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Comment on "Capital Taxation in an Enlarged EU: The Case for Tax Coordination and The Case for Tax Competition"

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1. Introduction

Over the last 20 years increasing economic integration has prompted a debate on the impact of tax competition on the location of economic activities and the need for tax coordination. Two radical views have emerged in the debate:

a) Tax competition is good: it enhances efficiency. Countries should compete globally and public services should also be exposed to competition. Tax competition can help restraining the size and the cost of government.[2]
b) Governments must have the power to raise as much revenue as necessary to finance the expenditure level that is deemed optimal. Tax competition can hamper the achievement of public targets, in particular it is harmful to redistribution policies.[3] Tax competition can also shift the tax burden from highly mobile bases (like capital) to less mobile bases (like labour), thereby inducing distortions and negative effects on

[1] The views expressed in this paper are those of the author and should not be attributed to the institution he is affiliated with.

[2] "Governments that could not provide good value for money would find their economies shrinking beneath them. For them, arbitrage in taxes and regulation would be a problem. For citizens and companies, though, such competition, even in its extreme form, might seem rather a good way of getting better, if not necessarily cheaper, government." (The Economist, 1998, p. 60).

[3] This point has been made very clearly by some European policymakers: "it is obvious … that undisciplined tax competition is unacceptable, socially and economically." (Strauss-Kahn, 2000, p. 2).

employment.[4] In the European Union (EU), this view is shared by the supporters of the European Social Model, who point to the need for tax coordination at the EU level.

The papers by Lars Feld and Bernd Genser provide a broad overview of these issues and examine the underlying technical and political dimensions. They highlight the open empirical questions and the controversial policy indications. The papers also consider the specific problems raised by the enlargement of the EU to ten New Member States, which has recently given new prominence to tax competition.

Both papers are very much cautious in highlighting both the benefits and costs of tax competition and tax coordination and in drawing policy prescriptions. However, the views taken by the authors are significantly different. Feld emphasises the benefits of tax competition and points to the problematic features of tax coordination. Genser shows that tax coordination can be useful and that – more specifically – greater tax coordination would be desirable in the EU.

2. Is Tax Competition Relevant?

On one point Feld and Genser fully agree: tax competition exerts important effects on business decisions. Feld, in particular, quotes several studies that point to the importance of tax competition (either deliberate or stemming from different national regimes) in location choices and concludes that the international and regional evidence provide overwhelming support for the existence of tax competition. He notes that governments engage in strategic tax settings and enter a process of tax and welfare competition.

The authors do not tackle directly the issue of the impact of tax competition on public revenues in the EU. In this regard, one should reconcile the evidence concerning the impact of tax competition on location choices with that on revenue trends. So far there is no evidence that corporate income tax (CIT) revenues are collapsing in the EU and OECD countries (European Commission, 2000; Devereux et al., 2002).

The average ratio of the CIT revenues to GDP in OECD countries has been about constant from 1980 to 2002 (at around 2.5% – 3%) in spite of the marked decline of the average CIT rate (from 48% in 1982 to 33% in 2004), implying that governments get more revenues per point of tax rate. This may depend both on the increase in the share of profits out of GDP and on the broadening of tax bases. The estimates of the European Commission concerning the average effective tax rate on capital point to a somewhat similar picture: in the euro-area this rate increased from 15% in 1970 to 17% in 1980 and 20.8% in 1990 and declined thereafter to

[4] See European Commission (1997).

about 19% in 2002 (Martinez-Mongay, 2003). Effective tax rates on profits recently seem to be on a declining trend, but they are still close to their peak.

In interpreting these results, one should consider that the decline in tax rates and the broadening of tax bases also reflect national policies not necessarily related to tax competition. The issue of tax base broadening was extensively discussed in many countries in the 1980s in a context in which tax competition was not yet prominent. Efficiency, simplicity and equity were the keywords of the reform proposals. There was a wide consensus on the need to broaden tax bases and reduce the dispersion of tax rates. These changes were expected to reduce tax induced distortions (Hagemann et al., 1987; OECD, 1993). In the following years several countries modified the structure of personal and corporate taxation (Hallerberg and Basinger, 1996).

