Towards Removing Tax-Induced Distortions to Investment Location: The Choice between International Competition and Co-ordination in Corporate Taxation

Richard S. Simmons
Assistant Professor
Department of Accounting and Finance
Lingnan University

ABSTRACT

In recent years, reductions in institutional barriers to international investment and in non-tax costs of transferring capital have left the existence of international corporate tax differentials as one of the most significant remaining causes of distortion to the optimum global allocation of resources. In the debate as to how to reduce this distortion, two main schools of thought have emerged. The first contends that market forces, or "tax competition", will spontaneously eliminate international corporate tax differentials. The second believes that these differentials can be eradicated only through international co-ordination of corporate taxes. The debate is currently most intense in the European Union (EU), where the existence of tax differentials threatens the achievement of the EU's expressed objectives. However, in a fast-integrating world economy, the lessons being learnt from the EU's experience may be valuable in a wider geographical context.

This article considers the comparative merits of these two approaches. Four criteria are employed: the size of the public sector and the efficient provision of public goods; problems in negotiating, obtaining, and implementing international agreement; the inclusiveness of any agreement; and the effectiveness of eliminating economic distortions. The article also considers other factors that may influence the choice of approach.
1. Introduction

In recent years, capital controls and foreign exchange restrictions have been reduced or completely removed in many countries, while non-tax costs of transferring capital have fallen worldwide. This has left the existence of corporate tax differentials amongst nations as one of the few remaining forms of distortion to the international free flow of capital (OECD, 1991). Indeed, they are widely seen as the last government-induced impediment to the complete liberalisation of world capital flows (see, for example, Owens, 1993). These differentials are now widely acknowledged as assuming an increasingly important role in determining the level and destination of foreign direct investment (FDI).

International corporate tax differentials, through their influence on investment location decisions, disrupt the optimum allocation of resources and reduce economic efficiency. This misallocation of resources is at the expense of the comparative advantage of countries in production and trade, and leads to diminished world capital productivity and reduced levels of global output.

Two main schools of thought have formed as to how this problem can be resolved. The first, which adopts what could be called the free market approach, suggests that as countries compete for investment from overseas, the process of so doing will eradicate international tax differentials. Corporate taxation is seen as the “price” of investing in a country, and, in the absence of other distortions, competitive pressures will force these prices together. In other words, in the presence of “tax competition”, countries will spontaneously harmonise their tax levels or face the loss of international investment and the disadvantages this brings. The second school believes that competitive pressures in themselves will not be sufficient to remove tax differentials, and that it is only through co-ordinated international action that tax-induced distortions to global investment can be significantly removed.

The objective of this article is to compare the comparative merits, and to consider the relative chances of adoption, of these two approaches. In particular, the article focuses on the European Union (EU), as it is there that the issue is most pressing today, and thus where the debate is currently most intense.

The issue is of direct relevance to the accomplishment of the EU’s objectives. Included in the objectives in the 1957 Treaty of Rome are the harmonious development of economic activities, a continuous and balanced expansion through the approximation of national economic policies, and, of particular relevance here, the harmonisation of the laws of member states to ensure no competitive distortions. A central feature of the EU’s approach to economic integration has been the principle that the actions or policies of individual governments should not distort the allocation of productive resources between member states. Tax-induced distortions to investment location clearly pose a threat to this principle.

While the dilemma is currently most pressing within the EU, in a fast-integrating world economy, the lessons learned from the EU’s experience are likely to become increasingly appropriate in a broader geographical context. As Bird and Wilkie (2000: 84) put it,

“The EU is an interesting laboratory – a kind of world tax base in microcosm – to evaluate issues of tax co-ordination.... At its core is a degree of economic uniformity, and a
corresponding subordination of Member State policies impinging on border-less economic interchange, that in a sense create the ideal economic world in microcosm.”

Efforts aimed at the harmonisation of corporate taxation in the EU have spanned over 40 years. Progress has been undeniably slow, but recently has resulted in some important EU Directives concerning withholding taxes, the taxation of dividend flows between parent and subsidiary companies, the tax implications of mergers within the EU, and the resolution of transfer pricing disputes (for a succinct review of these measures, see James, 2000). These measures have reduced some obstacles to cross-border co-operation between EU enterprises. However, little headway has been made with respect to eliminating the main cause of tax-induced distortions to investment: the differentials that exist between member states’ overall levels of corporate taxation.

