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Comment on "Capital Taxation in an Enlarged EU: Competition or Coordination?"

Martin Zagler
Vienna University of Economics and Business Administration

1. Introduction

This volume contains two excellent papers by Lars Feld and Bernd Genser. It is the ambition of this discussion to review and relate the two papers, and to set them in perspective. In one sense, the two papers are contradictory. Feld makes the point for tax competition, whereas Genser emphasizes the case for tax coordination, as the title already suggests. However, the two papers are also complementary in an important way. Whereas Feld focuses on theoretical arguments in favor of tax competition, Genser predominantly discusses European policy in favor of tax coordination. Taken together, these two papers give a magnificent overview over the literature on capital tax competition and coordination. However, they come to surprisingly different conclusions, and it is an ambition of this comment to identify the source of this divergence.

Instead of discussing each paper in turn, it turns out that we can discuss the two papers by answering a series of questions. First, we ask why we need capital taxation? Second, we ask why capital income taxes are set too low? Third, we ask why capital income taxes are set to high? Finally, we ask which form of tax coordination could improve welfare? These four questions should allow us to review the papers and understand why the two authors draw divergent conclusions.

2. Why Do We Need Capital Taxation?

Minimizing distortions, as suggested by the theory of optimal taxation is equivalent to minimizing the excess burden of taxation. In so doing, the theory ignores distributional consequences. In particular, it suggests the highest tax rates for inelastic goods, which tend to be necessities most consumed by poor individuals, whereas it suggests to tax elastic goods least, which conforms to consumption patterns of the rich. It also implies taxing first period consumption higher than

second period consumption ($t_1 > t_2$), which implies that young individuals should be taxed higher than old individuals. If young individuals are poorer than old, it also exhibits negative intergenerational distributional implications.

If we wish to include distributional considerations in taxation[1], we need to resort to a third best policy. In such a policy, capital taxation can be an important instrument to redistribute income vertically from capital to labor. If wealth correlates with income (as it empirically does), capital taxation can also contribute to the interpersonal or horizontal redistribution of income.

This suggests that in a closed economy, the predominant argument for capital taxation is redistribution. We cannot immediately carry this argument forward to the open economy, as in this case workers actually suffer from a capital tax increase in a particular country. However, if capital is indeed in inelastic supply globally (which it is at least in the short run), then the surplus to capital owners is equal to the total revenue, or rK. Hence, capital owners do earn rents in the open economy. If all countries introduce a tax on capital, the net interest rate would fall globally. This would not be the case if we tax labour. Hence, internationally capital income taxation still enables the redistribution of income. But it required the joint efforts of all countries, or tax coordination. Both the theory of optimal taxation and the international taxation of capital therefore come to the conclusion that capital taxation is allocatively inefficient, but improves equity within an economy. We should therefore tax capital predominantly because it improves the distribution of income.

According to Genser, from a purely economic perspective, capital income taxation should favor the efficient supply and utilization of capital in the enlarged internal capital market. Distributional questions are therefore not his concern. By contrast, Feld acknowledges the importance of tax competition for redistribution, and devotes both a theoretical and empirical chapter to the issue. He discusses the impact of migration (rich individuals move to countries with low taxes and low social transfers, whereas poor people would move in the opposite direction. He also acknowledges the fact that public expenditure will shift from welfare expenditures to infrastructure expenditures. He notes that firms supposedly benefit more heavily from a shift from social transfers to infrastructural spending.

Feld then reviews empirical literature for both the migration hypothesis, and finds little evidence in Europe, and the redistribution issue. In quoting Winner (1994), Feld notes that in 23 OECD countries and the time period 1965 to 2000, he finds that capital mobility shifts the tax burden from capital taxation to labor taxes. This clearly implies a deterioration in income distribution. Feld then continues to present a lot of evidence for Switzerland, where apparently tax competition among

[1] In a pure neoclassical economy, distribution is a non-issue. Production factors are rewarded according to their respective marginal product, and interpersonal differences in wealth are due to individual choice, in particular over patience, only.

cantons does not induce a decline in the Swiss welfare state. He uses this as evidence to refute the redistributional argument on empirical grounds. In passing, he notes however, that there is some redistribution at the federal level.

The European Union so far has no tax privileges. Still, there is some redistribution within Europe, particularly through structural and cohesion funds. However, these allow for redistribution only from rich regions in Europe to poor regions, but do not allow for intra-national redistribution. Moreover, they are quantitatively insignificant and certainly cannot replace redistribution through taxes and social transfers as undergone by EU Member States. It is of course illusionary to imagine the European Union to ever redistribute enough income to satisfy the needs of the people (similar to Swiss cantons today), so that indeed tax competition could lead to an outcome that does not correspond to the will of the people.