This suggests that changes in CIT rate and structure should not be interpreted only in view of international tax competition. Several other factors are also relevant. It is an open question whether and when the factors which have so far offset the reduction of CIT statutory rates will fade away and revenues will be more significantly affected by tax competition.

3. Is Tax Competition for the New EU Member States Relevant?

Tax competition is evidently not a new phenomenon. Multinational companies have long being taking into consideration and exploiting differences in tax regimes. In the EU the integration of factors and goods markets and monetary union have given growing prominence to differences in tax regimes. As Genser notes, the issue of tax harmonisation is nearly as old as the process of European integration.

Can we expect a sizeable increase of tax competition due to the enlargement of the EU? Genser expects that capital tax competition will indeed intensify in the enlarged EU. He notes that the increased dispersion of effective tax rates on capital returns within EU countries is likely to determine greater distortions in the allocation of the supply of capital and that the increased dispersion of statutory tax rates can create negative fiscal externalities. Genser also notes that in the medium run CIT competition in the enlarged capital market of the EU-25 is likely to reduce the level of CIT rates in the Member States. This is probably one of the considerations that leads him to advocate further tax harmonisation. [5]

[5] The issue has also raised the interest of policy makers. For instance, in 2000 a former French Finance Minister noted that it is unacceptable that those states most benefiting from the largesse of the Union in order to promote their development …fail to impose minimum tax disciplines. He also stressed that this problem has to be solved before enlargement of the EU. (Strauss-Kahn, 2000).

Without questioning the basic thrust of Genser's argument, some considerations suggest caution concerning the impact of EU enlargement. First, decisions about location depend on the overall tax structure. While CIT rates are relatively low in the New Member States, their overall public revenue to GDP ratios are relatively high (about 45%) in comparison to countries of similar development. Moreover, their public deficit levels do not seem to allow much room for reducing overall tax revenues. Second, the tax structure is just one of the relevant factors in the decisions about the location of business activities. Labour costs are probably more relevant.[6] Finally, before enlargement the EU Member States were already competing in the world market with countries characterised by lower tax rates.

In conclusion, enlargement may significantly increase tax competition in the EU, but this is part of a broader process of economic integration in which several other factors and other areas of the world play an important role.

4. Can We Assess the Revenue Costs of Tax Competition?

In order to properly assess the need for tax coordination, we would need estimates about the impact of competition on tax revenues.[7] The problem here is that we do not have clear-cut quantitative evidence about the size of revenue losses so far. For instance, we do not know what revenues would be cashed by the governments of France, Italy and Germany if Ireland had a CIT statutory rate in the range of those applied in the three countries.

Likewise, we are not in the position to predict future revenue losses, for instance those deriving from EU enlargement. We know that there may be a problem, but without quantitative estimates it is difficult to evaluate the cost of competition and the need for coordination or harmonization. This may partly explain why the lengthy debate on tax harmonization in the EU has not produced major results: as long as the effects of tax competition remain somewhat vague, it is difficult to expect that policy makers take action.

5. What Coordination?

After considering the evolution of the tax coordination debate at the EU level, Genser indicates some guidelines for CIT coordination in the EU. He suggests the introduction of a harmonized CIT base. European multinationals would consolidate profits on the basis of common accounting standards. Consolidated profits would

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[6] One can see in this regard that so far there has been very little debate concerning the Chinese CIT.

[7] Tax coordination has been advocated also for other reasons (e.g. the reduction of distortions in business activity and the cost of tax compliance). Obviously, the need for coordination should be assessed on the basis of all relevant aspects.

be allocated to each Member State according to an agreed apportionment formula based on easily verifiable business indicators. Each country would set its own tax rate. This solution would reduce profit shifting, compliance costs and the costs of tax administration and control. It would not interfere with different national approaches to the integration of the CIT and the personal income tax. Feld takes a different view and stresses that while a uniform tax base may provide several benefits, formula apportionment introduces relevant distortions and meets difficulties of implementation.