Nonetheless, there have been some determined efforts at such co-ordination, or “tax approximation” as it has been termed. After failed attempts to push through EU Directives on narrowing differences in the tax rates and tax bases of member states (in 1975 and 1988 respectively), EU leaders in 1997 agreed on a “Code of Conduct” with regard to business taxation. This Code attacks those specific tax practices that affect the location of business activity within the EU, or “harmful” tax competition”. However, these tax practices (for example, particular asset, corporate, or industry tax breaks, or special incentives for foreign investors) do not include the general level of corporate taxation pertaining in a member state. Thus, member states may still encourage investment through differentials between their statutory tax rates and those existing elsewhere in the EU (Ireland’s recent move to an overall tax rate of 12.5 per cent is a case in point), as this apparently constitutes “fair” competition.

There have been similar attempts to limit harmful tax competition in the OECD, of which all 15 (pre-enlargement) EU member states are members. Recently, the OECD issued a report (OECD, 1998) that, in similar vein to the EU, targeted what it termed “harmful preferential tax practices”. However, like the EU, the OECD made it clear that it was not attacking the general effective tax rates pertaining in member countries. The OECD report also targeted tax havens, many of which are dependencies of EU member states. It defined a tax haven using four criteria: nil or nominal taxes, an absence of substantial activities creating income, a lack of effective exchange of information, and a lack of transparency. However, in the face of strong opposition internally and from the Bush administration in the United States, the OECD eventually removed the first two criteria. By so doing, it effectively changed its approach towards tax havens from one that seeks to counter tax competition through tax differentials to one that aims to combat tax evasion.

Thus, the recent proposals of both the EU and the OECD do not currently target international tax differentials in overall corporate tax levels as a source of investment distortion. However, recent evidence on effective tax rates (Baker and McKenzie, 2001; European Commission, 2001) suggests that high differentials currently exist in the EU and represent incentives for companies to choose the most tax-favoured locations for their investments. Thus, the urgency in some quarters to continue to press for tax approximation.

This article is divided into five sections. The following section describes the current division
between member states within the EU. Section 3 compares the relative merits of the two schools of thought, while Section 4 considers other factors that may influence the choice of approach. A final section concludes.

2. The Division between EU Member States

Traditionally, many continental European countries have tended to accept a large role for regulation in the activities of their businesses and citizens. This contrasts with the recent tendency elsewhere towards the use of market forces to achieve government objectives. In the UK, such a tendency can be traced back to the Thatcher administration. The former prime minister’s attitude towards EU regulation in general was summed up thus: “We have not successfully rolled back the frontiers of the state in Britain, only to see them re-imposed at the Community level.” Such attitudes in general remain common in the UK, and generally harden further on matters of taxation. More recently, the current UK Chancellor of the Exchequer, Gordon Brown, has consistently stressed the Government’s “unswerving and firm” preference for tax competition over tax harmonisation.

A widespread view in UK government circles is that a competitive, market-led move towards converging tax rates and systems is more likely to be workable than an imposed one. In this view, tax rates are best set by the competing forces of a government’s desire to raise revenue on the one hand and its desire to encourage investment and domestic competitiveness on the other. Market forces will ensure that major differences in tax rates and bases between countries in a free market are unlikely to persist for long, except for valid economic reasons.

The UK Government was, until recently, confident that it was winning the battle for European hearts and minds in this long-running debate, with its preference for market forces underlining its commitment to low levels of corporate taxation. However, the picture in the EU is now less clear. The Finance Ministers of both Germany and France have in recent years been talking anew of the desire to harmonise rates of corporate taxation. Germany in particular stated that the harmonisation of taxes across the EU in order to avoid harmful tax competition was a priority in its most recent European presidency. Other countries, such as France, favour harmonisation as a means to achieve a fairer distribution of taxes between capital and labour.

The current position of the European Commission remains somewhat ambivalent. In a general policy statement on taxation, the Commission stated that the aim of the EU “is not to standardise compulsory taxes and contributions, but simply to ensure that they are compatible not only with each other but also with the aims of the Treaty” (European Commission, 2000: 5). Somewhat confusingly, the Commissioner responsible for the internal market and taxation, Fritz Bolkestein, stated in a press conference that he favoured tax competition between nations, and that there was no intention to harmonise the tax regimes of member states. He then added, “except in matters which relate to the internal market.”

On the other hand, several members of the Commission, in particular Pascal Lamay, the Trade Commissioner, have expressed strong support for the harmonisation of taxes.

