

Sustainability in Public Finances Concerning Transfer Pricing in the EU

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Ensuring the sustainability of public finances is a crucial concern for the European Union, particularly in the context of transfer pricing, which is focused on tax base erosion and profit shifting. Transfer pricing, involving the internal transfer of goods, services, or intellectual property between related entities, can significantly impact member states' tax revenues and overall economic stability. Base erosion and profit shifting is a term used to describe tax planning strategies that multinational companies use to exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax jurisdictions, thereby reducing their overall tax liability. The scope of this study examines these two topics, mainly by using jurisprudential methods and analysis of scientific sources, as well as to research the effect of tax-based erosion and inequality among state jurisdictions. The assessment and analysis of the problems in these areas have been going on for years, and in essence, the neuralgic points are clear in terms of problem definition. Nevertheless, appropriate normative solutions have either not been developed to a full extent or are being implemented slowly. Considering the lengthy process of adopting normative rules, the main aim of this study is to make suggestions for the field of law enforcement and organs of public administration that could lead to changes in the areas of transfer-pricing, base erosion, and profit shifting. In conclusion, three key areas of action are proposed. Firstly, the promotion and everyday implementation of digital taxation contribute to the efficient exchange of data. Secondly, much closer cooperation between tax authorities on this basis can be strengthened at the Member State level in practical administration. Thirdly, the more effective safeguarding of the single market by national administrations.

1. Introduction

Sustainability in society has emerged as a pressing and multifaceted global concern, reflecting a growing awareness of the need to balance economic, environmental, and social considerations in our collective actions. In an era marked by rapid population growth, resource depletion, climate change, and social inequalities, sustainability has become a guiding principle for individuals, communities, businesses, and governments alike (Toledo-Vazquez et al., 2022).

Sustainable public finances refer to the responsible and balanced management of government revenues, expenditures, and debt over the long term to ensure economic stability, social well-being, and environmental preservation for current and future generations. Achieving sustainable public finances requires careful consideration of economic, social, and environmental factors while maintaining fiscal discipline and responsibility (Onofrei et al., 2020). In the context of the EU, there are several key factors and aspects of the sustainability of public finances in general (Perotti et al., 1998), such as fiscal responsibility, long-term planning, balanced budgets, social inclusion and equity, green investments, debt management, shock resilience, transparency and accountability, revenue diversification, technology and innovation, as well as growth and economic development (Nyikos, 2022).

At the core of sustainable public finances is fiscal responsibility. Governments must strive to align their spending with revenue generation and avoid excessive borrowing that could lead to unsustainable debt levels. Sustainable public finances require long-term planning and vision. Governments should consider demographic trends, economic forecasts, and potential risks to develop realistic and forward-looking fiscal strategies. Maintaining balanced budgets, where government expenditures match revenues, is an essential element of

sustainability. Sustainable public finances prioritize social inclusion and equity. Governments should allocate resources to address poverty, inequality, and social challenges. Investments in education, healthcare, and social safety nets can foster an inclusive society with equal opportunities for all citizens. Integrating environmental considerations into public finances is vital for sustainability. Sustainable public finances involve responsible debt management. Governments should avoid overreliance on debt financing and ensure that borrowing is directed towards productive investments that generate positive returns for the economy. Having fiscal buffers and contingency plans can help mitigate the impact of unexpected events on public finances and maintain essential services even during challenging times. Transparent budgeting processes and accountability mechanisms are critical for sustainable public finances. Governments should engage in open dialogue with citizens, disclose budget information, and ensure that public funds are used efficiently and effectively. Sustainable public finances seek to diversify revenue streams, reducing reliance on a narrow tax base and exploring alternative sources of income, such as fees, fines, and non-tax revenues. Embracing technology and innovation can enhance fiscal management, increase efficiency, and improve service delivery, contributing to sustainable public finances.

Public finances encompass the entirety of the government's financial activities and policies, while public budgets are detailed plans outlining the government's income and spending for a specific period. Public finances involve managing government revenues, expenditures, and debt, while public budgets provide specific proposals for raising and allocating funds for various programs and services during a fiscal year. Successful public finance management relies on making prudent budgetary decisions that align with the government's economic and social objectives while ensuring fiscal sustainability and accountability. These two aspects, public finances, and public budgets, are closely interconnected, as budgets form a fundamental component of public finances (Beck and Możdżeń, 2022).

