EUROFRAME -

European Forecasting Network

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PRESS RELEASE

EMBARGO: 14:00 pm (Brussels Time)

Thursday October 6th 2005

The EUROFRAME – European Forecasting Network[*] Autumn 2005 Report entitled “Economic Assessment of the Euro Area: Forecasts and Policy Analysis” was launched today in Brussels. The report brings together ten leading European research institutes assessing the prospects for the Euro Area.

Central Forecast

“A group of ten of the most respected economic research institutes in Europe have forecast that Euro Area economic growth will experience a modest rate of expansion of 1.2% in 2005, 1.8% in 2006 and 2.0% in 2007. Oil prices have risen by US$20 since April and are expected to remain high at close to US$60 until 2007. EUROFRAME-EFN has revised down their forecasts by 0.2-0.3 percentage points from six months ago. This revision is limited as the negative impact of the high level of oil prices is substantially offset by the modest depreciation of the euro exchange rate and the drop in long-term interest rates. The Euro Area is still expected to record inflation rates at or close to 2 per cent with the unemployment improving but still in the order of 8.5 per cent over the period 2005-2007.

Interest rates are expected to remain at relatively low levels until 2007 when some modest rises are expected. In the context of moderate growth in the Euro Area, public finance positions are unlikely to show much significant improvement with deficits to GDP at around $2\frac{3}{4}$ per cent this year and next and 2.4% in 2007. Fiscal policy will however have a dampening effect on

[*] EUROFRAME - EFN *members are: CPB (The Hague), DIW (Berlin), ESRI (Dublin), ETLA (Helsinki), IfW (Kiel), NIESR (London), OFCE (Paris), PROMETEIA (Bologna), WIFO (Vienna) with CASE (Warsaw).*

economic growth at the Euro Area level over the next two years; Fiscal policy will be slightly contractionary in countries running deficits higher than 3% of GDP, while it will be neutral or slightly expansionary in the other countries.

RISKS

A significant risk to the EUROFRAME-EFN forecast is from a permanent rise in the oil price by US$20 per barrel. This would increase inflation and inflationary expectations requiring a monetary authority response. Output growth would be reduced by about 0.3 percentage points a year for each of the three years following the shock. Even with a response from the monetary authorities, raising rates by 0.7 percentage points at the end of 2005 and into 2006 and 2007, inflation would still be 0.5% higher on average over these three years. A stronger reaction of monetary authorities than suggested in our scenario would bring inflation down significantly but the output effects would increase in size and duration.

The role of China in reducing the burden currently placed on Europe from a global rebalancing is also considered in the EUROFRAME-EFN report. A 10 per cent Chinese Renminbi appreciation against the US dollar will dampen China's exports and output but this impact will be short-lived as domestic prices adjust rapidly moving the real exchange almost all the way back to initial levels. A Renminbi revaluation will not in itself provide a panacea for lifting the burden from Europe but a permanent increase in Chinese domestic demand would have an impact, albeit limited.

The Autumn 2005 Report also contains a *Special Policy Topic:*

"The Future of Corporate Taxation in the EU"

*"**The reduction of corporate tax rates and the recent decline in tax revenues point at tax competition in the EU.***
Further integration in the EU is bound to intensify tax competition, with widespread and continuous reduction in the statutory rates of companies' taxation. Moreover, the share of corporate tax revenue over GDP began to decline since the beginning of the new millennium, adding strain on the keeping of fiscal balances. The existence of 25 different tax systems increases transaction and compliance costs, penalising companies operating in the EU, relative to purely domestic companies. The 2001 European Commission's proposal for a common consolidated corporate tax base goes in the direction of reducing these costs. This levels the playing field both within the EU, for companies operating either domestically or in more than one member state, as well as between the EU and its worldwide competitors."

*"**The consolidation of the tax base will partly reduce profit shifting and the misallocation of FDI.***
Despite the still limited empirical evidence on the quantitative importance of profit shifting in the EU, the use of transfer pricing, thin capitalisation or similar tax planning devices are widely known and used by multinational companies to minimise their tax burden. However, implementing a system of formula apportionment in the EU would not usually, depending on the formula adopted, be able to entirely solve this problem. A common consolidated tax base with formula apportionment would also be unable to properly face the problem of the possible misallocation of capital which could be induced by tax rates differentials. The report shows that there is a wide dispersion of effective tax rates among EU countries and there is evidence that foreign direct investments are sensitive to these differentials. The risk of tough tax competition to attract FDI is limited by the prominent importance on non-tax factors in the location of FDI, but does exist in the European Union."

*"**Misallocation of capital can further be reduced by the introduction of a minimum tax rate.***
The Commission's proposal is strictly limited to tax base coordination: each member state would be left free to set the desired tax rate on apportioned profits. Moving in this direction would be an important step towards greater integration and a better functioning of the internal market, but would not constitute a complete and entirely satisfactory solution to all the relevant issues. To fully solve the problem of profit shifting, tax base coordination should be accompanied by tax rate harmonisation. To prevent misallocation of capital, a common rate is not necessary and could even be harmful, as long as higher rates are accompanied by location specific and as long as the common rate will force small, peripheral countries to increase their rates. That is why the proposal of a minimum tax rate tends to have a greater support. The level should be low enough to encourage growth in the EU and prevent losses for the less advantaged-low taxed countries. Otherwise, other solutions should be devised in order to compensate these countries losing from tax rate coordination."

For further details visit our web site on www.euroframe.org/efn*, or contact:*
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