3. Comparative Analysis of the Merits of the Two Approaches

From a review of the literature to date, four broad criteria can be employed to compare the merits of
the two approaches. These criteria are, first, the effect on size of the public sector and the efficient provision of public services; second, the difficulties involved in negotiating, obtaining, and implementing international agreement; third, international inclusiveness; and fourth, effectiveness in reducing distortions to investment location.

a. Effect on Size of the Public Sector and the Efficient Provision of Public Goods

Much tax competition literature has been devoted to the political economy of tax competition. This has, not surprisingly, provoked some impassioned debate, since one’s view as to whether the downward pressure on tax rates constitutes a welcome or undesirable development depends largely on one’s view of the size of government (Edwards and Keen, 1994).

The market-led approach is favoured by those who would reduce the amount of government participation in economies, as tax competition would tend to keep rates of tax low, restraining the growth of government, and, in their view, promoting greater efficiency in the public sector. The case for institutional competition has been argued since the seminal work of Tiebout (1956). The main thrust of this argument is that such competition will impose efficiencies on governments in the same way that competition does on firms that serve the same market. Thus, institutional competition will scale down a country’s public sector to its efficient size, and induce its government to optimise the range of public goods it offers to its citizens and firms (Sinn 1994).

Tax competition may thus deter budget expansion. Under its influence, an increase in a country’s level of tax (or a decrease in a competitor country’s level of tax) will, if capital is internationally mobile, lead to a loss of that country’s tax base. This loss of tax base will lead to an increase in the cost of public services per taxpayer if the same revenue is to be received by government. Bureaucrats may still make budget extensions (if they feel that the marginal benefits of the expansion are greater than the marginal costs). However, as the tax cost per taxpayer rises, political pressure from the electorate will lead to a tightening of budgets and a restriction of pressures for expansion.

This argument can be criticised in that corporate tax competition, far from reducing budget expansion, will simply force governments to shift the tax burden to the less internationally mobile factors, such as land or labour (see, for example, Sinn, 1990). Further, the conditions under which private competition works may not be applicable to competition between governments supplying public goods. Mintz (2000) addresses the question as to whether tax competition leads to optimal tax rates. He argues that, in a world without international tax co-ordination, governments may choose sub-optimal levels of public services financed by inefficient levels of taxes, since they may ignore the spill-over or “fiscal externality” effects of their decisions on other jurisdictions. Mintz suggests that governments may set taxes at either too high or too low a level, depending upon whether these externalities are negative or positive in value. This proposition rests upon the assumption that the fiscal authorities of a jurisdiction will choose tax rates to maximise the welfare of its citizens, and will ignore the welfare of non-residents. Because the externalities are not taken into account, welfare, although it is maximised internally to each country, is sub-optimal in the aggregate. A positive externality exists when an increase in a country’s tax rate
leads to greater capital investment in other countries. As Edwards and Keen (1994) point out, this tax base-stealing motive, leading to tax rates that are too low, is the concern that normally dominates the policy debate. However, the externality may be negative. This can occur when an increase in a host country's tax rate leads to a loss of tax revenues by the home country due to the crediting of host against home country taxation to relieve double taxation. In such cases, this may lead to taxes that are too high.9

Others would argue that unrestrained tax competition would be undesirable since it reduces potential revenues and hinders policy choices through the race to the bottom. In the EU, these fears may have assumed a greater significance nowadays after the introduction of the common currency, most member states thereby having given up control over monetary and exchange rate policy. This means that the use of taxation policy as an economic stabiliser might currently be seen to be of even greater importance. Nonetheless, there is some evidence to suggest that a race to the bottom is not currently taking place. Since 1998, no EU country with a comparatively low effective marginal tax rate has reduced its tax burden (Baker and McKenzie, 2001).10

Musgrave and Musgrave (1990) consider the role of tax competition in securing an efficient and equitable arrangement of public finances and in restraining over-expansion of government. They suggest that any analogy to competition in the private sector is an illusion. In international tax competition, any one player (in this case, a country) can exploit any other with which it transacts and use whatever forms of discrimination are most profitable. Unlike in private competition, however, the abused cannot respond by recourse to a mechanism whereby an equitable outcome is achieved. Further, such competition does not offer a way in which resources are drawn to their most efficient uses, nor does it ensure an equitable outcome in line with some predetermined entitlements. An equilibrium may be achieved, but there is no reason to believe that this equilibrium is the optimum one. Further, there is no way of controlling the process of tax competition in order to regulate precisely the degree of budget restriction. In an extreme scenario, tax competition can reduce tax levels to zero or near zero. At this point, although the efficiency costs of misallocation of capital are eliminated, it may lead to great inefficiencies due to sub-optimal budget levels. Musgrave and Musgrave conclude that tax competition is a very blunt instrument by which to remedy inefficiencies in domestic budget determination. Other methods, such as limiting increases in budget expenditure to increases in GDP (as has been practised for many years in some jurisdictions, for example, Hong Kong), or by improving the efficiency of domestic budgeting through, say, better methods of evaluating programmes, might be more effective.

