead to sub-optimal levels of cross-border investment by SMEs and/or to tax-driven distortions in the allocation of their investments. Thus, tax policy for SMEs in this context should be targeted:

(i) to encourage and increase SMEs' investment and cross-border expansion in other Member States in an improved EU-wide tax environment by removing the relevant company tax obstacles.

(ii) to minimise tax-induced efficiency losses in SMEs' investment allocation choices, that is, to render the tax issue as neutral a factor as possible in SMEs' decisions on where to allocate their investments across the EU.

These benefits can ultimately be expected to materialize, in sufficiently competitive markets, in terms of further economic benefits to consumers.

These constitute the fundamental **general** policy objectives of the measures under consideration below.

⁵⁷ Some insight into the poor survival rate of SMEs may be inferred from the very high attrition rate of firms from the UK ESRC CBR panel survey of UK SMEs. The ESRC CBR panel survey is a UK Economic and Social Research Council (ESRC) funded survey, administered and archived by the Centre for Business Research (CBR), based in the Department of Applied Economics at Cambridge University, United Kingdom.

In operational terms the **specific** goals are:

(i) To encourage SMEs in (further) internationalisation of their activities across the Internal Market (both, SMEs that currently operate only in a domestic context and already international SMEs). Internationalisation processes, however, have to be seen nowadays as a much more diversified business activity than just a mere ambition to sell/buy products in/from foreign markets and it has been argued that more complex forms of internationalisation (ie, the establishment of cross-border subsidiaries) lead to overall better performance of SMEs. Thus, the specific objective is to help SMEs wishing to set up branch/subsidiary businesses in other Member States to replace or complement national production for export with localisation abroad.

(ii) to remove SMEs' tax anomalies where they are specific to cross-border economic activity so that such activity can be undertaken in the Internal Market in the same or at least in a broadly comparable way as in national markets, i.e. by not imposing extra tax compliance costs and discriminatory loss compensation rules to international *versus* purely domestic activities of SMEs.

The achievement of these objectives is subject to several constraints. For instance, any measure taken for achieving these objectives should not at the same time lead to significant revenue shortfalls for Member States, open new major tax fraud or avoidance possibilities and/or compromise tax administrations' control possibilities of SMEs. All these effects would adversely affect the achievement of the overall economic and social benefits sought in the first place.

5. OPTIONS FOR REMOVING THE INTERNAL MARKET COMPANY TAX BARRIERS FOR SMEs

5.1. Earlier ideas and initiatives

A number of ideas and proposals for tackling the tax obstacles to SME cross-border expansion have already been developed even before the creation of the Internal Market. For instance, the Ruding report⁵⁸ examined the possibility of allowing businesses which are subject to personal income tax an option of taxation as if they were incorporated. This would reduce the distortions resulting from differing rates of corporate tax and income tax and open broader possibilities for the transfer of losses cross-border. These ideas were not taken up by Member States.

The above-mentioned Commission study of 2001 and the two subsequent Commission Communications have analysed various possibilities for addressing the specific Internal

⁵⁸ European Commission (1992): "Report of the Committee of Independent Experts on company taxation" (Ruding Committee).

Market tax problems of SMEs. Given that high compliance costs constitute one of if not the most important SME cross-border tax problem, particular attention was paid to possible Community actions in this area. Among the solutions considered were a simplified and uniform tax return and simplified bookkeeping rules for SMEs which they could file throughout the EU and the standardisation of formal and procedural requirements (similar filing dates, similar penalty regimes and a similar basis for charging interest on late payment, etc). Such action would have been in line with the ideas for moderating the administrative complexity relating to permanent establishments of SMEs (e.g. building sites) of the Commission Communication on the improvement of the tax environment of SMEs⁵⁹.

Similarly, thought was also given to the specific approach taken in many double taxation treaties which provides for generous transitional periods under which building and assembling companies can operate abroad without creating a permanent establishment. Such rules could be extended generally to SMEs which would then have more opportunities to familiarise themselves with the tax situation in the foreign country. The underlying idea of such an approach is that SMEs, given the choice, would want to start a new business establishment abroad on the basis of the legislation and tax system of their home country and then find their way gradually around the arrangements in the other country (learning by doing). In an initial phase, companies should thus have the possibility to fulfil their tax obligations, solely vis-à-vis the tax authorities of the Member State in which they have their head office, even if they operate in another Member State. Accounting, declaration and payment obligations would continue to apply solely in the home State.

As regards the issue of loss-compensation and in particular start-up losses, various possibilities to address this problem were considered. Some of the domestic solutions found in Member States were already considered by the Commission in 1994⁶⁰ (e.g. build up of reserves to meet future losses). However, it was concluded that at that time none of them was suitable for general application at EU level. A further idea that was considered was to exempt profits from tax for a limited starting period, for instance in the first two to five years. The deferred tax could then be spread over subsequent years.

⁵⁹ Commission Communication to the Council and to Parliament, 'The improvement of the tax environment of small and medium-sized enterprises' COM(1994)206, OJ C 187, pp.5-10.

⁶⁰ Commission Recommendation of 25.05.1994 concerning the taxation of small and medium-sized enterprises 94/390/EC, OJ L 177, pp.1-19.

5.2. Available options

The following policy options have been examined:

- No policy change
- Simplification and EU-wide standardisation of company tax filing and bookkeeping rules for international transactions
- Directive on cross-border loss-offset
- Direct subsidies by Member States/State Aid
- Home State Taxation pilot project

5.3. Initial screening

The policy options have been screened in order to determine which of them would be best suited to address the above-described tax obstacles to an economically desirable increased participation of SMEs in the Internal Market and tackling the company tax problems for SMEs to set up establishments in other Member states.

No policy change

If no specific action was taken to remove the specific SMEs tax obstacles in the Internal Market, the existing company-tax induced reluctance of SMEs to participate in the Internal Market would remain and the related economic potential would be continued to be foregone. One could argue that no specific action for the tax problems of SMEs is necessary as general measures for tackling the tax obstacles faced by all companies, regardless of their size, are under way. This is however not convincing. First, this was the approach followed in the past and the result is that larger enterprises benefit at large from the Internal Market while SMEs do not. Second, the pace of progress with these general measures is slow. Many of these are also of particular interest to larger companies, e.g. the improvement of the EU company tax directives on mergers⁶¹ and intra-group payments of dividends⁶² and interests and royalties⁶³. Similarly the long-term plans for a common consolidated EU tax base will mainly benefit large groups of companies⁶⁴. No policy change is therefore not an acceptable option.

⁶¹ Directive 2005/19/EC.

⁶² Directive 2003/121/EC.

⁶³ Directive 2003/49/EC; proposal COM(2003)841; Directive 2004/66/EC.

⁶⁴ See

http://europa.eu.int/comm/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm
for more information on the Common Consolidated Corporate Tax Base project.

Simplification and EU-wide standardisation of company tax filing and bookkeeping rules

A simplified and uniform tax return and simplified bookkeeping rules for small and medium-sized enterprises which they could file throughout the EU would constitute an enormous help for the businesses concerned and automatically reduce their compliance costs. Consideration could also be given to the standardisation of formal and procedural requirements (similar filing dates, similar penalty regimes and a similar basis for charging interest on late payment, etc).

However, if one examines the possible simplification and EU-wide standardisation of company tax filing and bookkeeping rules in the light of the preceding analysis of the tax problems of SMEs in the Internal Market and their economic effects, it appears that most of this approach, however useful it could be, falls short of addressing these tax obstacles in a comprehensive manner and could hardly be expected to have a noticeable remedial effect beyond individual cases. It would only address one aspect, that of formalities concerning filing and accounting obligations, of only one of the tax obstacles, that of disproportionate compliance costs.

Moreover, it is extremely doubtful that Member States' tax administrations are prepared, or in a position, to follow this approach as many of these formal obligations follow from national public laws that are not harmonised and fall largely outside the EU's competence. For instance, the issue of cross-border loss-offset and the peculiarities of creating foreign establishments (e.g. a subsidiary) would not be addressed. The simplification and EU-wide standardisation of company tax filing and bookkeeping rules is therefore no acceptable option.

EU initiative on cross-border loss-offset

The lack or problems with cross-border loss-offset in the EU constitute a general problem which concerns all size-classes of companies. The Commission intends to tackle this issue anyway by tabling an appropriate initiative, possibly a proposal for a directive. One could argue that this initiative would automatically also address one of the key issues hampering SMEs in the Internal Market. However, it would do so only in a partial way, as it would leave issues like disproportionate compliance costs untouched. Moreover, past Commission attempts in this area were not successful and while that may change in the future, not the least in the vein of expected ECJ decisions in this field⁶⁵, there is no reason to believe that a future cross-border loss-offset will be so simple and direct that SMEs will consider it as an encouragement to overcome their hesitance for creating foreign establishments. An initiative directive on cross-border loss-offset, which is generally extremely useful, is therefore no option for fully addressing the problems under consideration.

⁶⁵ e.g. in the Marks&Spencer case on cross-border loss-offset [C-446/03].

Direct subsidies by Member States/State Aid

Given the unanimity requirement in EU tax matters thought could be given to address the tax obstacles of SMEs by using a non-tax instrument, for instance that of targeted subsidies in order to encourage cross-border expansion of SMEs. Moreover, at EU-level SMEs are subject to specific State Aid rules (exemption regulation⁶⁶), which is why potential competition problems in this respect could probably be avoided in the design of the rules. Apart from this legal issue it must be underlined that such a solution would at best compensate for the tax obstacles but not resolve them. This does not seem to be an efficient way forward. Moreover, it will be difficult to quantify the necessary compensation for the subsidy. Direct subsidies by Member States or the provision of State Aid is therefore no suitable option for tackling the specific company tax problems of SMEs in the Internal Market.