The present study focuses on the revenue side of public budgets, in particular, base erosion and profit shifting (BEPS) related to transfer pricing. The examination of this issue is of particular importance, as global action on this issue, notably at the Organisation for Economic Co-operation and Development (OECD level), has produced only limited results over the last decade. In view of the OECD information on this phenomenon, base erosion and profit-shifting practices cost countries 100-240 billion USD (OECD, 2023) in lost revenue annually, which is the equivalent of 4-10 % of the global corporate income tax revenue. While the OECD regulatory regime has been tightening in recent years, with the introduction of new international provisions for both transfer pricing and BEPS, the amount of revenue foregone has remained stable in magnitude (Fuest et al., 2022; Tørsløv et al., 2023), i.e., the measures introduced have not brought about diametrical changes in the system. It can, therefore, be seen that, despite the legal regulatory attempts made so far, the phenomenon persists, and during the current crises (post-coronavirus economy, Ukraine war, demographic challenges, etc.) in Europe (Hoke and Tomašík, 2022), EU countries' budgets cannot afford to simply forgo 4-10 % of their revenues. Accessible literature and research up to date properly evaluates and recognizes the situation from a normative-regulatory point of view, given that it is a decades-old problem (see, e.g., tax havens). However, despite the efforts and propositions, a truly effective normative-regulatory solution has not been put in place yet. This is not necessarily a shortcoming of academic research, as it is very difficult to achieve profound normative changes in the area under study, given that they are always the result of political and diplomatic deals. This paper examines this phenomenon from a different perspective than the normative-regulatory approach, focusing on the issues of law enforcement and law enforcement principles, as they are usually less influenced by diplomatic agreements in international relations. For public administration bodies and organs of tax administration, it is not primarily international but domestic regulations and practices that are of primary concern. For this reason, the present study focuses not on recommendations for normative-regulatory solutions, but on proposals for legal practice and application. By introducing a number of key areas in the field of law enforcement principles from a practical point of view, it could lead to more efficient domestic practices and ultimately make the current system more efficient at the EU level.

2. Theoretical background

In the sphere of legal discourse concerning public budgets, the interrelation between income generation and transfer pricing merits comprehensive examination. Transfer pricing, in the context of multinational corporations, pertains to the pricing of goods, services, and intangible assets exchanged between related entities. This intricate financial practice can significantly impact the income part of public budgets, warranting a meticulous analysis of its implications and consequences (Saliterer et al., 2018).

The correlation between transfer pricing and public budgets' income is rooted in the potential for revenue erosion within the national fiscal frameworks, which can hinder taxation stability. The instability of tax revenue is a crucial risk for maintaining fiscal balance, as it can lead to fluctuations in revenues and make it challenging to maintain fiscal equilibrium, limiting the funds available for essential public services and investments (Evans, 2020).

Transfer pricing within the European Union is a significant concern due to multinational corporations operating across multiple member states. While the EU is a single market with the free movement of goods, services, and capital, each member state has its own tax laws and regulations. This creates opportunities for multinational companies to engage in transfer pricing practices that may shift profits to low-tax jurisdictions and potentially lead to tax avoidance. To address these issues, the EU has taken several measures to regulate and harmonize transfer pricing within its borders (Rojas and Nikou, 2023): a) The European Union has issued transfer pricing guidelines to promote consistency and fairness in intercompany transactions within the member states. These guidelines are based on the principles set forth by the Organisation for Economic Co-operation and Development (OECD) and help tax authorities in EU countries assess transfer pricing arrangements. b) The arm's length principle is a fundamental concept in transfer pricing, which suggests that the prices charged for goods and services between related parties should be the same as if they were unrelated parties. The EU member states adhere to this principle to determine whether transfer prices are in line with market conditions. c) The EU has established a Code of Conduct on Transfer Pricing Documentation to ensure that multinational companies provide detailed documentation and justifications for their transfer pricing practices. This requirement helps tax authorities evaluate whether the transfer prices are set at arm's length (Succio, 2010). d) Furthermore, the EU has implemented Country-by-Country Reporting requirements for multinational corporations with a consolidated group revenue exceeding a certain threshold. These companies are required to provide detailed financial and tax-related information for each country they operate in, including transfer pricing information. CbCR enhances transparency and enables tax authorities to assess potential tax risks and profit shifting. e) The Anti-Tax Avoidance Directives to combat aggressive tax planning and tax avoidance strategies, including those related to transfer pricing. ATAD includes measures to prevent hybrid mismatches, controlled foreign company (CFC) rules, and interest deduction limitations, among others. (De Charette, 2019). f) The EU member states have established a Mutual Agreement Procedure to resolve transfer pricing disputes between countries. If a multinational company faces double taxation due to divergent transfer pricing practices, it can seek resolution through the MAP to reach a consensus between the relevant tax authorities (Daudrikh, 2022). g) The EU Joint Transfer Pricing Forum was established to facilitate cooperation and exchange of information among tax authorities within the EU. It serves as a platform for discussing transfer pricing issues and developing best practices. h) The EU encourages cross-border tax audits and information exchange among its member states to address transfer pricing challenges effectively. Enhanced cooperation between tax authorities enables them to identify and address potential tax avoidance schemes (Čunderlík and Szakács, 2023).