Tax co-ordination, on the other hand, might be favoured by those who would promote a strong role for governments in the functioning of an economy, and fear that tax competition would precipitate a race to the bottom on tax levels. However, co-ordination can be criticised as a means whereby governments are able to avoid pressure to carry out necessary structural adjustments to their spending programmes, including the welfare state. Co-ordination is seen here as the potential cause of a "race to the top" of any proposed tax bands, allowing governments to continue high-tax policies that lead, for example, to high unemployment levels. It is, from this viewpoint, an enforced band of tax rates that seeks to overcome market forces by establishing a kind
of tax collectors' cartel, artificially maintaining higher rates than otherwise would be necessary (see, for example, Chown, 1989). Arguably, such anti-competitive co-ordination already exists in the EU with respect to value added taxes.

b. Difficulties Involved in Negotiating, Obtaining, and Implementing International Agreement

Obtaining agreement amongst nations on corporate tax co-ordination is problematic, to say the least. Barriers include the fears of governments of losing control, not only over tax revenues, spending, and macro-economic adjustment, but also in the more general and emotive sense of the loss of national sovereignty. They also include fears of economic realignment, changes in the redistribution of tax revenues between governments, and, for some nations, the effect on the domestic economy and foreign investment that rises in taxation due to co-ordination would bring. Even if it is assumed that the will to approximate is in place, there are the practical difficulties of doing so in the face of differing rates of inflation, differing effectiveness in collecting taxes, and the differing incidence of incorporation of businesses currently prevalent in individual countries.

Also, tax co-ordination raises concerns relating to nations' perceptions of equity. Co-ordination, by its very nature, is likely to restrict a country's ability to set its own tax levels according to its own preferences. As taxation reflects the culture of a society, it is also a manifestation of its sense of fairness. Co-ordination risks upsetting this sense of equity, even in a continent such as Europe that although diverse in its individual cultures, still shares, to some degree, a common heritage. If this risk is appropriate in a European context, it is likely to be even more so in a global one. It is also reasonable to suggest that, within a particular country, these perceptions of equity change over time. Co-ordination, with its in-built inflexibility, means that a country's tax system is unlikely to be as responsive to these changes as it would in its absence.

Tax co-ordination may also have costs in the sense of widening the division between rulers and ruled, thus creating a sense of injustice amongst the population. As already discussed, tax co-ordination may be expected to reduce economic distortions through eliminating disparities in taxes. Thus, the main argument on its behalf is that it reduces economic externalities and thus promotes the efficient allocation of resources. However, an argument against it is that it violates individuals' preferences, in that governments are not responsive to citizens' wishes.

Frey and Eichenberger (1996) investigate a particular conflict that exists between tax harmonisation and tax competition. Removing economic distortions through harmonisation comes at the price of increasing "political distortions", defined as distortions that occur when politicians pursue their own goals and thus deviate from the preferences of their citizens. Such distortions will occur if co-ordination is imposed. This is because, by imposing high and uniform taxes amongst jurisdictions, it limits the ability of citizens and firms to exit to another jurisdiction with lower taxes. On the other hand, tax competition reduces these political distortions, since each jurisdiction now has the opportunity to set taxes according to the preferences of its citizens, taking into account their demand for public services. Tax competition thus allows for the existence of tax differentials. These lead, however, to economic distortions. According to Frey and Eichenberger, each society is characterised by a particular combination of competition and harmonisation, the
result of a trade-off between political and economic distortions. The trade-off point is defined by the politico-economic interactions pertaining in the country.12

There may also be a strong preference for inertia in taxation because the structure of business organisations, or asset prices, may have been influenced by taxation (Smith, 1990). This preference may be threatened by co-ordination. Also, stability in taxation may also be seen as an encouragement to investment. Further, the negotiating and implementation of international co-ordination may also have a price in terms of economic resources, time, and political attention that may be unacceptable to governments or their electorates.

The above list amounts to a formidable array of disadvantages of any co-ordination strategy. After considering the list, it would seem that relying on tax competition would constitute an easier option for governments. After all, at first glance this option removes a requirement for governments to do anything that may be considered unacceptable to the electorate. However, upon more careful scrutiny, relying on market forces in tax policy involves many of the same problems of acceptance as the co-ordination option. Such reliance will, if left unfettered, similarly lead to a reduction in countries' control over their tax revenues and their ability to engage in macro-economic adjustment by restricting government options for corporate taxes. It will also likely entail, for most nations, a reduction in tax revenues and a redistribution of tax revenues between nations. Allowing market forces to rule can have economic and loss-of-sovereignty implications as much as co-ordination.