3. Why Are Capital Income Taxes Set too Low?

The previous chapter has concluded that the reason to coordination capital income taxation is predominantly an issue of income redistribution. Vertical redistribution implies that rich capital owners should pay part of welfare expenses. And, of course, firms should pay for public infrastructure that improves capital productivity. Sinn (2003) has proven that firms will not pay in full for public infrastructure when the public good exhibits increasing returns to scale. In our example, this would be the case if a small increase in the provision of infrastructure leads to a large decline in costs, whereas a small reduction in usage changes costs only little. Most public goods exhibit this property.

Starting from a capital tax rate that represents preferences over redistribution, governments have an incentive to reduce the capital tax rate. If other countries don't react, this reduction would lure in additional capital, leading to an increase in revenues. However, other countries have the same incentive to reduce tax rates, leading to tax competition below the socially preferable level, and in case of public goods with scale economies, even below self-financing of public infrastructure. This is the essence of the fiscal externality present with tax competition. Not only would workers have to bear the entire cost of the welfare state, they would also have to bear part of the infrastructure costs. Therefore, tax competition may not only be negative for equity considerations, but also from an efficiency perspective. (Sinn, 2003)

4. Why Are Capital Income Taxes Set too High?

Clearly, the above analysis has assumed that governments behave optimally when setting policy. However, optimality was constrained, as each government would have taken decisions of other governments as given. Fully benevolent governments

would get together and coordinate on a level of taxation, or a tax policy, which would ensure that at least all public infrastructure is financed through taxes on capital income. However, as Stiglitz (2000) has stated, good government is scarce public good. And this argument is frequently mentioned with respect to tax coordination. “The state does not always do what it ought to do. Political actors follow their own self-interest and seek to get rents from the political process.” (Feld, in this volume)

Even if we start from a situation of tax competition with fiscal externalities, raising tax rates may not necessarily improve welfare. As Keen and Edwards (1996) have demonstrated, capital taxation will only increase welfare for the citizens under certain conditions. In particular, tax coordination improves welfare through an income effect which internalizes the fiscal externality, implying higher revenue from capital taxation and a higher level of public expenditures. Tax coordination reduces welfare due to a substitution effect (or relative price effect), which identifies how much of the welfare gain the policymaker is able to divert from private welfare to rents. If the negative substitution effect outweighs the positive income effect, tax coordination may be inefficient from the beginning. Selfish policymakers will agree coordination measures until they can no longer extract private rents. Capital taxation among selfish policymakers may therefore almost certainly end up with capital taxes too high.

Both Feld and Genser address the behavior of policymakers. Feld implies that rent seeking of policymakers is indeed a crucial problem, and competition among policymakers, in particular over capital taxation, could improve welfare. Genser, by contrast, has a more positive view on policymakers. Whilst he does not explicitly express the issue of non-benevolent policymakers, he clearly states his belief that there is room for further coordination which properly implemented should be beneficial to the Member States.

5. Which Form of Tax Coordination Could Improve Welfare?

For the reasons mentioned above, there may be too much or too little capital taxation. Either way, tax coordination can be justified both on efficiency grounds and on distributional grounds. However, depending on the motivation for tax coordination, different regimes of coordination will be implemented. If capital taxation is coordinated in order to internalize fiscal externalities, we can expect countries to suffer from similar levels of externalities, and therefore a similar increase in tax rates will be supported. Even if tax coordination is due to rent-seeking politicians, we would expect similar behavior of politicians in similar constitutional systems (Janeba and Schjelderup, 2002), and therefore again similar increase in tax rates will be supported. However, if tax coordination is aspired in order to alter the vertical distribution, we would expect countries with different

preferences for equality to target different capital tax rates, rendering tax coordination more difficult.

When Genser discusses the sequence of proposals in the European Union to coordinate capital taxation, starting from the Neumark Report (1962), followed by the Van den Tempel Report (1970), the CIT Draft Directive, the Ruding Report (1992), and finally the Bolkestein Report (2001), we can speculate that the reason that policymakers could not agree was not so much the existence of market inefficiencies or the consequence of the political economy, but that agreement over the size of redistribution could not be reached because of differences in the underlying preference structure.

We can find support for this hypothesis in Feld (in this volume), who concludes: "Whilst (fiscal competition) does apparently not lead to any efficiency problems at least there is no evidence supporting this hypothesis, its impact on the ability of governments to conduct redistribution is less favorable." Feld then continues to discuss proposals to mitigate the problem, in particular residence requirements and delayed integration in welfare systems. He acknowledges that some form of tax coordination is required at least for multinationals, when he says: "One of the main problems of European corporate income taxation consists in the possibilities of multinational firms to shift profits to jurisdictions with low tax rates. […] In fact, profit shifting leads to a redistribution in the first place, because the finance minister has to forego tax payments while no relocation of firms occurs."

