I. INTRODUCTION

After a break of a few years, the European Union has recently again become active in the area of co-ordinating capital income taxes between Member States. In December 1997, the Council of Finance Ministers agreed to establish a high-level Working Party to implement a Code of Conduct on business taxation. In March 1998, the Commission proposed a revised draft of the 1990 Directive to eliminate withholding taxes on interest and royalty payments between associated companies within the EU. In May 1998, the Commission proposed a Directive designed to ensure minimum effective taxation of savings income within the EU, by ensuring that all Member States either apply a withholding tax of at least 20 per cent on cross-border interest payments to EU-resident individuals or provide information on interest income to other Member States.

Andreas Haufler has done an excellent job of setting one of these proposals — the proposed withholding tax on interest payments to individuals — as well as the proposal by the Ruding Committee (1992) for a minimum corporation tax rate, in a proper economic context. I will make a few more general comments,
II. ARE SOME FORMS OF TAX COMPETITION MORE HARMFUL?

I begin by asking a question: what is harmful tax competition? There are at least two attempts to define such competition in the field of business taxation: it is the subject of the Code of Conduct agreed by the Council of Finance Ministers, and it is also the subject of a recent investigation and report by the OECD’s Committee for Fiscal Affairs (1998). Although these definitions differ to some extent, I do not want to address technical issues. It is reasonably clear what both of these approaches are attacking. The EU’s approach focuses on discrimination between residents and non-residents and distinguishing between income arising from domestic, as opposed to foreign, real activity. The OECD’s approach focuses primarily on low rates of tax being charged on particular forms of income.

There is no doubt that attempts by individual countries to attract taxable income away from other countries can potentially undermine the taxable income in those other countries. As such, the OECD and the EU are certainly correct to address the issue. Whether they will be successful in their approaches is another matter. There will almost certainly be countries left out of any agreement on a Code of Conduct. In the EU context, this applies to all countries not in the EU. For the OECD, even two of its members (Luxemburg and Switzerland) could not agree to the recommendations of the report. And unless strong collective action is taken to prevent capital flows to tax havens not part of any Code of Conduct, then it is difficult to be optimistic about such a code having a significant impact. But this raises the issue of whether the OECD and the EU are following the right approach. An alternative approach would be to encourage countries to adopt sufficiently strong controlled foreign corporation (CFC) and transfer pricing rules, for example, that resident firms would find it much more difficult to shift profits into another country. If this were the case, the need for identifying tax havens would disappear. This could be done in steps, first perhaps by the OECD or the EU issuing guidelines of good practice for countries taxing the international income of their resident firms.

But to return to my question, I would argue that the description of such tax competition as ‘harmful’ is, in any case, misleading, in that it implies that other forms of tax competition are not harmful. But, for example, it is possible to interpret the UK’s recent gradual reduction of its corporation tax rate — which would not be included in either definition of ‘harmful’ tax competition — as a move to gain a competitive advantage over other countries. To the extent that other countries are obliged to follow suit, the capacity for raising tax revenue for business profits is reduced.
Having said that, it is not obvious that this implies a reduction in welfare. Here I would take issue with the arguments put forward by the European Commission. First, the Commission has presented and endorsed data designed to show that, over the last 10 years, taxes on labour income have risen steadily, while taxes on ‘other factors’ have fallen (European Commission (1997), using data from Eurostat (1997)). But it is entirely misleading to present such data as implying the need for a Code of Conduct on business taxation. Business taxes are only part of the taxes on ‘other factors’, and the revenue derived from them has, in fact, been reasonably constant as a share of GDP for several years (see, for example, Chennells and Griffith (1997)). Not only that, but, as Haufler points out and attempts to explain, marginal effective tax rates have also been remarkably constant, despite significant corporation tax reforms in virtually all EU countries over the last 15 years.