Unrestrained tax competition also raises concerns for a country's concept of tax equity, in particular vertical equity, since such competition may also lead to restrictions on a country's ability to tax income from capital. The reasons for this concern are twofold. First, richer members of society are more likely to earn income from the capital source. Second, fiscal competition, in the personal taxation as well as capital taxation spheres, would likely also mean that a country's ability to provide redistributive programmes for its residents would be curtailed.13

c. International Inclusiveness

The difficulties involved in obtaining international agreement lead to a further inherent disadvantage of any strategy involving international tax co-ordination: only those nations that agree to harmonise their policies are so bound. Nations outside the circle may therefore choose to continue to practice tax competition, thus subjecting those within to its effects. Significantly, the greater the number of nations that join the circle, the more the benefits of tax competition on those that stay outside are increased. On the other hand, tax competition by its nature requires no supra-national agreement. If a country wishes to enjoy the benefits (and suffer the drawbacks) of foreign investment by opening its borders to such capital flows, then that country will find itself automatically subject to international tax competition.

While the number of countries within those groupings committed to combating harmful tax competition, the EU and the OECD, is indeed considerable, and contain most of the economically significant economies in the world, they do not represent the entire world. Countries that have an interest in maintaining tax-induced distortions to investment can stay "out of the loop". Such countries might not only be those that are not bound by the shared principles of the supra-
national organisations, but also may be countries within the EU and OECD themselves (see, for example, the Swiss and Luxembourg abstentions attached to the 1998 OECD report). The EU and OECD can, given their economic muscle, exert pressure on these countries, but there are limits to this pressure, there being no legal backing for it. Such pressure can also result in constitutional crises for member countries if pressure on their own tax haven dependencies (usually independent in matters of taxation) is too strong.

d. Effectiveness in Reducing Distortions to Investment Location

If the many problems in obtaining international agreement with regards to the standardisation of tax systems, rates, and bases can be overcome, then the strategy of corporate tax co-ordination, when combined with measures to reduce tax obstacles to international co-operation between companies, represents an effective means of significantly reducing tax-induced economic distortions. However, these distortions will likely not entirely vanish, as tax differentials will still remain due to international differences in inflation rates, the effectiveness of tax collection, and the incidence of incorporation. Furthermore, distortions to investment location will still occur in the presence of harmonised taxes if government spending remains unharmonised. Indeed, harmonising taxation without harmonising government expenditure risks exacerbating distortions to investment.

In light of these problems, the strategy of allowing tax competition to eliminate economic distortions has certain advantages. Many of the issues complicating the negotiation and implementation of tax co-ordination, such as the existence of international differences in inflation, effectiveness of tax collection, and levels of government spending, would be automatically taken into account by market forces. For example, these forces would allow a country with a comparatively well-developed infrastructure due to high government spending to maintain a comparatively high level of taxation.

Nonetheless, tax competition represents a less-than-perfect solution to the problem of tax-induced economic distortions. While it is possible to conclude that it may reduce tax differentials in tax rates and bases, full harmonisation of tax regimes requires more than such convergence. Issues that tax competition is unlikely to solve on its own include the problems of differences in tax systems in the way they relieve international double taxation of income; the treatment of losses; and the tax treatment of dividends, interest, and royalties distributed across national borders. Such problems are likely to be resolved only through international co-ordination.

Furthermore, it could be argued that tax competition in itself does not necessarily lead to a more efficient allocation of resources unless it results in approximation, a result that is still to be proved. An equally likely outcome would be to provide a climate in which countries would aim to attract businesses through being the most tax-efficient rather than the least-cost locations. This is unlikely to improve the allocation of resources. A problem for the proponents of tax competition is therefore that it may lead to a misallocation of capital amongst nations. In such a scenario, as Musgrave and Musgrave (1990) point out, it may be that the inefficiency costs of this misallocation are greater than the efficiency benefits gained from curtailing the over-expansion of government budgets.
4. Other Factors Influencing the Choice

In addition to the comparative merits of the two approaches based on the four criteria above, other factors could influence their eventual choice between competition and co-ordination. These are now considered.

An important current demographic development could be of great importance in swaying government viewpoints. The population of most first-world countries, including all EU member states, is ageing rapidly. There are three main reasons for this. First, life expectancy is increasing (due to a combination of better public health and medical advances) to the extent that in most developed countries a child born today can expect to live well into his or her 70s. Second, the "baby-boomers", born in those countries in the years after World War II, are now approaching retirement age. Third, the birth rate in many countries (and especially in Europe, for example, in Italy and Germany) is decreasing rapidly to the extent that, if it were not for net immigration, these countries would be experiencing a declining population for the first time in several decades.

