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Competition – Location – Harmonization: The Challenges of Capital Taxation after EU Enlargement

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Welcome Address

Joseph Schumpeter wrote in his essay "Die Krise des Steuerstaates"[1] (1918) that public finance is one of the best starting points to analyze the social and political situation. And he continues that this is particularly true for periods of fundamental change and of transformation because this is usually reflected in problems of public finances. Taking the current European situation as it is and given the ongoing political discussions concerning capital taxation all over Europe, one – at least – cannot rule out that he might be right again.

Taxation, in general, is at the core of public action since centuries. It affects the propensity of work, the propensity to save, risk taking and innovation. It influences cyclical developments, long-term growth via effects on investment and capital accumulation and the taxation of income and wealth. One basic tax principle is that taxation, when intended to correct market failures or to generate revenues for public tasks, should not (excessively) distort economic decisions and reduce incentives to work, invest and take risks. This principle is of particular interest in the context of open economies as openness offers mobile factors of production the possibility to move – to move to those places which promise them, ceteris paribus, the highest rate of return after taxation. However location decisions, if based dominantly on the basis of tax differences, distort the international allocation of capital and reduce international welfare.

[1] J. Schumpeter (1976) Die Krise des Steuerstaates, in R. Hickel (ed.), R. Goldscheid, J. Schumpeter, Die Finanzkrise des Steuerstaates, Beiträge zur politischen Ökonomie der Staatsfinanzen, Frankfurt am Main.

Six Questions to Address the Relevant Issues

In this highly topical workshop a number of issues is pointed out which are at the core of today's academic discussion. Approaching issues of capital taxation under the specific conditions of EU-enlargement very much sharpens the importance and the relevance of this topic.[2]

In general, six questions may be seen as the main points to be addressed in the overall context of capital or corporate income taxation:

(i) Is it justified to collect corporate income taxes?

(ii) If yes, which effects they may have on growth?

(iii) What are the arguments for tax competition versus tax harmonization?

(iv) Is there an – economic or political – need for coordinating corporate tax and capital tax policies in the European Union?

(v) What are the relevant differences in effective tax rates between Old and New Member States of the enlarged EU?

(vi) And, finally, how important are effective tax rates and/or differences in corporate tax rate as a location factor for FDIs?

Keeping these elements in mind, what is the overall starting point for all these issues? Significant regional differences in the corporate tax burden currently dominate the tax policy debate not only in Austria but all over Europe. In particular, some of the New Member States have only recently implemented or announced tax reforms that aim at making them more attractive for FDI and as a business location in general. For example, in Austria – as in many other countries – the recent tax reform included a significant cut of the corporate income tax rate, which was mainly triggered by considerable differences in tax burdens compared to some neighboring countries.

This illustrates that in small and open or in open and integrating economies, the policy makers introducing tax reforms have to take into account that spillover effects tend to be important. In the end, tax policy can be used as a form of beggar-thy-neighbor policy, including all kinds of negative macroeconomic consequences. In nowadays political reality, concerns about the effects of tax rates on international competitiveness are obviously the driving forces behind corporate tax reforms.

[2] For an excellent overview of the relevant issues see Devereux, M. P., Griffith, R., Klemm, A., Corporate income tax reforms and international tax competition, Economic Policy 35 (2002).

The situation becomes further complicated by the argument raised in the public debate that (large) corporations tend to evade taxation by shifting profits from high-tax to low-tax countries. On today's globalized markets it is not only easier for investors and corporations to shift assets or activities across borders but definitely harder for a state not to participate in the competition for internationally mobile capital. The ongoing integration process evidently restricts the room for taxing mobile tax bases on the cost of immobile tax bases.

Hence, the ongoing integration process has – considered from the perspective of governments - an impact, not only in terms of creating scope for proactive measures in global location competition. This process evidently restricts the room for tax increases on mobile tax bases on the cost of immobile tax bases. In an open economy, the problem of levying taxes on mobile tax bases hinges on the possibility of an induced tax base flight (positive externality to other countries) or a tax induced tax base import (negative externality to other countries). The latter implies the strategic use of tax policy measures designed to attract tax bases, such as financial capital, by offering foreign investors favorable tax treatment of capital income. However, we all are aware, that the empirical findings, about tax-induced location decision of FDI are rather inconclusive.

Tax Reforms and the History of the Corporate Taxation Debate in Europe

Discussing the challenges of capital taxation today, one needs to ask first for a definite understanding of what has happened in the field of corporate taxation in Europe over the last two decades. Empirically, statutory tax rates on corporate income declined significantly since the early 1980s in all EU Member States. At the same time, effective taxation has decreased much less but it converged somewhat across countries.

In the 1980s, efficiency, simplicity and equity were the keywords of tax reform proposals – based on the consensus for a need to broaden tax bases and reduce dispersion of tax rates in order to reduce tax induced distortions. In the late 1990s, somewhat contrary to the reforms a decade before, the reforms also aimed at reducing the overall tax burden. Specific targets of the reforms in the 1980s were (i) to promote employment and investment via lower marginal taxation, (ii) to increase tax neutrality with respect to savings and financing instruments, (iii) to improve the efficiency of tax administration and, last but not least, (iv) to simplify tax codes. However, tax-cutting and base-broadening reforms have had the effect that, on average across EU Member States, effective tax rates on marginal investment have remained fairly stable.