Home State Taxation pilot project

The approach of Home State Taxation (HST), which was originally not particularly targeted at SMEs⁶⁷, could be applied specifically for this group of companies in a pilot project. Under a HST-regime a company that does business in more than one country could calculate its taxable profits in all countries according to the rules in its home country. The taxable income would then be apportioned between the countries according to some key (e.g. turnover, payroll or other) and each of the countries would apply its own tax rate to its apportionment of the profit.

The Home State Taxation approach is based on the principle of mutual recognition and as such fully respects the principles of subsidiarity and proportionality. A Commission Communication to this effect could be taken up by Member States and adapted to possible regional specificities. Moreover, it could be implemented relatively quickly, for instance by using the instrument of tax treaties. Its application to SMEs is supported by the European Parliament⁶⁸ and the European Economic and Social Committee⁶⁹. The business community concerned also endorses this approach⁷⁰. Research by the

⁶⁶ Commission Regulation (EC) No 70/2001 of 12.01.2001 on the application of Articles 87 and 88 of the EC Treaty to State aid to small and medium-sized enterprises; OJ L 10 dated 13.01.2001, p.3.

⁶⁷ The concept of "Home State Taxation" has been developed by Malcolm Gammie and Sven-Olof Lodin as a potential 'tax solution' for the European Company Statute. See Gammie, M. and Lodin, S.-O. (1999): "The Taxation of the European Company", *European Taxation* and Gammie, M. (1998): "Taxation Issues for the European Company", *EC Tax Review*. The authors have continuously elaborated the approach and published a complete book on it: Lodin, S.-O. and Gammie, M. (2001): *Home State Taxation*, IBFD Publications, Amsterdam.

⁶⁸ Report on the Commission Communication to the Council, the European Parliament and the Economic and Social Committee on "Tax policy in the European Union – Priorities for the years ahead" (COM(2001) 260 – C5-0597/2001 – 2001/2248(COS)).

⁶⁹ Opinion ECO/127.

⁷⁰ See for instance the UEAPME press release dated 11.06.2004 and the Summary Report on the outcome of the Commission services' consultation of interested parties on *The experimental*

Commission services, independent research institutes and academics⁷¹ confirm its potential to effectively address the tax obstacles of SMEs in the Internal Market. Given that the application of 'home state' tax rules also to foreign activities of a SME reduces tax-induced compliance costs and usually makes sure that losses can be directly offset against profits, Home State Taxation is a suitable, measured and at the same time comprehensive option to tackle the tax obstacles faced by SMEs wishing to expand within the Internal Market.

Definition of pilot scheme

There are various possibilities to define precisely the meaning of 'pilot project'.

- First, 'pilot scheme' could mean a purely theoretical exercise in which some selected businesses and the responsible tax administrations re-calculate the hypothetical effects of applying home state tax rules to international business activities (taxable income, tax liability, revenue effects, etc).
- Second, the tax administrations of the interested Member States could select a sample of appropriate "model companies", perhaps including only those active in border regions and allow them – on a reciprocal basis – to carry out their business in other Member States or perhaps only the neighbouring country under the tax rules of their home country. This approach would limit the revenue consequences for Member States and allow tax administrations to gather valuable *practical* experience with the approach in a manageable but not very resource-intensive way. This approach of selecting a sample of "trustworthy" businesses/model companies for establishing, for instance, information needed for general tax audits (e.g. average profitability figures in specific industries) appears to be common practice. Thus, the experiment would be limited to a handful of sample model companies.
- Third, one could opt for a very broad understanding of 'pilot scheme' and provide for a general implementation of HST to appropriately defined SMEs (and subject to additional technical conditions).

In the public consultation held on the pilot scheme idea (see chapter 2 above) a majority of contributions argued in favour of a real-life test approach for the pilot scheme since a purely theoretical exercise could miss problem areas and practical implementation issues. However, theoretical simulations on the economic effects could still constitute a useful first step or deepen the theoretical foundation of the approach. Many respondents to the consultation recommended a broad pilot scheme to ensure a representative sample of participating companies and favoured a scheme which would allow all companies in a

application of "Home State Taxation" to small and medium-sized enterprises in the EU [February - June 2003] mentioned above (chapter 2).
⁷¹ *ibidem*.

Member State with a business also in the co-operating neighbouring state, identified as an SME according to the special criteria set up, to participate.

The Commission services agree with these views. Only a practical test which is in principle open to all enterprises meeting the relevant conditions and requirements will provide the desired experience with HST which lies at the heart of the pilot scheme idea. Moreover, a restricted pilot would risk creating new discrimination issues.

The basic concepts of Home State Taxation

The basic concept and the fundamental objective of the HST pilot scheme are very simple: to tackle the tax obstacles encountered by SMEs when they operate in other EU Member States in addition to their own (home state) by granting them the possibility to apply the well-known corporate tax rules of their home state only. The key points of an appropriate pilot scheme as developed over the last years taking into account the contributions from academia, SME federations and individual enterprises as well as tax administrations can be summarised as follows:

Table 5: Key points of the Home State Taxation pilot scheme for SMEs

- **Basic approach:** Under the pilot scheme, SMEs active in more than one Member State can compute their taxable income (tax base) according to the rules of the system of the Home State of the 'parent company' (lead company or head office) only.
- **Tax rates:** Each participating Member State continues to tax at its own corporate tax rate its share of the profits of the group's business activities in that State.
- **Which SMEs:** Either small and medium-sized enterprises or, if need be from a Member States' perspective, only small enterprises in the official EU definition of SMEs can participate in the pilot scheme.
- **Who is part of the group:** The group of businesses included for the SME in the scheme is defined on the basis of the 'Home State' minimum participation rules for group taxation.
- **Partnerships** are not included in the scope of the scheme unless the tax administrations concerned agree on a specific individual request.
- **Timeframe:** The pilot scheme runs for at least 5 years (e.g. 1 January 2007 – 31 December 2011).
- **Sectors of economy:** Specific sectors which are subject to separate tax rules are not included in the pilot scheme (e.g. shipping, agricultural activities, etc).
- **Which taxes:** Taxes other than corporation taxes are in principle not included in the scope of the scheme. However, Member States could continue to apply national (profit-related) surcharges on the corporate tax or corporate tax base as established under the conditions in the pilot scheme.
- **Which is the Home State:** The "Home State" of a participating SME-group is defined as the country of tax residence of the parent company (or headquarter), if need be with the help of the usually applicable tiebreaker rules.
- **Administrative rules:** The pilot scheme includes specific anti-avoidance rules and provisions for special cases (e.g. change of ownership; business expansion, business fluctuations, etc).

- **Tax assessment and payment:** Participating companies will self-assess, report and pay the local tax but the calculation of the combined profits of the group will only need to be filed by the parent company in the Home State. The other tax administrations concerned receive copies.
- **Allocation formula for tax base:** The tax base as established on the basis of the Home State rules is apportioned on the basis of a simple formula (e.g. payroll and sales at 50% each) among the Member States concerned. A common allocation mechanism is assumed for all participating SME-groups.
- **Third country income** of group members falls outside the scope of the scheme and is added to the income of the group member after apportionment.
- **Tax audits** would be carried out by the Home State authorities, if need be jointly with the partner administration. The general rules for mutual assistance in the EU would apply.
- **Monitoring:** Commission and Member States may create a monitoring group for supervising the pilot scheme, considering possible practical problems and assessing its success.

5.4. Conclusion of initial screening of options and policy choice

It follows from the foregoing analysis that among the available options for tearing down the specific Internal Market corporate tax barriers for SMEs only the approach of Home State Taxation could achieve the intended result and should therefore be pursued further in a "real-life" pilot scheme which would be open to all qualifying SMEs.

6. IMPACT ANALYSIS

The following analysis sets out the key elements of the HST option and examines its expected economic, social and environmental impacts. The objective is twofold: on the one hand, to explain qualitatively in more details, the channels, both in terms of firms' behaviour and general expected effects, through which the HST may remove the Community's tax barriers faced by SMEs willing to establish their activity in the Internal Market. On the other hand, when possible, quantitative estimates of the various possible effects are presented⁷². All in all, the entire exercise provides some idea of the overall possible economic, social and environmental impact of this policy.

6.1. Economic impact assessment of the Home State Taxation option

The economic impact assessment is undertaken below by analysing the possible effect of the HST pilot project on various driving forces and economic agents:

- First, the actual effect of the HST measures on SMEs is analysed: both for internationally active SMEs and for SMEs that currently only operate in a

⁷² However, given the difficulties in obtaining the relevant data for such evaluation, the possibilities for providing useful quantitative estimates are very limited and the actual quantitative estimations presented only have to be taken with care.

- domestic context but may be pushed to internationalise their activity, following the reforms.
- Second, the transmission of the effects of improved cross-border establishments into the economic situation of host and home Member States and the indirect effects into consumers' welfare are analysed (the economy-wide impact assessment of HST).
 - The potential revenue and cost effects of HST measures for the Member States' national tax administrations.