This phenomenon of "greying" populations has important ramifications for public finance, and hence taxation policy. According to Peterson (1999), if present trends continue, within 30 years most countries would have to increase their public spending by 9 per cent to 16 per cent merely to fulfil their public retirement promises. An ageing population additionally requires greater spending on health and social care. Governments can meet this expenditure only out of borrowing or taxation. However, the ageing of the population means that this increase in taxation is to be funded by a comparatively smaller tax base, as the percentage of the population of working age declines.

There are four further important reasons why demand for public expenditure is likely to increase in future, all concerned with the fact that the populations of developed countries are growing richer. First, the demand for good healthcare increases not only as populations age but also as they grow more prosperous. Additionally, as technological changes improve the means of delivering improved health, public expectations increase accordingly. This new technology is invariably expensive. Improved healthcare may be partly met out of the private sector and an increase in private health insurance. However, as mentioned by Turner (2001: 241), breakthroughs in genetic science may soon be able to reveal those members of the population more susceptible to illness than others. In such a world, it will be more difficult for such people to be covered by health insurance schemes, thus creating a demand for public healthcare. Second, given recent changes in the labour market, especially the increased rewards conferred upon those with skills and the need to continually update and renew those skills, the demand for education will undoubtedly increase. Again, this may be met partly by the private sector. However, it is likely that the basic education of children, accorded a higher priority by richer and more educated parents, will remain largely in the public sphere. Third, as people grow richer and more educated, they are likely to give a greater priority to an improved physical environment in terms of a reduction in pollution. An appropriate response to such demands will necessarily be largely borne by government through, for example, the greater provision of public transport. Fourth, as prosperity rises, often unevenly, transfers to the poorer sections of society become greater as the consensus view of poverty changes, this view being relatively, not absolutely, defined (Brennan and Buchanan, 1980).
The dilemma for governments is therefore clear. Large increases in public expenditure may be required at the very time that the increased international mobility of capital and labour are transpiring to make it increasingly difficult for governments to levy taxes at levels that would occasion flows of these scarce resources overseas. The attractions of co-ordinating taxes at levels that would not pertain under market forces become much clearer under these conditions. These attractions become still clearer when governments consider a further threat to their tax revenues: that posed by the difficulties involved in the taxation of e-commerce.

Frey and Eichenburger (1996) suggest that there may be a further factor favouring harmonisation: a natural tendency towards harmonisation over competition in government circles. They suggest that four groups – economic theorists, economic advisors, politicians, and interest groups – are potentially biased in that direction. First, economic theorists are biased in this way since the assumption in much of the economic literature is that democracy works efficiently and citizens’ views are well represented. If so, political distortions are small (compared to economic ones). This tends to favour harmonisation in the academic literature.

Second, governments’ choice of economic advisors may also result in a tendency towards harmonisation. Governments are likely to be predisposed towards the avoidance of political competition, and so favour harmonisation, and they may be expected to choose members of the advising committee on the basis of the desired outcome. Also, those economists who have a technocratic view of society and who thus believe that they have a role to play in influencing government tend to be those who wish to do so by sitting on advisory committees. They also tend to favour harmonisation. Further, once the committee is in place, it might be expected to be predisposed towards a negotiated conclusion, likely to be some kind of harmonisation, rather than come to an adversarial conclusion, which is what competition represents.

Third, politicians may be disposed towards harmonisation since it enhances the importance and power of their position. This is because harmonisation diminishes the incentive for the disgruntled to exit the jurisdiction, as taxes are equalised, and reduces the incentive to raise protest against increases in taxation, as the decision-making process is centralised.

Fourth, interest groups may be disposed towards harmonisation. The benefits from harmonisation to their sector may be distinct and identifiable, whereas any costs are more likely to be spread so thinly that the likelihood of protest is reduced. Also, they may have an opportunity to influence the ultimate effects of harmonisation to their advantage by taking part in the bargaining process (possibly as economic advisors). Interest groups may favour harmonisation since any resultant benefits of that harmonisation to their interests may be foreseen with greater accuracy than under competition. Competition, on the other hand, would normally be expected to reduce the power of pressure groups, as the market determines the results in a less predictable manner. As an example, it was at one time widely expected that business people would favour tax competition, as it would likely result in lower taxes for their corporations. However, when the Ruding Committee (1992) surveyed the views of business people on the issue, an overwhelming majority (67 per cent) believed that harmonisation was desirable, regardless of the means taken to achieve it. By
contrast, less than one quarter (23 per cent) of respondents felt that the better way to achieve harmonisation was through the use of market forces.