3. Methodology

In the present research, the effects of transfer pricing across countries are examined. Within this framework, the interpretation of certain legal and regulatory solutions and the presentation of certain sample solutions will be discussed. The study will use a traditional jurisprudential approach, which will focus on the examination and analysis of individual scientific sources and the presentation of current trends. Within this framework, legal interpretation and applied EU, respectively OECD policies will be examined by presenting the risks and trends and by examining the factors influencing public finance sustainability that are the subject of the research. In more detail, the effect of tax-based erosion and inequality among state jurisdictions are discussed.

4. Results and Discussion

Tax base erosion and revenue losses (BEPS) in the context of transfer pricing refer to the reduction of a country's tax revenue caused by aggressive tax planning and profit-shifting strategies employed by multinational corporations. These practices exploit discrepancies in tax laws and regulations between different jurisdictions to artificially shift profits from high-tax jurisdictions to low-tax or tax-haven jurisdictions, where tax rates are significantly lower or non-existent. Consequently, the taxable income of multinational corporations within high-tax jurisdictions is diminished, resulting in reduced tax payments and diminished revenue for the government. (Bradbury et al., 2018). Key factors contributing to tax base erosion and revenue losses include: a) transfer mispricing: Multinational corporations may manipulate the prices at which goods, services, and intangible assets are transferred between related entities to reduce taxable income in high-tax jurisdictions. This is commonly known as transfer mispricing or transfer pricing manipulation (Wier, 2020); b) intangible asset shifting: The shifting of intangible assets, such as intellectual property rights, patents, trademarks, and copyrights, to low-tax jurisdictions can result in reduced profits in high-tax jurisdictions and inflated profits in low-tax jurisdictions (Crotti, 2021); c) debt shifting: Multinational corporations may use intercompany loans and financing arrangements to shift debt to high-tax jurisdictions, leading to higher deductible interest expenses and lower taxable income (Schindler and Schjelderup, 2012); d) thin capitalization: Thin capitalization occurs when multinational corporations finance their subsidiaries with a high proportion of debt compared to equity. This

enables them to claim higher interest deductions, reducing taxable income in high-tax jurisdictions (De Mooij and Liu, 2021) and d) hybrid mismatches, which exploit differences in the tax treatment of financial instruments or entities between different countries to generate double non-taxation or excessive deductions (OECD, 2012). The consequences of tax base erosion and revenue losses can be significant. They can lead to reduced government revenues, increasing fiscal deficits and debt burdens, deepening income inequality, and the erosion of tax fairness. Meanwhile, the basic rationale for BEPS is the different tax rates in each country, which also gives a very diverse picture of the EU landscape based on OECD data (Table 1).

Table 1: Corporate Income Tax (CIT) Rates EU

State	Central CIT Rates	Subcentral CIT Rates	Combined CIT Rates
Austria	25.0		25.0
Belgium	25.0		25.0
Bulgaria	10.0		10.0
Croatia	18.0		18.0
Cyprus	12.5		12.5
Czechia	19.0		19.0
Denmark	22.0		22.0
Estonia	20.0		20.0
Finland	20.0		20.0
France	25.8		25.8
Germany	15.8	14.0	29.8
Greece	22.0		22.0
Hungary	9.0		9.0
Ireland	12.5		12.5
Italy	24.0	3.9	27.9
Latvia	20.0		20.0
Lithuania	15.0		15.0
Luxembourg	18.2	6.8	25.0
Malta	35.0		35.0
Netherlands	25.8		25.8
Poland	19.0		19.0
Portugal	30.0	1.5	31.5
Romania	16.0		16.0
Slovakia	21.0		21.0
Slovenia	19.0		19.0
Spain	25.0		25.0
Sweden	20.6		20.6

The table shows that the combined tax rate of almost half of the EU countries ranges between 15-24 % (13 countries, 48 %), while in four countries (Bulgaria, Cyprus, Hungary and Ireland, 14 % of all EU states) the rate is much lower (around 10 %) and for 10 countries (37 % of all EU states) it is equal or more than 25 %. Nevertheless, there are still large differences in the 15-25 % zone, with 11 countries having a tax rate of around 20 %. However, from a tax revenue perspective, it is not insignificant - as can be seen from the table - that the EU's strongest economies (e.g., Germany, France) typically have very high tax rates, while Ireland, the frontrunner in hosting global players in the digital economy, has one of the lowest tax rates in the EU. Such and similar tax differences within the EU free market, especially in the internal digital markets, can generate significant tax revenue shortfalls at the national level. Another source of problems is that tax rules differ from country to country, so corporate tax is not just a question of the tax rate but also of the internal accounting in each Member State and the communication between tax authorities. This shows a rather significant inequality among jurisdictions (Rogers and Oats, 2019). This phenomenon is often exacerbated by various factors, including variations in tax policies, tax rates, and the presence of tax havens. Inequality among jurisdictions has significant implications for global tax systems, economic development, and social welfare. The dark side of transfer pricing: Its role in tax avoidance and wealth retentiveness (Sikka and Willmott, 2010).