6.1.1. The impact of HST on SMEs

In this section, the possible effects of HST on SMEs are analyzed:

- The HST pilot project directly benefits existing multi-national SMEs: First of all, it is without doubt that HST benefits the SMEs that currently have cross-border establishments in Member States other/s than that of the parent company. The benefits for these enterprises will comprise improved loss compensation and lower tax compliance costs. Sections 6.1.1.1 and 6.1.1.2 below give a qualitative assessment and a quantitative estimate of the extent of these benefits for currently internationalized SMEs. The final effect of these benefits should be to increase productive investments by international SMEs and to further improve their allocation of resources.
- In addition to benefits for existing multi-national SMEs, the removal of tax barriers by HST measures may also affect the decision by companies to start new activities cross-border (i.e., new cross-border holdings in foreign subsidiaries, foreign direct investment, new foreign branches, etc). This applies both to companies already operating cross-border wishing to expand to other Member States but equally well, and more importantly, to companies so far operating in a domestic context only. Section 6.1.1.2 highlights the main issues that come into play when a company decides whether to start activities cross-border. In particular, the way in which the reaction of these companies may be affected by HST will be discussed.

6.1.1.1. The impact of HST on already existing international SMEs

To gain an idea of the characteristics of the first economic agents affected by the HST pilot project, ie existing international groups of SMEs in the EU, information from the above-mentioned "*Internationalisation of SMEs*" report is used here to analyse the impact of this policy⁷³:

⁷³ Other characteristics of existing international groups of SMEs (for example, average number of domestic or foreign subsidiaries, main locations for EU-based SME parents' foreign investments in

–The report alleges that foreign supply relationships are the most common form of internationalisation, being the case for 30 % of all SMEs. The second most prevailing form of internationalisation is exporting, undertaken by 18% of SMEs. 3% of the surveyed SMEs have collaborative relationships primarily with foreign SMEs, whilst another 3% have established foreign subsidiaries or branches. It is the latter SMEs' group that will be mainly affected by the HST measures and its resulting removal of tax barriers.

–The report also shows that there are differences in the likelihood of becoming international within groupings of SMEs according to the size of the enterprise: larger SMEs are more often involved in some form of internationalisation than smaller ones. Also larger SMEs more often have subsidiaries or branches abroad or are involved in more than one form of internationalisation (approximately 12% of micro, 28% of small and 45% of medium-sized enterprises have forms of internationalisation such as a subsidiary, branch or joint venture abroad **or** a combination of more than one form of internationalisation). Therefore, in general large SMEs (50-249 employees, of which around 230.000 exist) are the most likely to be affected by the HST measures.

–The report also shows that smaller countries are more internationalised: whilst for most European countries a mere 1-4 % of the SMEs have established subsidiaries abroad, in small countries with more open economies (ie, Luxembourg, Austria) this percentage may go up to nearly 10%. Therefore, existing SMEs set in these countries may be relatively more likely to be affected by HST measures (as compared to SMEs in other EU Member States), since a higher proportion of them are parent companies with foreign subsidiaries.

–Regarding the sector implications, the form of internationalization of SMEs that may be affected by HST measures (e.g. SMEs with subsidiaries and branches abroad) is most frequent within manufacturing and wholesale (around 30% of SMEs in these sectors have subsidiaries abroad or more than one form of internationalisation). Within these two sectors and transport/communication, the percentage of SMEs that have subsidiaries abroad or more than one form of internationalisation is actually higher than the percentage that merely has a foreign supplier or exports as isolated forms of internationalisation. Thus, these are the sectors more likely to be affected by HST measures, as regards the already operating international groups of SMEs.

The next two sections try to quantify the two types of direct cost savings effects that the HST scheme would grant to SMEs already operating internationally *via* cross-border subsidiaries and branches: that is, estimates of the potential cross-border loss compensation that could occur under HST *and* of the reduction in tax compliance costs

form of foreign subsidiaries, etc) have been shown above in Section 3, from analysis of the AMADEUS database.

for these internationalised SMEs are provided⁷⁴. The qualitative implications of such saving measures are also discussed.

6.1.1.1.1. The effects of cross-border loss offsetting

One important feature of the HST method is the proposition that profitable SMEs in one Member State may offset immediately possible losses incurred by other company/ies of the same group, held beyond a certain ownership level⁷⁵, in other Member State/s for the purpose of assessing the total tax base.

The qualitative effects of cross-border loss compensation

Currently, the cross-border loss compensation arrangements that are present in the Member States are applicable mostly to domestic subsidiaries or to foreign permanent establishments, whereas few provisions are available to foreign subsidiaries. This biases investments of parent companies towards the home state, affects the form in which international activities are organized and puts investments by taking a degree of control in foreign companies and foreign direct investment (ie, establishment of foreign subsidiaries) at a disadvantage. In economic terms this means that the dissimilar treatment of loss compensation for the different situations is not neutral for firms' decisions and leads to a less efficient allocation of resources. As HST measures allow for a single system of loss compensation to all members of a given multinational SME group (regardless of the location or form of the group member that incurred the losses), ie, the same system of loss compensation applicable to domestic group taxation, it should lead to a more efficient, non tax-biased, allocation of resources through SMEs investments across the EU.

It is worth at this point providing an overview of the current tax treatment of losses in domestic group taxation schemes in Member States, as these would actually be the loss compensation rules applicable to international members of SMEs groups with a parent company in the corresponding Member State. These are shown in following table.

⁷⁴ The numbers presented should be taken with prudence anyway, because of the difficulties in obtaining the relevant data and the number of assumptions necessary to make the estimations.

⁷⁵ The minimum participation thresholds (and other conditions) for members of international groups of SMEs to qualify for the HST scheme, should be those applicable to determine **domestic group membership** for tax purposes in the 'home state' of the parent company. These participation thresholds for domestic group taxation differ from Member State to Member State and are the following (for the countries with some form of domestic group taxation): Austria 50%, Cyprus 75%, Denmark 100%, Germany 50%, Finland 90%, France 95%, Ireland 75%, Italy 50%, Latvia 90%, Luxembourg 95%, Malta 51%, Netherlands 95%, Poland 95%, Portugal 90%, Slovenia 90%, Spain 75%, Sweden 90%, UK 75%.

Table 6: Overview of tax treatment of losses in domestic group taxation schemes in MS

No group relief	Intra-group loss transfer	“Pooling” of results of a group	Full tax consolidation ⁷⁶
<ul style="list-style-type: none"> • Belgium • Czech Republic • Greece • Lithuania • Hungary • Slovakia (• Estonia)⁷⁷ 	<p>a) “Group-relief”</p> <ul style="list-style-type: none"> • Ireland • Cyprus • Malta • United Kingdom <p>b) “intra-group contribution”</p> <ul style="list-style-type: none"> • Latvia • Finland • Sweden 	<ul style="list-style-type: none"> • Denmark • Germany • Spain • France • Italy • Luxembourg • Austria • Poland • Portugal • Slovenia 	<ul style="list-style-type: none"> • “fiscale eenheid” in the Netherlands
No loss compensation available, i.e. a group of companies is disregarded for tax purposes	Every group member is taxed separately; losses may be transferred on a definitive basis from one group member to another	Each group member determines its tax base which is then pooled at the level of the parent company	Legal personality of each group member is disregarded for tax purposes, the result of the subsidiaries are treated as if realized by the parent company

There are seven countries that do not provide any form of group-relief of losses in their domestic cases. As the idea of HST is that the domestic tax rules of the 'home state' of the parent company would apply to EU-wide activities of the group, the international groups of SMEs whose parents are established in those countries will not have access to cross-border loss-offsetting (just as purely domestic groups in those countries do not have group loss compensation available).

International groups of SMEs whose parents are established in all other countries will have access to some form of group cross-border loss compensation under HST: either

⁷⁶ The term “consolidation” in its original meaning is used in accounting for the aggregation of the individual financial statements of all group members with elimination of all intra-group transactions affecting the profit and loss account.

A “genuine tax consolidation” as used for Dutch tax purposes means the aggregation of all individual pre-tax results of group members with elimination of all intra-group transactions; the tax base is the overall net result of the group. Genuine tax consolidation therefore is only applicable within the framework of one single tax base.

The term “pooling” is used for the aggregation of individual tax results of various group members without the elimination of intra-group transactions being a prerequisite. The term “pooling” therefore also includes a genuine tax consolidation. The term “pooling” is consequently only used in reference to one single tax base.

⁷⁷ Due to the particular features of the Estonian tax system which defers taxation until distribution of profits, no consolidation is necessary – loss must have been set-off against profits, because otherwise no profit distribution and thus taxation is possible.

intra-group transfer of losses, or 'pooling' of results at the level of the parent company or full tax consolidation (with elimination of all intra-group transactions of all members of the international group). All these methods when applied domestically (and so would be in international cases) provide for a vertical (i.e. between parent and subsidiary) and horizontal (i.e. between subsidiaries) loss-compensation throughout the group.

The possibilities of cross-border loss compensation represent a financial advantage for businesses, which is estimated below. Also, allowing the offsetting of losses in start-ups/early-stage companies outside the Home State may provide greater access to finance at an essential stage in a company's development life-cycle, lessening supply-side constraints imposed by risk adverse financial provision from banks and other financial institutions.