In parallel to this empirical developments, one has also to be aware of important historical changes in European corporate tax policy as well, on the one hand influencing and on the other hand reflecting changing policy attitudes towards

capital taxation. In 1992, the EU's Ruding Committee proposed a minimum statutory corporation tax rate of 30%. At that time, only Ireland had a lower rate than this – and then only for the manufacturing industry. Now, 12 years later, not only most of the New Member States but also about one third of the Old EU Member States have tax rates at or below this level. In contrast, the Bolkestein Report of 2001 suggested implementing a common consolidated corporate tax base and home state taxation for small and medium sized enterprises. However, empirical studies asking whether European countries have engaged in some form of tax competition in corporate income taxation over the past decades show that no strong conclusions can be drawn and that one has to be very cautious in interpreting the evidence. If anything, effective tax rates seem to have in fact converged across countries.

Last but not least, in order to prevent harmful tax competition and to tackle the tax avoidance practice of multinational corporations, the EU Council has adopted a resolution on a Code of Conduct for business taxation – although this is not expected to produce significant results in the short term. On the face of it all these reforms seem consistent with the predictions of economic theory. It has been argued that increasing capital mobility will lead to a "race to the bottom" as countries compete with each other to attract capital (based on source-based capital income taxes). Policy makers have been concerned that this downward pressure on corporate income taxes might lead to a loss of revenue, and thus provide a constraint on government activity. In 1997 the European Commission also expressed concern that this process is forcing governments to rely more heavily on taxes on labor which will in turn increase unemployment. The European Commission and the OECD have made attempts at international coordination to counter what they see as "harmful" tax competition.

The view that corporate income tax rates have fallen in response to increased mobility of capital, as countries compete to lower the cost of capital within their jurisdictions, is not generally borne out by data. However, countries may instead compete for the activities of mobile multinational firms, which have access to valuable proprietary assets, rather than simply for mobile capital. The literature on multinational firms emphasizes that such firms make discrete investment choices: for example, whether to export to a new market or to produce locally, or within a new location to site a new production facility. The impact of taxes on such discrete decisions is not captured by the effective marginal tax rate. Instead, it depends on the proportion of total profit taken in tax, measured by the effective average tax rate. This measure also depends on both, the tax rate and the tax base, so that the effect of the rate-cutting, base-broadening reforms could be either to increase or decrease this effective rate. The evidence point to a fall in the effective average tax rate averaged across countries. This however, means, that the "standard" model from the theoretical tax competition literature does not explain the reforms, since it

(implicitly) focuses on only one aspect of the tax schedule – the effective marginal tax rate.

The finding that there has been a decline in the effective average tax rate may indicate a process of competition to attract more profitable and mobile firms as a fall in this rate benefits more profitable firms. If such firms also tend to be more mobile – and if their mobility has increased over time – then governments may gain by shifting the shape of the tax schedule in order to attract them.

A different explanation for the observed reforms is the idea that governments also compete for flows of taxable profit as well as for inward flows of capital. That is, conditional on where they locate their real activities, firms may be able to shift their profit between countries in order to reduce their worldwide tax liabilities. A reduction in the cost of profit shifting would provoke governments to lower the tax rates and also the tax allowances in order to recoup the tax revenue lost from being obliged to have a lower tax rate.

Tax Competition versus Tax Harmonization – Is there a Clearcut Policy Advise for the Reality of Tax Policy?

One of the current hot topics as well from a theoretical as, in particular, from a policy point of view is the issue of tax competition versus tax harmonization. The well known standard result of the literature on tax competition is that countries have an incentive to reduce taxes on locally invested capital. The intuitive explanation behind is that a small country cannot influence the world rate of return available to domestic investors. In this setting, if countries compete to attract foreign capital, they have an incentive to reduce taxes on capital and keep them at a low level.

This basic result needs to be further qualified by specifying the tax principle applied in taxing cross-border investment, namely whether capital income is taxed according to the source-based or the residence-based principle of taxation. In reality, the enforcement of the residence principle in taxing worldwide corporate income is confronted with a number of administrative and practical difficulties. Therefore, capital in most countries is taxed on the basis of the source principle. This departure from the residence-based tax principle and the application of the source principle lies at the heart of the worries expressed within the EU over the last decades.

Under these conditions, it is not surprising that the economic debate and the political process have moved forward to discuss issues of tax harmonization, thereby avoiding negative effects of tax competition. Surprisingly little research has yet been undertaken on the economic effects of tax harmonization, which – of course - has its specific problems as for example moral hazard or differences in preferences. Hence, it might be reasonable to go into the direction of some hybrid

form between tax competition and tax harmonization which tries to establish some fundamental common rules across countries by “tax coordination”.

No doubt, issues of capital and corporate taxation are at the core of the European tax policy debate and will continue to stay there for some time. Today’s workshop offers the opportunity to shed light on a number of important aspects in this context. It is my particular pleasure to welcome you all and to thank you for joining us today here at Oesterreichische Nationalbank, first of all those who have accepted our invitation to act as speakers or discussants. Special thanks, of course, go to the organizers of the workshop who have invested a lot of efforts over the last month to make this event possible. I am quite sure that we will see fascinating and stimulating discussions.