International tax inequality can have several negative effects. The following can be included: a) unhealthy tax competition between states, which can result in a "race to the bottom," where nations lower their tax rates and offer preferential tax regimes to attract multinational corporations and investment. This can lead to reduced tax revenue and fiscal capacity, particularly for developing countries, as multinational corporations may shift profits

to jurisdictions with more favorable tax environments (Choi et al., 2020); b) the existence of tax havens, which havens exacerbate inequality among jurisdictions by siphoning off taxable income from higher-tax countries. The lack of consistent and comprehensive global tax rules can contribute to tax inequality. Varying tax laws and treaties between countries can create opportunities for aggressive tax planning and profit shifting, leading to imbalances in tax revenue collection (Pesiri, 2022); c) Base Erosion and Profit Shifting, which are strategies used by multinational corporations to exploit gaps and mismatches in tax rules between jurisdictions, artificially shifting profits to low-tax jurisdictions. This practice erodes the tax base and exacerbates tax inequality, as multinational corporations reduce their tax contributions in higher-tax jurisdictions (BEPS, 2023); d) capacity constraints in public administration: Developing countries may face capacity constraints in tax administration and enforcement, leading to challenges in effectively capturing tax revenue from multinational corporations and wealthy individuals. This can contribute to disparities in fiscal capacity and revenue generation among jurisdictions; e) impact on social welfare: Inequality among jurisdictions can impact social welfare and public services. Countries with lower tax revenues may face challenges in adequately funding essential services such as healthcare, education, and infrastructure development, potentially leading to disparities in living standards and social well-being; f) Wide disparities in tax policies and revenue collection among jurisdictions can have implications for global economic stability. Unequal tax practices can create distortions in trade and investment patterns, potentially impacting economic growth and financial markets.

Addressing inequality among jurisdictions requires international cooperation and coordinated efforts in the fields of international tax cooperation, global tax reforms, administrative capacity building, and enhanced transparency and information exchange between tax authorities (Brychta et al., 2020).

5. Conclusions

At the EU level, the main arenas for action on BEPS and transfer pricing issues are the international cooperation platforms at the OECD level, but there is a need to accelerate the process at the EU level. This is mainly due to the current complex crises (post-COVID, the war in Ukraine, demographic changes, ageing society, etc.), which require a rapid response. Otherwise, the long-term budgetary planning and sustainability of Member States will be put at risk, either by losing revenue sources or by increasing state debt. As has already been mentioned, the existing legal approach focuses first and foremost on defining the problem, in which it is excellent at identifying the problem points and formulating proposals for a regulatory solution. However, coming from social sciences, the proposals always depend on the political will of the currents. In the present study, therefore, it is important to expand the existing theoretical base and to make new proposals that can move the debate forward on a practical level at the EU level. With this in mind, and based on the above analysis, the following areas should be the most imminent changes on the EU level: a) Digital taxation is crucial in the EU context concerning this matter as it addresses the challenges posed by the digital economy's borderless nature and profit-shifting opportunities. With digital companies often operating across EU borders without a physical presence, they can exploit gaps in traditional tax rules, leading to uneven tax distribution and harmful tax competition among member states, as even in the EU, there are also significant differences between tax rates and tax burdens. Digital taxation would primarily speed up the exchange of information between national authorities. The main current limitation is the level of preparedness of national tax administrations, which can be monitored and improved under national competence, even without international factors. Digital taxation would thus be an important tool for greater cooperation between national authorities. b) Enhanced cooperation between national authorities is another essential element, as it facilitates the sharing of information, best practices, and strategies among member states. By collaborating on tax rulings, challenging harmful practices, and conducting joint audits of multinational corporations, EU countries can strengthen their collective efforts to prevent profit shifting and ensure that tax regulations are consistently applied. In this respect, there are significant regional differences between Member States of the EU. Such coordination is vital to safeguard the integrity of the EU's tax system. c) Safeguarding the single market is critical in the EU context as it ensures fair competition among businesses and prevents market distortions caused by BEPS and malicious transfer pricing practices. This is particularly true for cross-border transfer pricing instruments, which have an impact on the relationship between countries. In this respect, it is worth noting that in some respects, it goes beyond the realm of tax administration, as both through public procurement rules and economic competition rules, countries can put pressure on companies to ensure that the budget of the country concerned is the real beneficiary of the actual revenue generated in that country. Market protection must, therefore, also be reflected in concrete administrative action at the Member State level, a factor that each Member State is vigilantly monitoring in its own national economy.

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