A quantitative estimate of the potential losses that could be compensated by existing international SMEs under HST

The investigation into the potential amount of losses that could be compensated under HST was done through an exercise using the AMADEUS database. In order to quantify the total amount of losses that could be compensated under HST the following steps are taken as part of such an exercise:

- (1) Out of the 7145 international groups of SMEs in the database shown in table 2, 2077 of them have parent companies set in 'home states' with appropriate intra-group loss-offsetting rules⁷⁸ and present the relevant information for an estimation of cross-border loss compensation: that is, profits/losses of the parent company and at least one cross-border subsidiary of each group⁷⁹. The distribution of this sample of 2077 international groups of SMEs with actual profits/losses information and with cross-border loss compensation possibilities as available in the 'home state', and their HST-qualifying subsidiaries⁸⁰ (6632 in total, ie an average of 3.2 HST-qualifying subsidiaries in the sample), is reported in table 7 by countries of the parent companies.
- (2) Next, the profits/losses of the parent company and subsidiaries of each group are extracted and, on a group-by-group basis, it is calculated whether the full amount of potential losses of some group members can be compensated against the profits of other cross-border group member/s, for each international group of SMEs in the sample. Cross-border loss relief in these calculations is allowed both vertically (ie, downward when losses of the parent company are compensated against profits

⁷⁸ Thus, international groups of SMEs with parents established in the seven countries that do *not* allow domestic group relief of any kind, are ruled out from the exercise that estimates potential HST-driven cross-border loss compensation.

⁷⁹ Profits/losses information is complete for about 70% of the companies making up the groups in this sub-sample.

⁸⁰ That is, subsidiaries qualify for HST in the exercise by application of the corresponding home state minimum participation thresholds for domestic group taxation.

of subsidiary/ies located in another Member State or upward when losses of a foreign subsidiary are offset against profits of its parent company, located in another country) and horizontally (ie, compensation across subsidiaries of the same group, respectively located in different Member States)⁸¹.

- (3) After mapping subsidiaries to parent SMEs companies' profits/losses of each group of multinational SMEs and analysing the possibilities of cross-border loss compensation for each group –up to a maximum of positive profits elsewhere within each group–, the estimates of possible cross-border losses that can be compensated under HST, that would not exist in general without HST measures, are reported aggregated by Member State of the parent companies in the last columns of table 7. In order to handle representativity concerns over the sample, the total amount of cross-border compensated losses is weighted by country by reference to the assumed true weighting factor described above in table 2, in order to replicate the assumed real distribution of international groups of SMEs by country. The seven countries where domestic tax legislation does not provide any form of domestic group loss relief would extend this system to international groups of SMEs with parent companies located in those territories and therefore show no cross-border loss compensation available under HST.

Table 7 reflects the main figures resulting from this exercise calculated for this sample of the database for the years 2003 and 2001, aggregated by Member State. The following insights can be obtained from these results:

- The total (weighted) amount of prospect cross-border loss compensation for this sample of international groups of SMEs (with parents set in countries with appropriate loss offsetting rules), which did not exist before HST, is about 190 and 275 million euros for the years 2003 and 2001 respectively. Since the sample represents approximately 8% of total SMEs in the EU (about 2 millions SMEs out of 23 millions) we can estimate, under the assumption of accurate representativity of this sample, **the possible total amount of the potential losses that could be compensated under HST for existing international groups of SMEs in the order of 2.4 to 3.4 billion euros per annum** (ie 12,5 times the sample size), depending on the years.
- Although not shown in table 7, it has been computed that this estimated amount of cross-border losses that can be compensated under HST and that would not exist without this policy, represents an average of around **10% of the total losses of the international SMEs groups** considered in this sample of groups

⁸¹ In a proper application of the HST mechanics, the calculation of profits and losses of each group member would be done under the single set of tax rules of the 'home State' of each parent company, whereas in this exercise profits and losses of each member of international groups of SMEs are reported according to the tax rules of the particular State where each company resides (i.e., the data provided by the database) and calculations are made accordingly. This can be therefore a source of certain mismatch with a real case situation.

with cross-border information of profits/losses and with parent companies set in Member States with appropriate group loss offsetting rules.

- The results also show that an average of **30% to 40%** (depending on the years) **of the existing international SMEs groups could benefit from the HST cross-border loss compensation possibilities** (ie, total number of groups in which cross-border loss compensation is actually reported *versus* total number of groups with cross-border information in the sample).
- The estimated amount of immediate savings in tax payments for existing international SMEs in the EU is obtained by multiplying the roughly 3 billion euros by the average effective top statutory tax rate on corporate income in the EU-25 which was 28.7% in 2003⁸². This results in estimated **immediate savings in tax payments equal to around 860 million euros** which compares with 220 billion euros in corporate tax revenues in the EU-25⁸³.

This figure should not be understood, however, as a net HST-induced loss of tax revenues for the tax authorities. If the losses that are reported by the subsidiaries with cross-border parents (or by parents with cross-border subsidiaries) can currently be carried forward to future profits -or carried back to profits made in the past-, then this implies that part of these losses can be compensated already in the absence of HST. Thus, HST would only affect the *timing* in which the offsetting can be made, allowing an immediate compensation, instead of waiting for the conclusion of future potentially profitable fiscal years. This is financially advantageous to the companies, as it implies *present* savings *versus* potential future reductions in tax payments (ie it is a financial advantage reducing the tax bill in 1000 euros today instead of reducing it in 1000 euros in say 5 years). For example, an SME company that can currently carry its losses forward would gain by being able to compensate its losses immediately under HST because it could derive interest income from the reduction in tax revenues *today* instead of *tomorrow*. Therefore, the real quantitative advantage of HST for the companies that could carry forward their losses should be calculated as the difference between the present savings in tax payments (under HST) and the present value of the stream of future tax reductions (under carried forward of losses provisions).

⁸² European Commission (2005): "Structures of the taxation systems in the European Union", DG Taxation and Customs Union.

⁸³ Calculations based on 2003 New Cronos data.

Table 7. Cross border loss-compensation estimations under HST

	Groups with cross-border information			Nr of groups with cross-border loss compensation		thousand euros cross-border loss-compensation for groups with cross-border information			
	SMEs parents cos. in MS	HST-qualifying subsidiaries of the SMEs parent cos in MS	Total nr of cos. of groups with cross-border information			Unweighted		Weighted	
				2003	2001	2003	2001	2003	2001
AT	6	26	32	2	1	90	221	1115	2739
BE	-	-	-	-	-	-	-	-	-
CY	1	1	2	0	0	0	0	0	0
CZ	-	-	-	-	-	-	-	-	-
DK	160	474	634	58	38	15773	7822	4386	2175
EE	-	-	-	-	-	-	-	-	-
FI	35	72	107	9	9	913	1114	646	788
FR	346	937	1283	133	120	34085	31200	27500	25173
DE	22	44	66	4	7	482	1937	16338	65656
EL	-	-	-	-	-	-	-	-	-
HU	-	-	-	-	-	-	-	-	-
IE	81	274	355	27	25	4492	2399	1518	810
IT	174	328	502	71	51	35501	55051	84959	131745
LV	2	2	4	2	0	65	0	166	0
LT	-	-	-	-	-	-	-	-	-
LU	0	0	0	0	0	0	0	0	0
NL	199	1061	1260	76	65	13890	16213	6672	7788
MA	0	0	0	0	0	0	0	0	0
PL	1	1	2	1	1	6	38	507	3208
PT	13	34	47	4	5	723	275	4320	1643
SK	-	-	-	-	-	-	-	-	-
SI	0	0	0	0	0	0	0	0	0
ES	165	381	546	57	55	6936	5496	11512	9122
SE	407	1662	2069	170	138	42347	29902	6211	4386
UK	465	1335	1800	179	154	25482	19486	22904	17514
Total	2077	6632	8709	793	669	180785	171154	188754	272747

6.1.1.1.2 The effects of HST on the compliance costs/administrative tax burden of international SMEs

Another important direct effect of the HST proposal is the reduction of tax compliance costs for the SMEs that are already operating cross-border (and for those SMEs that might decide to start up cross-border establishments in the future).

The implications of extra cross-border compliance costs

The above-mentioned "*Internationalisation of SMEs*" report shows that the most frequently cited internal barrier by SMEs to internationalisation is the 'high costs of the internationalisation process'. These costs may include purchasing legal consulting services, the translation of documents, greater travel expenses and higher business and financial risks. By facilitating tax compliance on cross-border activities, some of these costs may be clearly addressed by HST measures, especially as the report also shows that these costs are mostly felt by SMEs with the most complex international activities such as establishments abroad (24%), ie the main group of SMEs targeted by the HST project.

In turn, the most cited external barrier to internationalisation cited in this report is 'existing laws and regulations', typically of the target countries, mentioned by 29% of SMEs with foreign subsidiaries/branches or several forms of internationalisation. It can not, on the basis of this report be concluded to what extent this barrier is related to the differences in national regulations (lack of harmonisation) or to a general lack of knowledge on legal regimes and to what extent it is due to specific difficulties created by existing national regulations. It seems that, in any case, HST measures may provide a relief to the sort of external barriers perceived by SMEs, by providing a single set of rules for the calculation of an international group of SMEs' corporate tax base, which should reduce their total compliance costs.

On the other hand, the European Tax Survey⁸⁴ shows that in the EU SMEs bear higher compliance costs (relative to sales) than large companies. The result that compliance costs are regressive to size is a well established finding in literature on the 'compliance burden'⁸⁵, which shows even more clearly the relevance of targeting the HST pilot project to European SMEs. Also, one UK study⁸⁶ finds that most small businesses operate on the margins of profitability and survival. It suggests that survival is highly elastic with respect to changes in the interest rate on loans, the tax rate on profits and the administrative burden imposed by regulation. Thus, reduction of SME's compliance costs may contribute to their likelihood of survival.