The authors also differ in their evaluation of the impact on revenue. Genser notes that as formula apportionment provides a largely inelastic tax base, it creates an incentive to increase tax rates. Feld quotes some studies that argue that formula apportionment does not discourage Member States to reduce tax rates strategically in order to attract tax payments.

In the end, the two positions largely reflect different opinions concerning the need for tax coordination. Genser believes that tax coordination is necessary and supports a solution that takes into account the lengthy debate at the EU level. Feld criticises the formula apportionment solution and does not offer any alternative solution, since he believes that there is no need for coordination. So, basically, the issue is: can we afford to lose the revenues currently provided by the CIT?

6. Can We Afford to Lose the CIT?

Feld does not worry. He notes that there are no clear-cut indications concerning the impact of tax competition on income distribution. He shows that there is no evidence that tax competition is determining the collapse of the welfare state.[8] On the other hand, Feld notes that there is evidence that fiscal competition induces higher efficiency in the provision of public goods and better economic performance. For these reasons he does not advocate tax coordination.

However, one cannot assume that the budgetary problems created by tax competition will necessarily be modest also in the future. Primary public expenditure in the EU-15 has been about stable over the last 20 years at about 45% of GDP. Without reforms, ageing would increase this ratio by about 5% by the year 2040. Even assuming that spending will be curtailed by new reforms, it is very likely that there will be no much room to absorb sizeable revenue losses. This implies that revenue losses in the taxes affected by competition might either increase deficits or require revenue increases in other areas, such as indirect taxation.

There are economic reasons for considering that in some European countries public sectors are too large and that some retrenchment would be useful. However,

[8] This contrasts with earlier views pointing to the risk that unmitigated tax competition would determine a crisis of European welfare states (Sinn, 1990).

tax competition is not the only way to improve the efficiency of public sectors. Moreover, if the size of the public sector reflects national preferences as interpreted by government and parliament, tax competition seems a very indirect and poorly targeted way to reach the optimal size of the public sector (Sørensen, 2004). The most direct way would be an open discussion concerning the desirable size of the public sector in each country.

Moreover, tax policy has many objectives and constraints (OECD, 2001). Equity considerations are still very important. The public in EU Member States does not seem to accept that returns on capital are not taxed (although it accepts that rates on capital are lower than those on labour). One can also see that a sizeable part of the tax cuts introduced in recent years in EU Member States have been addressed to personal income taxes (Balassone et al., 2003). This may suggest that if governments want to reduce the burden on companies, they will also have to introduce cuts targeted to households.

This may imply that it is unlikely that we can live without some kind of CIT. It may also suggest that we need some tax coordination, at least to contain profit shifting and to minimise compliance and administrative costs.

7. What Indications from the Debate?

The papers highlight the complexity of international tax competition. They also confirm that there is a mismatch between the rich theoretical insights provided by the extensive literature and the more ambiguous policy indications.[9] The estimates of the impact of tax competition, particularly on public revenues, remain unsatisfactory. There is clearly a need for further empirical work.[10]

In this context it is not surprising that progress at the EU level is relatively modest. Surely the need for unanimity does not help tax coordination, but in other areas of policy (e.g., internal market and monetary union) EU governments have managed to reach agreements leading to greater economic integration. In the end, it is likely that coordination will take place if and when the costs of tax competition appears to be too high.

Although from different perspectives, the papers show that in their extreme forms both tax competition and tax harmonisation are problematic. While European budgets are not in the position to sustain large revenue losses, the case for large scale tax coordination is not self-evident. Moreover, no solution to the coordination issue is evidently optimal on all grounds.

This suggests the need for a pragmatic, cautious, gradual approach, trying to get some benefits both from competition and coordination (Cnossen, 2001). One

[9] This point is more extensively examined in Zodrow (2003).

[10] Referring to the international aspects of taxation, Kay (1990) stressed that there is probably no area of tax policy where further research effort is so clearly required (p. 69).

should also keep in mind that international tax competition is surely important, but tax policy has several objectives and constraints.

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