Genser, too, isolates the taxation of multinationals as the main objective of European corporate income tax coordination. However his motivation is rather different. His three main arguments are the provision of a level playing field for business activities, non-discrimination of cross border activities, and the mitigation of fiscal externalities. Whilst the latter has been discussed at length throughout this comment, the prior two deserve some consideration. Non-discrimination is certainly a central aspect of the common market, and can be traced back to the founding document of the European Union, the Treaty of Rome. However, it is a political argument more than an economic argument. The provision of a level playing field can be traced back to the concept of Ordnungspolitik, which received some attention in the German theoretical debate on economic policy. It postulates that competition between firms is always beneficial, and should therefore be a goal of economic policy. If there is already competition within countries, international competition cannot provide any more efficiency gains.

Starting from a very different background, both authors support the recommendations of the Bolkestein Report (2001) to introduce consolidated accounting for European multinationals. Genser goes even further by suggesting: "Consolidation of company profits should be mandatory for EU multinational companies according to harmonized corporate income tax accounting standards. […] The reallocation of consolidated profits to taxable subsidiaries of multinational

corporations should be based on an apportionment formula using multiple weights based on easily verifiable business figures. […] National autonomy in setting corporate income tax rates on taxable corporate profits should prevail."

The arguments in favor of consolidation typically are a reduction in compliance costs for firms, the ensuring of international loss offset, reduced monitoring and control costs of tax authorities, the elimination of fiscal externalities, and compliance with capital export neutrality (Genser, in this volume). On the other hand, it distorts the optimal location choice of firms (Pethig and Wagener, 2003) and requires national tax authorities to share information. However, following the Parent/Subsidiary Directive (1969 and 1990), the Merger Directive (1969 and 1990) and the Arbitration Directive (1974 and 1990), we find that national tax authorities need to share information even under separate accounting.

6. Concluding Remarks

The aim of this comment was to review and discuss two papers on capital taxation by Feld and Genser, and set those papers in perspective to the vast literature on capital tax competition and coordination. The main argument of this comment has been that capital tax coordination is predominantly an issue of distribution. Capital is in perfectly elastic supply in a small open economy. Therefore the tax incidence falls to the immobile factor, labor. By contrast, capital is in inelastic supply at the international level. Hence coordinated taxation of capital can shift income from labor to capital. If distribution is the main concern, then tax coordination will only arise if countries have similar preferences over redistributive policies, at least under the current European political institutions of unanimity.

This discussion has also shown that fiscal externalities are a concern, and capital tax coordination could also be motivated on efficiency grounds. I think it is fair to say that the focus of the paper by Genser in this volume is clearly on the latter, whereas in the same volume Feld leans more to the explanation of redistribution. Neither author refutes the other assumption completely, however. In my humble opinion, where the authors really differ is their belief over the nature of the political economy. Whereas Genser assumes benevolent policymakers, Feld insinuates a political process that is at least in part driven by self-interest.

This distinction makes all the difference in the position towards tax coordination in the two papers. A benevolent view on public decision-making implies that tax coordination is favorable both to internalize fiscal externality and engage in redistributive policies. By contrast, a negative perspective on the political process induces support of political competition to minimize rent seeking. Despite these differences, both authors agree that consolidation of tax bases for multinationals, as suggested by the Bolkestein Report, is indeed a worthwhile cause. Given that both authors agree on a policy measure, we may indeed assume that this is a welfare enhancing strategy.

The coordination of the tax base does not necessarily imply a reduction competition over tax rates. Indeed, with a common tax base, information over favorable tax regimes is more readily available, and hence competition in tax rates may get fiercer. In addition, this may induce further competition in subsidies, tax holiday regulation, and tax enforcement, as suggested by Feld in this volume.

Finally, we have to be aware that the elimination of capital tax competition does not necessarily preclude tax competition. We know from national accounting identities that capital income plus labor income plus investment is equivalent to consumption plus total savings, or $rK + wL + I = Y = C + S$ (Cnossen, 2001). Rearranging this equation, we find that the capital income tax base, and hence capital income taxation, can be replicated with a consumption tax, a tax on net savings and a wage subsidy, $rK = C - wL + (S - I)$. Instead of capital tax competition, competition could merely shift to commodity tax competition (see Lockwood, 2001) accommodated by an increase in labor taxation.

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