The European Tax Survey also proves statistically that parent companies with a subsidiary, branch or permanent establishment abroad bear higher compliance costs than

⁸⁴ European Commission (2004): "European Tax Survey", *Commission Staff Working Paper*, SEC(2004)1128/2.

⁸⁵ See Cressy (2000) and Chittenden *et al.* (2000).

⁸⁶ Cressy (2000).

parent companies with a subsidiary, branch or permanent establishment in the home State and companies without a subsidiary, branch or permanent establishments. Therefore there is a cross-border element to compliance costs, which the HST proposals may eliminate.

In summary, the preceding analysis suggests that HST, by reducing the tax compliance costs of international groups of SMEs, may affect the costs' structure of firms and may help to remove deterrent factors to the exploitation of the investment possibilities in the Internal Market by SMEs. This reduction of firms' costs should eventually encourage further cross-border investments and allow a better allocation of resources by these enterprises.

A quantitative estimate of the compliance costs reduction due to HST in terms of GDP

Below it is estimated the direct savings in tax compliance costs for existing international groups of SMEs in the EU, attributable to the HST scheme measures are estimated. These estimates have to be taken only with great caution, as the aggregation of data and the simplifying assumptions made, may distort the estimations.

The basis of the quantitative assessment will be the available information from various sources (mentioned below) on cross-border compliance costs, compliance costs as proportion of total corporate tax payments by SMEs, total corporate income tax revenues, etc.

The approach takes as a starting point the possible reduction in compliance costs for cross-border situations that HST may induce. It then estimates the amount of compliance costs as a percentage of taxes paid by SMEs. Combining these figures with the corporate income taxes paid by international SMEs (with subsidiaries abroad) as a fraction of GDP provides an estimate of the direct compliance costs savings as a fraction of GDP for existing multinational SMEs with subsidiaries/branches abroad.

In more detail, in order to quantify the total amount of tax compliance costs that could be saved under HST by existing multinational SMEs, the following steps are taken:

- 1) Estimate the HST-driven percentage reduction in compliance costs for international SMEs: EU companies with subsidiaries abroad (SMEs and large companies) are estimated to spend 26% of VAT and company taxation-related compliance costs on *company taxation compliance costs abroad*⁸⁷. This is the category of compliance costs that HST may reduce. However, there are reasons why the HST-driven reduction in compliance costs could be higher or lower than this percentage. For example, the HST pilot scheme does not fully eliminate all compliance costs abroad because there will always be a minimum amount of compliance requirements. On the other hand, for international SMEs the compliance burden could be disproportionately high, suggesting an even higher share of foreign company taxation compliance costs and therefore higher savings

⁸⁷ European Commission (2004): "European Tax Survey", SEC(2004)1128/2.

for these enterprises following the application of HST. Balancing the different arguments we assume that on average the HST proposal reduces total compliance costs of existing international SMEs by **20%** (ie, 20% is the percentage of total compliance costs born by international SMEs assumed to be potentially saved due to the reduction in *company taxation compliance costs abroad* granted by HST).

- 2) Estimate the percentage of total compliance costs as a proportion of the corporate tax bills for SMEs: Relatively few estimates are available for the percentage of compliance costs as a proportion of corporate tax payments for SMEs⁸⁸. Based on the available evidence, compliance cost-to-tax payments of 15% to 30% can be considered. The estimations carried out for a prudent **15%** assumption on this figure are reported below.
- 3) Estimate the percentage of the corporate tax bills of international SMEs as a proportion of EU GDP: To derive an estimation of this figure, several sub-percentages are used:
 - The average percentage of corporate income taxes on EU-25 GDP, which amounted to 2.7% in 2003⁸⁹.
 - The percentage of total taxes on profits attributable to SMEs (versus large companies). This figure is estimated from the taxes on profits in the BACH Database, which collects data for six industrial sectors and seven countries (Austria, Belgium, France, Italy, Netherlands, Portugal and Spain). According to this database SMEs contribute 33% of the total taxes on profits (compared to 67% for large companies). Thus, the figure of 33% is taken as approximating the percentage of revenues obtained from taxing SMEs' profits in the EU-25, which combined with the figure of the previous point implies that around 0.9% (= 2.7% * 33%) of EU GDP are revenues from corporate income taxes paid by SMEs.
 - Still, the previous 0.9% refers to the percentage of tax revenues of *all* SMEs on EU GDP, whilst HST would only affect the tax compliance costs of international SMEs with international establishments like subsidiaries abroad. Estimates of the percentage of corporate taxes paid by these particular international SMEs on total tax payments of SMEs, which is our sought figure at this stage, do not exist to our knowledge. Then, below it is simply assumed that as 3% is the proportion of SMEs with subsidiaries abroad, 3% is also the proportion of corporate taxes paid by international SMEs on total SMEs

⁸⁸ See European Commission (2004): "European Tax Survey" and Slemrod, J. and Venkatesh, V. (2002): "The income tax compliance costs of large and mid-size businesses", Report to IRS LMSB Division submitted by the Office of Tax Policy Research, University of Michigan Business School.

⁸⁹ See European Commission (2005): "Structures of the taxation systems in the European Union", DG Taxation and Customs Union.

corporate tax payments (which is, admittedly a rather simplistic assumption). Combined with the previous figure, this implies that **0.027%** (= 0.9% * 3%) of EU GDP are revenues from corporate income taxes of international SMEs with subsidiaries abroad.

With all this information, the direct costs savings due to the HST simplification of the administrative burden for current international SMEs with cross-border subsidiaries is calculated as a percentage of EU GDP. **The quantitative compliance costs savings estimate, under the most conservative assumptions, equals 0.00081%⁹⁰ in terms of EU GDP, which amounts to approximately 70 million euros per annum for the EU-25.** By varying the assumptions on the percentages used to more pessimistic or optimistic approaches, it is easy to carry out a sensitivity analysis for the quantitative estimate presented.

In addition to these direct effects on cost savings, medium term effects of the HST proposal can be tentatively estimated. A Dutch study on administrative burdens⁹¹ based on a general equilibrium model, shows that a reduction of the administrative burden on companies by 0.9% expressed in terms of GDP increases GDP by 1.7% in the long term (when taking R&D spillovers into account). Under the given assumptions and if the same ratio of transmission effects could be translated to the EU-wide economy, this would mean a non-negligible **increase in EU GDP equal to 0.00153% in the long term due to the HST-driven tax compliance costs reduction of existing international groups of SMEs.**

6.1.1.2. The effects of HST on the decision of domestic SMEs to start new cross-border investments

Besides existing multinational SMEs, the HST project should also benefit the SMEs that currently operate only in a domestic context and push them to internationalise their activity. Internationalisation processes, however, have to be seen nowadays as a much more diversified business activity than just a mere ambition to sell/buy products in/from foreign markets. Thus, this policy proposal is in particular directed at SMEs wishing to start new cross-border investments by, for instance, setting up branch/subsidiary businesses in other Member States to replace or complement national production for export with localisation abroad⁹².

⁹⁰ This is calculated as the product of 20% (ie, estimated reduction in compliance costs for international SMEs with cross-border establishments) times 15% (ie, estimated proportion of compliance costs on the corporate tax bills of international SMEs) times 0.027% (estimated tax revenues from corporate income taxes of international SMEs with subsidiaries abroad on EU GDP).

⁹¹ Tang, P. and Verweij, G. (2004): "Reducing the administrative burden in the European Union", *CPB Netherlands Bureau for Economic Policy Analysis*, CPB Memorandum.

⁹² Companies can set up establishments abroad for a variety of reasons and in different forms. For example, they can set up sales offices in other Member States to serve the local markets better. Otherwise, they can set up a production facility to produce a final product and sell it to the market

Despite the benefits that may be obtained from international activities, almost 60% of the non-internationalised SMEs in the ENSR 2003 Enterprise Survey⁹³ have not even considered internationalising. That is, a large number of SMEs operate only in the local market. Possibly, in a considerable number of cases, these non-international SMEs have no wish whatsoever to engage in international activities: their decision may be based on their belief that the domestic demand is sufficient, their consideration that internationalisation is irrelevant for their line of business, or a lack of ambition to grow beyond a certain size or beyond the domestic market, etc. However, in other cases their hesitation might be based on existing barriers and not a lack of interest or opportunities. It is the business conditions of this latter group of SMEs, with stated aims of expanding into other EU States, which is targeted by the HST project, in particular insofar as their decision might be biased by tax considerations.

The measures of the HST project may motivate these companies to go international, as the elimination of tax-barriers affects the trade-off between the benefits and costs of internationalisation they face. The costs and benefits of setting up establishments abroad, which companies balance when considering changing their domestic setting into an international one, are briefly revised below, as well as the possible impact of the HST scheme on them.

The benefits may consist, in the first place, of increased access to markets which can involve trade costs savings. Other benefits lie in the strategic advantages offered by establishing cross-border activities⁹⁴. A SME could decide to locate establishments close to cross-border competitors to have easier access to information and technologies. The decision to become international is therefore not merely motivated by a potential to increase sales, but it is an important means of gaining know-how and insight into new useful technologies⁹⁵. Other important benefits that cross-border establishments can provide are input factor cost savings (minimisation of labour costs or cheaper access to finance in foreign capital markets) and/or specialised sub-suppliers. Internationalisation

in that country or export it to other Member States. They can also choose to produce an intermediate product and import it back to the country of the parent company. If companies produce a number of different products they can produce them in different Member States for export to another group of Member States or countries outside the EU. This proves that the creation of subsidiaries abroad might not merely be a question of getting a sales platform for the company's products. Foreign subsidiaries can just as well be a platform for access to cheap labour (e.g. via sub-suppliers) or access to know-how, knowledge and technology.