It is even more misleading to argue that increasing taxes on labour and falling taxes on other factors are likely to have resulted in higher unemployment. This is to misunderstand fundamentally the effective incidence of taxation. The basic economic theory was well put by Haufler. It is that, with highly mobile international capital markets, the burden of source-based capital taxes is likely to be shifted onto relatively immobile factors. This occurs because the international investor demands a higher pre-tax rate of return from his investment in a particular country (or the EU), so that the post-tax return is equivalent to that that he could earn elsewhere. But this is likely to result in lower real investment since the marginal product of capital in the country (or the EU) must be higher, and also to result in lower wages and lower employment. By contrast, a revenue-neutral switch to a tax levied directly on labour would remove this negative impact on investment and raise national welfare. Of course, this is not to say that taxes on labour have no impact on employment. But explaining unemployment in the EU is a difficult task (see, for example, a recent collection of papers on the issue in the Economic Journal, for example Nickell (1998)).

So the argument that a Code of Conduct designed to bolster business taxes within the EU will help to reduce unemployment is fundamentally flawed. This does not mean, of course, that there should be no Code of Conduct — or at least an attempt to prevent an outflow of profit. There may be other good reasons why countries would prefer to maintain a revenue-raising business tax. Indeed, it is hard not to have some sympathy with the Commission. Tax affairs in the EU require unanimous agreement, and Member States are extremely reluctant to give up the right to levy taxes. It seems that, in order to persuade Member States even to engage in a non-legally binding Code of Conduct, it is necessary to overstate vastly the argument in favour.
III. TREATMENT OF ALTERNATIVE SOURCES OF FINANCE AND TYPES OF INCOME

Haufler provides a very useful economic analysis of the likely impact of the withholding tax on interest payments to non-resident EU investors. The fundamental issue is essentially the same one as already discussed about tax incidence. International investors investing in the EU require a post-tax rate of return equal to that that they could earn elsewhere. Any withholding tax levied on such investors will require an increase in the interest rate to compensate them (some empirical evidence on this is referenced in Haufler’s paper). A crucial feature of the proposed withholding tax is therefore that it will not be levied on income accruing to non-EU investors. It is therefore unlikely to result in increases in the interest rate in the EU. The incidence of the tax is therefore likely to be on EU citizens — particularly those for whom placing their savings outside the EU would be particularly costly. However, an implication of this argument is that many investors would be likely to shift their activities outside the EU, which may have serious consequences for the financial sector within the EU.

Further, the combination of the proposed introduction of a withholding tax on interest payments to EU-resident individuals, and the proposed abolition of withholding taxes on interest payments between associated EU-resident companies, raises some concern as to whether the Commission has any long-term view of where the EU tax system is heading. Traditionally, it has been the case that equity income has been taxed primarily in the source country and interest income (which is exempt from corporation tax) is taxed in the country of residence. The new withholding tax is therefore inconsistent with this. However, that in itself is not necessarily a problem. The more pressing issue is the extent to which differing treatment of interest income according to the identity of the recipient is likely to create distortions in financing behaviour of European businesses.

Of course, as Haufler again notes, the traditional distinction between equity income being taxed on a source basis and debt finance on a residence basis has, in any case, become increasingly hard to maintain, as new financial instruments that blur the distinction between debt and equity have become more widely available. There are significant problems involved in an international context of avoiding double taxation of cash flows arising from such financial instruments, but also avoiding them not being taxed at all. This is certainly a vital area for international agreement in which the European Commission could give a lead in the future. But the basic problem remains that, in most business taxes, debt and equity are treated differently. And if there exists a financial instrument that is, say, treated as equity for tax purposes but has the relevant properties of debt, then the system breaks down. This suggests that the only long-term solution is likely to be a tax base that does not discriminate between debt and equity.
IV. TREATMENT OF DIFFERENT FORMS OF INCOME

The other aspect of the Commission’s proposals concerns the abolition of withholding taxes on royalty payments. The reason why this is deemed to be one of the most important issues facing the EU is unclear (although Gammie (1998) provides some evidence that businesses consider it to be so, and it is perhaps likely that more important issues are even less likely to find unanimous agreement).

