Appendix 3

Is Tax Harmonization Desirable?
A dissenting view

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a) Taxes and Infrastructure

Those who fear a “race to the bottom” normally do not take the fact that firms benefit from the infrastructure of a country including the guarantee of property rights into account. However, we cannot analyze tax competition and neglect the provision of public goods. Insofar as the marginal product of capital is positively affected by the supply of infrastructure services, taxes are enforceable as equivalence for these services. So there is a lower limit for a potential race to the bottom. It is defined by the value of the services offered by the government to the corporations or other users. Tax competition does not prevent the public provision of services.[1]

The argument can even be strengthened. Tax competition might lead to a kind of benefit taxation instead of zero tax rates. Different and non-converging tax rates can be the result of tax competition. Tax competition may be a way to force governments to supply public services efficiently and to reduce government expenditures in general. As a by-product, tax competition reduces the power of both the bureaucracy and interest groups. Such a result is undeniably beneficial.

Tax competition “puts pressure on governments to abolish tax financing and to switch to direct pricing through such devices as fees …” (Blankart 2002: 372). “It is true that not all government services can be provided by direct charges. But governments, under the … pressure of competition, would have an incentive to find out those charges that come closest to prices” (Blankart 2002: 372). It would be “revealed endogenously which goods are more private and which are more public” (Blankart 2002: 372).

From an evolutionary institutionalist perspective, it is necessary to enable national states to react to tax competition (Blankart 2000: 135). If taxes are harmonized, national governments will compete by using different policy instruments (e.g. subsidies or regulation intensity on product and factor markets (Blankart 2000: 140)).

b) Taxes and Redistribution

With regard to the effect of tax competition on income redistribution, a harmful erosion of the welfare state is expected by many observers. However, if capital is highly mobile and if redistribution via the social security system is put under pressure because of tax rate cuts and if private insurance becomes more important, this would be a plausible advantage from an efficiency point of view. In general, redistribution which is enforced by the government despite of a lack of consensus in the society, is problematic.[2]

If tax competition would lead to a reduction of efficient redistribution, it would be harmful. However, efficient redistribution would not vanish due to tax competition. An efficient system of assistance for the poor equates to welfare gains for the total population. As an example: an incentive-compatible system of social assistance may be advantageous for the general public and may survive (or would even be introduced) in a process of tax competition. Social security produced in this way is a positive factor of production. Social policy is thought to be adequate if people are induced to invest in real and human capital in a more risky way than they would have done otherwise. People are assumed to react in this way because a minimum income is guaranteed in case of failure.

It can be concluded that tax competition does not make income redistribution impossible. An increase of factor mobility is only a danger for involuntary redistribution based on the power of simple majorities. Redistribution based on a consensus (or a qualified majority) is not excluded in a process of tax competition. Altruism and redistribution resulting thereof are not excluded as well. However, redistribution which is only in the interest of the favored groups are endangered by tax competition.

c) Competition as a Means of Discovering Better Policy

As for the institutional aspects of tax competition, it should not be forgotten that information is created and spread about by the trial and error process of competition among policies. Governments may learn from the policy failures and successes of other governments. Competition might turn out to be an instrument of discovering better solutions for economic policy problems. All one needs to assume to advocate policy competition is that governments are not omniscient. This is also true for tax competition. The assumption that governments are not omniscient is sufficient to opt for tax competition over tax harmonization (Sinn, S. 1990). It is not necessary to assume that a government necessarily Leviathan.[3]

d) Do We Need a Common Tax Base?

Tax base harmonization is seen to lead to less distortions in the allocation of resources (especially capital), to less impediments for the cross-border transactions of firms, to lower compliance costs, to more security in the application of the tax legislation and to a closer connection between national governments' services and national taxes.

The reasoning seems to be convincing. However, any harmonization measure with respect to the tax bases is probably a first step towards harmonizing the tax rates. Moreover, it is by no means uncontroversial that taxing capital income is a good idea from an efficiency as well as from a redistribution point of view.