⁹³ See the above-mentioned "*Internationalisation of SMEs*" report.

⁹⁴ See Brainard L. (1997): "An empirical assessment of the proximity-concentration tradeoff between sales and trade", *American Economic Review*, Vol. 87, pp. 520-544. Brainard (1997) presents evidence that the share of sales by foreign affiliates is greater when transports costs and trade barriers are higher. Hanson, G. H., Mataloni Jr., R. J. and Slaughter, M. J. (2003): "Vertical production networks in multinational firms", *NBER Working Paper* no. 9723, show that trade costs reduce the import of intermediate inputs by foreign affiliates.

⁹⁵ For instance, it is interesting to note that access to know-how or technology is the second most cited motive for internationalisation for SMEs with more complex forms of internationalisation (ie, with subsidiaries abroad), according to the ENSR 2003 Enterprise Survey.

may also permit access to *additional* production capacity with the result of lower average costs from a better exploitation of scale and scope economies.

To benefit from cross-border investments there are also costs to incur by SMEs:

- The possible costs of multi-nationalization include costs of disintegration of the domestic company and foregone economies of scale, for example in case of substitution of exports with production abroad. If production activities are split across a border (i.e., horizontal differentiation of investments), disintegration costs can arise. For example a SME can decide to duplicate part of its production by setting up an assembly plant cross-border to serve a foreign market in addition to a home plant. In this case of horizontal investment some economies of scale are lost due to the duplication of activities. For vertical cross-border investment the disintegration costs consist of packaging and freight costs or the time it takes to ship products between plants⁹⁶.
- Another key parameter in many investment decisions is the installation costs of the investment. The relatively high fixed cost of investing abroad makes it easier for large companies to invest cross-border. It explains why SMEs that are internationalized are relatively large⁹⁷. Various methods have been used to study the implication of the irreversibility of a fixed investment and a general conclusion in recent literature is that increased uncertainty leads to lower investment rates⁹⁸. These results underline the role of transparency in tax rules.
- ‘Other costs of internationalisation’ may include undertaking marketing analysis abroad, purchasing legal consulting services, the translation of documents, adapting products to foreign markets, greater travel expenses and higher business and financial risks.

By facilitating tax compliance on cross-border activities, some of these costs may be addressed by HST measures: in particular, HST addresses some of the ‘other costs of internationalisation’ and somehow the installation costs. Fewer impediments to cross-border investments will reduce the high fixed cost of cross-border investments and encourage also the smaller SMEs to engage in cross-border activities. By reducing the complexity of the tax system (i.e. the compliance burden and the unpredictability of tax

⁹⁶ Therefore removing barriers to the freedom of establishment has an undetermined effect on economies of scale and scope of SMEs. For firms that may decide the substitution of domestic production for export with a new physical investment abroad (thus, perhaps duplicating some costs) some economics of scale are foregone. In other cases, when the new investment abroad complements the domestic one, the final overall production function might be more efficient, due to the economies of scale and scope gained.

⁹⁷ OECD (2004): "Facilitating SMEs access to international markets", Background Document for OECD Conference on "Promoting entrepreneurship and innovative SMEs in a global economy: towards a more responsible and inclusive globalisation".

⁹⁸ Carruth, A., Dickerson, A. and Henley, A. (2000): "What do we know about investment under uncertainty?", *Journal of Economic Survey*, Vol. 14(2), pp. 119-153.

liabilities which have deterred foreign direct investment by increasing transaction costs) the implementation of HST should reduce some production costs associated with the instalment and development of an investment abroad. HST may therefore ease the costs of internationalisation for SMEs and increase the probability of successful and profitable cross-border expansion⁹⁹.

Having said all that, **what is the expected number of companies that may decide to become international following the implementation of HST?** Ideally it would be desirable to know the numbers of companies that will be affected most profoundly by HST. That is to say, how many eligible SMEs are presently hesitant about developing their activities in other Member States via branches and/or subsidiaries and will be encouraged to do so when HST is in place? How many extra companies are likely to expand cross-border given a more straightforward administration system and the off-setting losses in other Member States possibilities? How will the start-up/early-stage survival rate of the extra companies that decide to expand will be affected by the cross-state loss-offsetting measures introduced by HST? All these questions are difficult, if not impossible, to answer a priori and the most reliable answers can only be gained by the implementation and monitoring of the pilot scheme. Notwithstanding this, the increased participation of SMEs in the Internal Market following a voluntary pilot scheme that would bring about a change in their EU-wide company tax base and compliance costs, can be expected to be limited, all the more because the tax factor is just one of the obstacles impeding cross-border expansion of SMEs. So overall, the proportion of new SMEs willing or able to participate in the scheme would be expected to be low. An optimistic scenario could be increased foreign investment within the EU by SMEs of up to 6% following HST implementation. Interestingly, an – admittedly not representative – questionnaire launched by the Commission services (see Chapter 2 above) reveals a much higher interest of around half of the respondents indicating that they were interested in taking part in a possible pilot scheme.

Despite the clear benefits of HST for new entrants in the international market, and even if this is perhaps one of the most important positive effects of HST in the long-term, a more detailed quantitative evaluation of the HST impact on potentially new multinational SMEs groups is unfeasible. Thus, questions like which type of company would be most likely to benefit from the new rules and become international and to enter which markets (i.e. those where they export already or those where labour costs are lower or where technology is available) remain largely unsolved.

⁹⁹ The extent to which the reduction of compliance and transaction costs (that cut the ‘other costs of internationalisation’ and installation costs) will compensate the disintegration costs or the reduction of scale economies in the home country following the decision to undertake an investment abroad, will depend on a variety of economic factors, like the degree of integration of the product markets involved and the structure of the labour market in the host country as well as the transport costs and, therefore, the geographical extent of the concerned market.

6.1.2. The economy-wide effects of HST: transmission of effects into home and host countries

Now that the impact of HST measures on SMEs (either already multinational or potentially so) has been assessed, this section will show how the effects of cross-border investments by SMEs would translate to home and host Member States and thereby what the economy-wide impact of the proposed policy would be.

6.1.2.1. Host Countries effects

The impact of the implementation of HST on the host Member State depends on a number of different elements.

First, the removed barriers to entry could lead to more companies entering markets in the host state. This reduces the price-cost marks and less efficient companies tend to be replaced by the more efficient ones, thus resulting in gains in the allocation of resources. As empirical evidence shows that foreign companies are often more productive and competitive than domestic ones¹⁰⁰ this might imply some crowding-out of local SMEs.

In addition, further productivity efficiency gains may be expected because management and workers of companies in the host Member State need to improve the organisation of their work in order to withstand increased competition effects. Moreover, recent evidence also shows productivity gains as a result of reductions in entry barriers and reduction of technology gaps as a consequence of lowering administrative barriers¹⁰¹.

On the other hand, other studies point at important positive effects of increased competition on host Member States on local companies, especially through the market for input factors. Foreign investments, in the form of subsidiaries or production plants, represent important clients for small locally-based suppliers and sub-contractors and they secure the transfer of technology and management skills to domestic SMEs. Other theoretical¹⁰² and empirical¹⁰³ studies show that multinationals, through the creation of linkages with indigenous suppliers can exert positive effects on the development of indigenous firms in host countries.

¹⁰⁰ See Criscuolo, Ch. and Martin, R. (2004): "Multinationals and US productivity: evidence for Great Britain", *Working Paper*; Griffith, R., Redding, S. and Simpson, H. (2004): "Foreign ownership and productivity: new evidence from the service sector and the R&D lab", *IFS Discussion Paper*; and Navaretti, G.B. and Venables, A.J. (2004): *Multinationals in the world economy*, Princeton University Press.

¹⁰¹ Nicoletti, G. and Scarpetta, S. (2003): "Regulation, productivity and growth: OECD evidence", *OECD Economics Department Working Paper*.

¹⁰² Markusen, J.R. and Venables, A.J. (1999): "Foreign direct investment as a catalyst for industrial development", *European Economic Review*, Vol. 43, pp. 335-356.

¹⁰³ Görg, H. and Strobl, E. (2002): "Multinational companies and indigenous development: An empirical analysis", *European Economic Review*, Vol. 46, pp. 1305-1322, estimate empirically a model describing the entry of indigenous firms using data for the Irish manufacturing sector. Their results indicate that there is a positive effect of multinational companies on the entry of indigenous firms for a variety of alternative specifications.

Other positive results may arise from the spillover effects that multi-national companies have on the local companies in the host Member State. Two types of spillover effects are possible. First technological spillovers occur if the cross-border activities of a SME transfer technology to local companies. In addition, local companies could learn about the market in which they are operating and acquire skills unknown to them before their contact with foreign affiliate. For technological spillovers to occur the evidence shows that the host country needs to have a minimum level of capacity to absorb the skills and technology that a foreign affiliate uses¹⁰⁴. The other type of spillover occurs when domestic companies benefit from the interactions with foreign affiliate if the activity of the foreign affiliate, which buys intermediate products from a local supplier, leads to a product quality improvement of the local supplier which will benefit other domestic buyers.