It should be noted, to begin with, that withholding taxes on royalties are fundamentally different from withholding taxes on dividends, which are already the subject of an EU ban as applied to dividends paid between associated companies. That is because dividends are generally paid out of taxed income. That is, profits (net of interest payments) earned by a subsidiary of a foreign company generally face corporation tax in the source country at the same rate as profits earned by domestic companies. A further withholding tax on dividends paid to non-resident shareholders clearly discriminates against those non-residents. But this is not true of royalty payments to non-residents, which — in the absence of a withholding tax — generally escape tax altogether in the source country. So banning withholding taxes implies that the source country cannot levy any tax on income paid to non-residents in the form of a royalty (unless the corporation tax denies a deduction for royalty payments).

The principle that taxes on royalty payments should be on a residence basis, rather than a source basis, is, however, consistent with the principle that royalty income generated was in fact ‘earned’ in the residence country. That is, for example, if the parent company permits a foreign subsidiary to sell a patented product, it would generally be agreed that at least part of the profit generated is a return to the R&D undertaken by the parent, say, which generated the patent, which in turn permits a higher price to be charged for the product.

But the issue of distinguishing where profit is generated of course underlies the entire international tax system, based on transactions taking place at ‘arm’s-length’ prices. Defenders of this system point to the fact that rules have been gradually established over time which have made it possible to operate such a system. But there are at least three arguments that count against the system.

The first is that the system is, in fact, not working well. The existence of international-level collaboration concerning so-called ‘harmful’ tax competition is a testament to the fact that multinational businesses can, and do, shift profits between countries to reduce their overall tax liabilities. Further, as Haufler argues, the type of tax reform seen over the last 15 years — a reduction in the tax rate and an expansion of the tax base — is consistent with an attempt to prevent an outflow of profit while maintaining the same incentives for real investment.

The second argument is that, as business barriers break down within Europe, maintaining separate accounting across countries is likely to become more difficult. As Gammie (1998) has recently argued, the EU is likely to move in the
direction of federal countries such as the US and Canada, which both have single accounting within the country and do not attempt to divide income between states or provinces.

The third — and related — argument against separate accounting is simply that there is no economic rationale for it. If I have an idea in London, produce a good based on that idea in Paris, market it in Vienna, finance it in Milan and sell it everywhere, where did I make the profit? Each part of the international operation is a necessary feature of the activity; without it, there would be no profit. So each part might have a claim to all the profit. But that clearly fails an adding-up property that the profits allocated to each jurisdiction must add up to 100 per cent of total profit. If all these activities took place in different cities within a single Member State, no one would argue that profit should be allocated to each city. It is equally incoherent to allocate the profit of a multinational company to individual countries.

This argument — and the forces that continue to increase integration within the EU, such as a single currency — suggests that eventually a company active in more than one EU country must be taxed on its EU-wide profit, without an attempt to allocate that profit between jurisdictions. This might not be something that the Council of Finance Ministers is likely to agree unanimously in the short term. But there are ways in which such a system could operate that would not imply giving up all sovereignty in such taxation. One, proposed by Gammie (1998), is that each company’s taxable income is determined on a residence basis on its EU-wide profit. The administration of the tax could be carried out by the Revenue authority of the country of residence of the business. Taxable income could be apportioned to individual Member States on the basis of a relatively simple formula, as is commonly used in the US and Canada. Each Member State would be free to charge its own tax rate on that income. This proposal would avoid the main objection to moving from the arm’s-length principle to some form of apportionment of total profit raised by Owens (1993): namely, that there would need to be a common definition of a consolidated tax base. However, given that allowances under corporation tax systems are, in fact, broadly similar across Member States, there would need to be relatively little change in tax bases.

Such a system would not create a fully efficient market to the extent that tax rates might still differ between countries. It would also not remove the possibility that businesses have an incentive to shift profits out of the EU. But it would remove the need to allocate profits within the EU and would therefore effectively solve the problem of ‘harmful’ tax competition within the EU.

REFERENCES