Fieleke (1988) accepts this natural inclination of government towards harmonisation. To him, it raises concerns applicable to all forms of international economic co-ordination. He argues that it is risky to encourage a high degree of collaboration between governments. Such collaboration might encourage governments in the pursuit of economic policies designed to maintain or promote their own power or wealth rather than to serve their own constituencies. He mentions that the very expansion of government required for co-ordination is a case in point. Further, he points out that co-ordination could be used as an excuse to evade responsibility for politically painful but appropriate policies (such as tax increases), or worse, governments could use inaction as a bargaining device to induce desired changes in foreign policies. He also concludes that presently not enough is known about how the world economy functions to ensure that macro-economic policy co-ordination, including that on taxation, would improve the outcome.

Weighed against the above factors favouring harmonisation is the fact that in the EU, tax proposals require unanimous acceptance amongst member states in order to be passed. This requirement means that vetoes are likely to be exercised by countries if any moves are out of tune with the wishes of their electorates. But as the number of member states expands, unanimous agreement in areas such as taxation will likely become even more difficult to secure. This problem is likely to be further exacerbated by the increase in tax diversity within the EU caused by the admission of new members, in particular the ex-Soviet bloc states. These countries, by dint of their recent past and level of economic development, have tax systems that, although currently being reformed, still differ markedly in many respects from those of the pre-enlargement member states.

However, in response to a perceived need to enhance the decision-making ability of the EU, there are signs that, as it expands to embrace more nations, the idea of greater use of qualified majority voting (QMV) is becoming more popular. The European Commission itself has recently become one of the foremost proponents of a change to QMV on certain taxation issues (European Commission, 2000). It feels that since globalisation and European Monetary Union has led to a need for greater integration of fiscal policies, greater “efficiency” in the decision-making process is necessary in order to cope with this challenge.

It is clear that while the governments of some member states (for example, France) are currently very supportive of changes to the unanimity principle, others (in particular, the UK) are not. At the 2000 Nice summit, the UK and others successfully blocked a proposal to remove the single-country veto and to introduce QMV on taxation matters. As unanimous agreement is needed at EU level for reform of the voting system, and given the strong support for the veto amongst some member states, the proposal’s chance of success was always small. It would appear then that it is likely that the single-country veto will remain in place for the foreseeable future. It is thus best to be cautious about the chances of an eventual move to QMV on taxation matters. Nonetheless, the Commission remains optimistic. It feels that the views of member states are currently shifting in this area; although at one time
only a few member states supported QMV, now most are in favour.

If neither pure tax competition nor tax approximation constitute on their own complete and acceptable solutions to the problem of tax-induced investment distortions, then might some alternative solution be preferred? Tax competition employs market forces to ensure that international investment is allocated efficiently. On the other hand, tax approximation, with its emphasis on the standardisation of tax rates and bases, necessarily curtails these market forces and is thus largely incompatible with the existence of tax competition. However, many other forms of international tax agreement may be employed side by side with tax competition to reduce distortions to investment. The adoption of these forms of agreement does not require accord on such fundamental aspects of tax policy as tax rates and bases. These arrangements do not seek to standardise the tax levels of individual countries; rather, they avoid such contentious matters, concentrating primarily on those international aspects of tax systems that have the capability to affect other nations negatively. Governments are likely to be much more amenable to negotiation with respect to these aspects of their tax systems, as they are more used to dealing with them on a bilateral or multilateral basis. Areas of potential discord, such as the effects of agreement on the level of the public sector, on considerations of equity, and on government revenue, are thus likely to be much less affected by these arrangements.

It is thus no surprise that the EU has achieved greater success with its efforts concerning, for example, the resolution of transfer pricing disputes, than with those relating to systems, statutory rates, and bases. Similarly, the EU Code of Conduct and the OECD's attack on harmful preferential tax practices have been able to commandeer more widespread support within their memberships. While these measures do not directly eliminate international differentials in tax levels, the barring of the use of certain harmful tax measures may encourage nations to use the manipulation of overall tax rates to compete for FDI. The effect of such competition may be to reduce overall tax differentials amongst nations.

Thus, while the strategies recently adopted by the EU and OECD are unlikely to result in the total elimination of economic distortions, they may provide an environment in which tax competition can promote a gradual convergence of taxes to the point where a further stage of approximation will either be unnecessary or much less traumatic to individual countries. They can also be combined with additional efforts to reduce tax-induced distortions to investment, such as the harmonisation or elimination of withholding taxes on all forms of international flows. For these reasons, it may be that at this stage, they constitute the most appropriate basis for reducing these distortions.