In summary, there are reasons to believe that the increased competition effects may benefit local companies of the host countries. In addition, in order to have technological spillovers the host Member State needs to have a minimum level of capacity to absorb the technologies that foreign affiliates use.

Finally, increased competition in the host country may eventually have a positive effect on consumers' welfare (throughout the whole EU). The degree of competition of the markets will determine the relative distribution of the benefits between producers (higher profits) and consumers (lower prices). The higher the degree of competition in the market, the higher the reduction of cost translating into lower price. Considering the ever increasing degree of competition in the EU products market, the implementation of HST, should result in a relatively (to profit) important increase of benefits in favour of consumers, thus permitting a corresponding increase in their welfare. Obviously, a complete translation of the cost reduction into price reduction is only a theoretical option associated with the hypothetical situation of perfect competition.

6.1.2.2. Home Countries effects

In addition to the effects of cross-border activities on the host Member State outlined above there could also be effects for the home Member State of the parent SMEs. For example, the establishment of a cross-border production facility could replace exports from the home Member State or complement it. In principle this depends on the nature of cross-border investments e.g. whether it is horizontal or vertical. The evidence points to a complementary relationship in general but in some cases where plants are duplicated a substitutable relationship is present¹⁰⁵.

Another effect on the home state concerns the upgrading of technology. Evidence shows that the location of plants in areas known for intensive R&D operations enhances the R&D activities and productivity in plants that operate in the home Member State. The

¹⁰⁴ Navaretti and Venables (2004).

¹⁰⁵ *ibidem*.

benefits for home Member States can be expected to consist of skill-upgrading and the use of new technologies after cross-border investments¹⁰⁶.

6.1.3. The effects of HST on Member States' tax administrations

This section finally assesses the impact that the implementation of HST will have on the national tax administrations of Member States.

In the first place, they may be affected by the possibility of immediate cross-border loss compensation between members of the same group of SMEs. While it has been argued that such a measure is, without doubt, financially advantageous for groups of EU SMEs, it also may have an impact on Member States' revenues. Those Member States where members of a particular SME group have positive profits against which cross-border losses can now be immediately offset may suffer some costs, as they might see some of their potential corporate tax revenues from SMEs income foregone, when other group members incur losses elsewhere. However, the net effect of the HST system on the revenues of these Member States, compared with the present situation -that allocates the SMEs groups' income according to separate accounting standards- is not necessarily negative: it will depend on the shares that these Member States receive from the groups' tax bases following the application of the agreed allocation mechanism. These shares could allocate higher or lower tax bases than they would have had otherwise (before cross-border loss compensation and HST). In turn, Member States where the loss-making firms within the groups are located can on the whole benefit from an immediate cross-border loss compensation effect and the mechanics of HST: this would be the case when the apportioning mechanism allocated to them positive shares of the total group tax base in a given year (regardless of the non-profitability of the business in that territory in that year). That would normally be the case (ie, all Member States where SMEs groups are active receive positive shares of their respective total tax bases) when allocation was based on factors such as labour costs, number of employees, turnover or assets, as these factors always have *positive* values for any firm, also the non-profitable ones. As the same Member State can be both "loser" and "winner" for different SMEs groups (compared to the present situation) the net effect on national tax revenues of the cross-border loss-offsetting introduced by HST is largely undetermined for particular Member States.

Hence Member States can be affected by the new distribution of profits realized by the agreed apportioning mechanism. An exercise that simulates the distribution effects of various apportioning methods, using the data of the SMEs sample of international groups with cross-border information from Amadeus (as described above in table 7), and in particular, the members of those groups with profits/loss information, is shown in table 8. The table shows that apportionment based on different weightings of apportioning factors such as 'payroll', 'turnover' or 'assets' always provides positive shares of the international SMEs groups' company tax bases to the participating Member States, whilst this is not

¹⁰⁶ ibidem.

the case under the current profit-based distribution of international SMEs' tax bases, where losses accumulate in some countries.

The application of HST will also increase costs to fiscal administrations, due to an increased administrative burden and the need to coordinate with other fiscal authorities.

On the other hand, it is important to consider also that the net present value of tax revenues may well increase, due to resulting future tax revenue increases, attributable to improved SME profits/survival and to the expected benefits to the EU economy as a whole.

This analysis helps to answer the question of whether HST could lead to substantive changes in revenue yield to some Member States. Corporate tax revenue constitutes a small proportion of national GDP in EU economies. In fact, corporate tax typically constitutes less than 4% of GDP and less than 10% of total tax receipts for each EU-25 country¹⁰⁷. A further breakdown of this data to show the proportion of corporate income tax received from SMEs and especially, from internationalised groups of SMEs (ie with foreign investments), would clearly indicate that the proportions of GDP 'at risk' in individual Member States due to the HST scheme are extremely low¹⁰⁸. This lends weight to the expectation that tax revenue implications of the HST scheme would be low and not present insurmountable adverse consequences for any Member State.

¹⁰⁷ The average figures show that taxes on corporations' income represent 2.7% of GDP and 6.7% of total tax revenues for the EU-25. See European Commission (2005): "Structures of the taxation systems in the European Union", DG Taxation and Customs Union.

¹⁰⁸ For example, under the assumptions used above that 33% of corporate income tax revenues are raised *from SMEs* and only 3% of this is obtained from *international groups of SMEs*, the proportion of corporate income tax from international groups of SMEs can be tentatively estimated in the order of just 0.066% of total tax revenues on average for the EU-25 Member States.

Table 8: Results of possible apportioning mechanisms for the distribution of international groups of SMEs' tax bases compared to the actual situation

MS	Unweighted current <u>distribution</u> of the sample of international groups of SMEs <u>tax bases</u> (*)	Weighted (by nr. of cos.) current <u>distribution</u> of the sample of international groups of SMEs <u>tax bases</u> (*)	Distribution of international groups of SMEs tax bases when apportionment is based on 'payroll'		Distribution of international groups of SMEs tax bases when apportionment is based on 'payroll' (1/2) and 'turnover' (1/2)		Distribution of international groups of SMEs tax bases when apportionment is based on 'payroll' (1/3), 'turnover' (1/3) and 'assets' (1/3)	
			%	% Change wrt current (weighted) situation	%	% Change wrt current (weighted) situation	%	% Change wrt current (weighted) situation
AT	3.65%	58.48%	1.49%	-56.99%	2.38%	-56.10%	3.59%	-54.89%
BE	31.35%	1.86%	0.85%	-1.01%	0.79%	-1.07%	0.90%	-0.95%
CY	-1.11%	-11.00%	0.50%	11.50%	0.41%	11.42%	0.52%	11.53%
CZ	0.34%	3.85%	5.66%	1.81%	3.90%	0.05%	2.87%	-0.98%
DK	2.11%	0.38%	0.81%	0.44%	0.58%	0.20%	0.65%	0.27%
EE	3.21%	0.29%	0.18%	-0.11%	0.12%	-0.16%	0.10%	-0.19%
FI	3.89%	0.99%	0.56%	-0.43%	0.47%	-0.51%	0.45%	-0.54%
FR	2.30%	0.74%	9.21%	8.47%	8.13%	7.39%	8.07%	7.34%
DE	0.20%	8.20%	20.99%	12.79%	32.26	24.06%	32.44%	24.24%
EL	0.31%	3.05%	0.87%	-2.18%	0.74%	-2.31%	0.75%	-2.30%
HU	-0.16%	-1.41%	0.00%	1.41%	0.31%	1.72%	0.52%	1.93%
IE	1.21%	0.51%	0.46%	-0.05%	0.46%	-0.05%	0.54%	0.03%
IT	-3.76%	-8.18%	22.13%	30.30%	18.37	26.54%	17.63%	25.80%
LV	-0.16%	-0.09%	0.34%	0.43%	0.20%	0.29%	0.15%	0.24%
LT	0.07%	0.20%	0.48%	0.28%	0.31%	0.11%	0.24%	0.04%
LU	0.02%	0.17%	0.00%	-0.17%	0.00%	-0.17%	0.01%	-0.15%
NL	11.29%	4.61%	5.65%	1.03%	4.32%	-0.30%	4.43%	-0.19%
MA	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
PL	0.62%	2.49%	6.99%	4.50%	4.81%	2.32%	3.83%	1.34%
PT	1.29%	4.21%	0.92%	-3.29%	1.97%	-2.24%	2.56%	-1.65%
SK	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
SI	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
ES	37.16%	29.95%	9.39%	-20.56%	9.00%	-20.95%	9.24%	-20.71%
SE	5.89%	0.54%	1.86%	1.31%	1.57%	1.03%	1.47%	0.92%
UK	0.29%	0.16%	10.67%	10.51%	8.90%	8.73%	9.05%	8.88%
Total	100%	100%	100%		100%		100%	

(*) The profits/loss amount reported in the database is taken as a proxy for the 'corporate tax base'.

Finally, given the limited character of the pilot scheme, its strict anti-avoidance rules and the tight control and monitoring process (see below), the impact of the pilot on national tax administrations will be limited to the re-allocation of tasks and staff as necessary to introduce and manage the scheme. In particular, the potential risk of more fraud, delocalisation, "pilot scheme shopping" and similar risks have been fully taken into account in the design of the scheme and can be expected to be minimal. A certain additional costs for tax administrations could be caused by the need to control and monitor the experiment but there is no reason whatsoever to believe that it would be very high or disproportionate in view of the potential economic gains. Currently, smaller companies are anyway hardly audited by Member States. Moreover, it should not be forgotten that the proposed scheme would be optional for enterprises and Member States.