A common tax base might be a good idea if there were a curb on the propensity of politicians to make bad decisions. Specifically, any universal definition of taxable income should be predicated on the ability of companies to opt out of the system. In effect, the simplicity of a harmonized tax base must be matched with the liberalizing power of tax competition.

e) Advantages of Tax Competition

Tax competition and different tax rates are not only not harmful, they are advantageous (Vaubel 2001: 58–59). The optimal level of tax upon which government revenues depend is itself dependant upon the optimal level of expenditure which may well differ from country to country. The adequate ratio between tax revenues and revenues from borrowing depends from the level of public investment which—again—is not the same for every country. Given that the amount of tax revenues the optimal structure of tax revenues depends on factors such as "tax mentality" etc. Assuming an identical structure as to the kinds of taxes the structure of the tax rates depends on the specific supply and demand conditions on the relevant markets. This is a basic message of the literature on optimal taxation theory.

All in all, different ways of taxing people do not amount to a distortion. They reflect different preferences and different endowments of resources. The tax system is one of the many factors which determines the comparative advantage of a country. It is essentially a factor similar to wages or infrastructure. Distortions are not created by different taxes but by tax harmonization.

f) Special Aspects

Recently, the tax treatment of Marks & Spencer, a British multinational in the food and textiles sector, gained public interest. Britain allows firms to offset losses of subsidiaries in Britain, but not losses of subsidiaries abroad, against corporate profits. Marks & Spencer wants to be allowed to offset losses of its French, Belgian and German subsidiaries against its profits at other outlets.

If the European Court of Justice would decide in favour of Marks & Spencer, tax competition would be weakened and national tax autonomy would suffer. In addition, there would be further knock on implications. Using the Court's potential argument it is possible to forbid tax rate differences between EU countries or wage differentials in the EU member countries.

g) Some Remarks on the Debate on the Tax Policy of the EU Accession Countries

Government expenditures in the EU are high in relation to nominal GDP. Many observers believe that government expenditures in the old EU countries are too high and should be reduced in order to foster economic growth. Tax competition is an important instrument for achieving this aim. Pressure on the accession countries to raise their tax rates would be counterproductive.
A catch-up process in the new EU countries is desirable according to most observers. Low tax rates can be an important instrument for catching-up. Thus it would not be helpful to force the new countries to raise their tax rates.
This conclusion remains valid if the EU transfers to these countries are taken into account. EU subsidies e.g. for agriculture have to be assessed independently from tax policy measures and from the accession of new countries. This cannot be done here. But it should be mentioned that the EU subsidies for the new EU countries would be the lower the faster the new countries are growing.
The introduction of minimum tax rates in the new EU countries would mean that these countries take over elements of the bad tax systems of countries like Germany. This would be disadvantageous for the EU as a whole and it would be detrimental for the new countries.

h) References

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[1] The assessment of tax competition becomes more complicated if the quantities of capital and public infrastructure have not to be used in a fixed ratio in the production process. If using the "infrastruc-ture" of a country causes costs and is characterized by some rivalry in consump-tion the argument has to be refined (cf. Sinn, H.-W. 1997). This case is not considered here. However, it can be doubted that this case (of increasing returns to scale) is important in the real world (Blankart 2000: 133). In addition, there would be no case for tax har-monization (Boss 2003; Gern et al 2004: 102–104). Any potential inefficiency would only be an intermediate result of tax competition. Governments would have an incentive to react in order to restore efficiency. However, competition is necessary as a precondition for such a reaction (Blankart 2000: 133–134).
[2] "Redistribution is desirable if it is voluntary—either in the form of private charity or by way of government transfers based on a general consensus. As economists, we know that giving may be in the interest of the giver and that, owing to externalities or economies of scale, collective giving may be more efficient than individual giving. As long as collective giving is voluntary, it is a Pareto improvement" (Vaubel 1996: 159). "By contrast, if redistribution … is imposed by the state even

though a consensus is lacking, we can no longer be sure that the benefits will outweigh the costs because it is not possible to compare the cardinal utilities of different persons in a scientific way" (Vaubel 1996: 159).

[3] If institutional competition is modeled in such a way that the optimal output of public goods is known and that governments behave in the interest of the citizens it is not surprising that centralization dominates decentrali-za-tion. However, this is not the world we live in.