5. Concluding Remarks
The question of whether tax-induced distortions to the optimum allocation of FDI should be reduced through corporate tax competition or co-ordination is a major issue in international taxation. The debate is presently most intense in the EU, where the existence of tax differentials threatens the achievement of the EU's expressed objectives. However, with the world economy integrating apace, the EU's experience is likely to become increasingly important in a wider geographical context in future.
The choice between tax competition and co-ordination may in the long term depend largely on the political persuasions of electorates as to the extent to which they accept market forces or government involvement as the main driving force for change; in other words, how they view the role of governments in the economy. It may depend, therefore, on whether voters see a greater value in harmonising taxes at a comparatively high level, with, presumably, an accompanying high level of public investment, or whether competition should be allowed to lower tax levels to encourage private investment. The choice thus partly lies in the hands of factors such as the swings of political direction taken in Europe and elsewhere. It will also depend on the future readiness of governments and electorates to accede further to the authority of supra-national bodies, over which there currently is considerable uncertainty.

The difficulties involved in achieving tax co-ordination in the EU are considerable, especially in view of the current unanimity requirement for passing tax proposals. However, certain demographic changes may increase the pressure on governments for some measure of co-ordination. The existence of governmental bias towards co-ordination also favours it as a possible solution. On the other hand, allowing tax competition to spontaneously eliminate tax differentials, while having several inherent practical advantages, represents an incomplete and unpredictable solution. The limitations of both approaches may mean that the strategy of targeting the more overt forms of tax-induced distortions to investment, while avoiding a direct assault upon international corporate tax differentials, may, at least for the near future, be the most expeditious solution to this intractable and increasingly important problem.

References


Endnotes

1. Although approximation is, strictly speaking, only one form of co-ordination, the three terms, approximation, co-ordination, and harmonisation, are often used interchangeably, and are thus used in this way here. For a discussion on this point, see James (1999).

2. Of the 10 states that entered the Union on 1 May 2004, Poland, Hungary, the Czech Republic, and Slovakia are OECD members.


4. For example, in 2000 alone, in speeches at a conference at the US Embassy, London (3 May), at the Mansion House (15 June), and at the Royal Economic Society (13 July).

5. Stated at a meeting of the Finance Ministers of 11 left-wing EU governments, 22 November 1998.


7. As reported in “Tax Competition or I’m a Dutchman”, The Times (of London), 30 June 2000.

8. M. Lamay was quoted as saying, “I definitely think that fiscal competition should not take place” (as reported in The Economist, 7 July 2001, p. 40).

9. As Mintz (2000) points out, in the EU, member states have been forced by a decision of the European Court of Justice (in the Metallgesellschaft and Hoechst joint cases) to limit tax crediting which discriminates between foreign and domestic shareholders.

10. The race to the bottom scenario has also been questioned by reference to other aspects of public interest, such as environmental standards. Given the costs involved to potential investors, one might suppose that the competitive process might discourage governments from enacting high environmental standards. However, this does not appear to be the case, at least in the developed world. See Oates (2001).

11. As Frey and Eichenberger (1996) point out, however, the distortions will not occur if the citizens of the countries involved enter into voluntary agreement to harmonise their taxes.

12. Full harmonisation is not likely to be attained, not only because of official policy decisions but also through the tax evasion and avoidance of firms and the illicit actions of governments who may have an incentive to undermine the effects of harmonisation. As Frey and Eichenberger (1996: 342) conclude: “Reality is thus characterised by a combination of official harmonisation with (mostly unofficial) disharmonisation of government policy.”

13. Persson and Tabellini (1990) show that there are political as well as economic ramifications of the increase in resource mobility and tax competition. They argue that tax policy reflects both the economic and political features of each country. Changes in the mobility of resources will, through tax competition, therefore affect the politico-economic equilibrium. Tax competition tends to push down tax rates, so electors would tend to vote for a policy maker
skilled in the tax competition game and one who is further to the left in order to mitigate the effects of the increased tax competition. The result of this is that not only do tax rates converge but so also do the political preferences of countries.

14. Huizinga (1991) expands on this point by showing how international tax competition leads to special tax breaks for overseas investors. He points out that tax competition in the form of such tax breaks may lead to two-way international flows (the cross-hauling) of capital which are socially harmful. He concludes that, paradoxically, measures that result in an increase in those costs associated with foreign investment can be socially beneficial.