6.2 Social and environmental impact assessment of the Home State Taxation option

HST measures would also have some environmental and notably social effects.

The **social effects** can be assessed by analyzing the impact of this policy on the labour markets of the host and home countries:

Regarding the **host countries**, evidence on anticompetitive regulation in the product market suggests that positive effects on employment can be expected from the fact that HST reduces the compliance burden for cross-border companies¹⁰⁹. Further evidence indicates that multi-national companies pay higher wages than local companies in the host countries¹¹⁰. With respect to the skill of workers the impact will depend on the skill requirements of the cross-border activities vis-à-vis those of the local companies in the host country. There is not much empirical evidence available on this issue but skilled workers appear to be concentrated in multi-national companies. In addition, multi-national companies appear to adjust employment relatively quickly compared with domestic companies. Studies investigating whether employment is more volatile in multi-national companies compared with domestic companies do not confirm this hypothesis. The evidence suggests that multi-national companies preserve employment when labour demand shocks occur¹¹¹.

¹⁰⁹ See OECD (2001): "Product and labour market interactions in OECD countries", *Economics Department Working Paper*. In addition, Cincera, M. (2004): "Impact of market entry and exit on EU productivity and growth performance", Report commissioned by DG ECFIN of the European Commission, finds positive effects of deregulation on entry and exit rates.

¹¹⁰ UK evidence is shown in Driffield, N. and Girma, S. (2003): "Regional foreign direct investment and wage spillovers: plant level evidence from the UK electronics industry", *Oxford Bulletin of Economics and Statistics*, Vol. 65, pp. 453-474. For US evidence see Feliciano, Z. and Lipsey, R.E. (1999): "Foreign ownership and wages in the United States 1987-1992", *NBER Working Paper* 6923. A small survey is presented in Navaretti and Venables (2004).

¹¹¹ Navaretti and Venables (2004).

In summary, the available empirical evidence on differences between multi-national companies and domestic companies suggests that productivity, skills of workers and wages are higher in multi-national companies whilst job-insecurity of workers in multi-national companies is not necessarily higher.

As regards the **home country**, one of the key issues is how low labour costs in other countries affect employment in the home Member State. Do low labour costs in host countries where affiliates are located increase or decrease employment in the home country? The available empirical evidence indicates that given cross-border investments an increase in the wage costs of affiliates increases (decreases) employment in the parent company if the activities in the parent and cross-border affiliate are substitutes (complements). Concerning the start-up of cross-border activities, a recent study suggests that there are no differences in employment dynamics between companies that start investing cross-border and non-investing companies¹¹². In addition to the number of workers in the home country other evidence suggests that the skill-intensity increases in the parent company especially where it concerns vertical cross-border investments in cheap labour locations¹¹³.

In summary, HST measures can be assessed as having a positive social impact, namely higher employment.

Concerning the **environmental impacts**, in view of the nature of the measure no direct impacts are to be expected. It is nevertheless obvious that if the expected efficiency gains of HST materialise, this will indirectly imply increasing some environmental costs following increased activity.

6.3. Regional impacts

The overall positive effects of the measure will probably not be distributed equally in the geographical sense. It is reasonable to assume that many SMEs that decide to set up for the first time an establishment in another Member State will be located in border regions and will decide to create that establishment at the other side of the frontier in the border region. Such regions can therefore be expected to benefit in a particular way from the proposed measure. This argument can however also work the other way round: The propensity to cross-border trade is generally already higher in border regions; therefore the measure could, at least in single cases, particularly benefit SMEs in more remote regions that need an incentive to engage into cross-border economic activity.

¹¹² Navaretti, G. B. and Castellani, D. (2004): "Investments abroad and performance at home: evidence from Italian Multinationals", *CEPR Working Paper*, No. 4284.

¹¹³ Evidence for Sweden is presented in Hansson, P. (2001): "Skill upgrading and production transfer within Swedish multinationals in the 1990s", *CEPS Working Document*, No. 163. Evidence for Japan is presented in Head, K. and Ries, J. (2002): "Offshore production and skill-upgrading by Japanese manufacturing firms", *Journal of International Economics*, Vol. 58, pp. 81-105.

Under the HST approach, the domestic group taxation, consolidation or loss-offset rules would apply to all activities of the SMEs within interested Member States. This implies that for those countries which do not operate such domestic rules (that is, Belgium, Czech Republic, Estonia, Greece, Hungary, Lithuania and Slovakia) one essential feature of HST from a business perspective is not available. Whether or not the compliance cost reduction is sufficient to attract business interest to the scheme is difficult to assess but *ceteris paribus* it can be expected that fewer SMEs in the countries concerned will participate than in countries with appropriate loss-offset rules.

6.4. Conclusions

HST is designed to improve the business conditions in the Internal Market for SMEs, which constitute one of the key drivers in economic growth. Current tax provisions in the EU penalise SMEs willing to internationalise their activities because they *de facto* impose supplementary compliance costs and offer few provisions to foreign subsidiaries to compensate for cross-border losses. This encourages SMEs to internalise activities and discourages their investing in a degree of control in foreign companies and their establishment of foreign subsidiaries.

The implementation of HST, through the removal of these tax barriers, is a measure aimed at promoting SMEs' investments in the Internal Market, by contributing to the process of costs optimisation of firms¹¹⁴, and at a better allocation of the resources, notably physical capital investment. In fact, such a measure allows business to make sounder economic choices based on the productivity of factors and less distorted by the influence of (some) taxation costs.

The present impact assessment has analyzed (some of) the effects of HST on the main economic agents and driving forces of the economy. First, this measure will automatically benefit the SMEs already installed abroad. This first benefit derives from the increased possibilities of cross-border loss compensation, which remove an important distortion to the efficient allocation of resources. The second benefit is that removed compliance burden due to dealing with several tax administrations, which will improve the structure of costs of these firms and possibly encourage them make to further investments.

A key factor to the actual gains following the implementation of the HST scheme will be the reaction of presently purely domestic SMEs to the removal of tax induced barriers to cross-border investments. The introduction of loss compensation will encourage domestic SMEs to explore cross-border physical investments where they did not consider it before or where it was too costly for such companies. This should lead to an increased number of start-up cross-border companies by SMEs and to the increased likelihood of survival during the first years of business. However this effect should not be expected for international groups of SMEs with parent companies established in countries that do not

¹¹⁴ See European Commission (1988): "The Economics of 1992", *European Economy*, No. 35.

have appropriate group loss compensation rules in their domestic tax legislation. Also the lighter compliance burden due to dealing with several tax administrations may act as an incentive to start up a cross-border establishment. The economic benefits of the scheme could be recognised in the medium- to long-term as sufficient levels of greater cross-border expansion and survival become realised. Due to technological developments, the global business environment is also increasingly likely to favour SMEs engaging in cross-border activity and neighbouring countries will most likely constitute the easiest and most frequent business partners.

Besides the direct effects on SMEs, HST measures also provide gains to the markets of the home and host Member States, for example for companies associated with foreign subsidiaries such as suppliers or collaborating business partners or by the improved transfers of technology and know-how. By increasing the openness of the Internal Market the HST scheme increases the potential efficiency and output of the EU economy. The efficiency gains offered will benefit consumers in the form of lower prices for products, improved quality and a greater variety of products.

To conclude, the implementation of HST will bring the economic benefits associated with a liberalisation policy within the framework of the freedom of establishment.

The implementation of HST will also have implications for tax administrations. These will include higher administration and control costs and some revenue consequences following the possibility to offset losses cross-border and the apportioning of tax bases results. Nevertheless, there are reasons to think that all these effects will be rather reduced. Of course, the precise short-term risks to individual MS' tax revenues and the possible benefits/losses are impossible to assess a priori. However given the proportions of enterprises and of taxation revenue involved, the risks are not sufficient to bring the scheme into question, especially given the expected benefits to the EU economy as a whole.

The assessment has also analysed environmental and notably social aspects of HST, and concluded that there would be positive social effects from HST, namely higher employment. The most important issue of creating favourable conditions to support expanding SMEs capable of achieving the employment growth and profitability necessary to sustain global economic competitiveness is clearly addressed by HST.

Whilst the present impact assessment has been able to measure just the short-term effects of the proposed policy, it can be firmly expected that the non-quantifiable long-term dynamic effects, will be even more important to the EU economy as a whole. If the long-term dynamic impact could be factored in by sound methodology, the overall result of the HST-effects would prove considerably more beneficial. It is worth remembering that the "Cecchini report on the Cost of Non-Europe" made estimations of the dynamic effects following a liberalisation policy.

By definition the actual impact of such a HST pilot scheme can only be positive as it would be voluntary for both Member States and interested companies.

7. IMPLEMENTATION, MONITORING AND EX-POST EVALUATION

It is suggested that the pilot scheme is implemented via a multilateral agreement or, in bilateral relations, via a supplementing protocol to the applicable double-taxation treaty. The Commission and interested Member States will create a monitoring group for supervising the functioning of the pilot scheme, considering possible practical problems and assessing its success. This will ensure, but only to the extent that there is a real practical need for it, a continuous evaluation and reports. After the proposed five year period an ex-post evaluation will be carried out jointly by the responsible Member States and transmitted to the Commission and the monitoring group.