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Do we need tax harmonization in the EU?

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Kiel Working Paper No. 916

**Do We Need Tax Harmonization
in the EU?**

by

Alfred Boss



Institut für Weltwirtschaft an der Universität Kiel
The Kiel Institute of World Economics

Kiel Institute of World Economics
Düsternbrooker Weg 120, D-24105 Kiel

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Abstract

For many years there have been political intentions to harmonize tax rates in Europe. As to capital income taxation, competition is often seen to be especially harmful. Facing a high degree of international capital mobility, every country is expected to reduce its tax rate in order to attract new capital or not to lose capital allocated in the country (“race to the bottom”).

It is shown that the development of capital income tax rates in the European Union (EU) and in other industrialized countries as well as the development of corporate income tax revenues do not indicate that a race to the bottom has taken place. If tax competition should become as fierce as some observers seem to fear, the arguments in favor of tax competition instead of harmonization should be kept in mind. If tax rates are cut in a process of competition, government expenditures have to be reduced; this helps to avoid waste and inefficiencies in the public sector. In addition, tax competition might help to find better tax systems, and every country could learn from the experiences of other countries. In contrast, tax harmonization would probably lead to higher taxes in the EU.

JEL Classification: H 20, H 87

Keywords: Tax Competition, Tax Rate Harmonization, Value-added Taxation in the EU, Capital Income Taxation in the EU

Table of Contents

A.	Tax Rate Differences in Europe — an Overview	1
B.	Is VAT Rate Harmonization Necessary?	5
	1. The Main Elements of Value-added Taxation.....	5
	2. Is the Integration of Markets Impeded by Tax Rate Differentials?.....	6
C.	Does Harmonization of Capital Income Taxes Make Sense?	10
	1. The Problem	10
	2. The Theoretical Background of the Harmonization Argument	11
	3. What Happened to Corporate Income Taxation?	13
	4. Germany: A Special Case	17
	5. The Arguments Against Harmonization.....	17
	6. Harmonization of Taxes on Interest Income in the EU?	21
D.	Concluding Remarks.....	23
	Bibliography	24

Do We Need Tax Harmonization in the EU?

For many years there are political intentions to harmonize tax rates in western Europe. The Commission of the European Union (EU) even exerts some political pressure to adjust the value-added tax (VAT) rates in a union-wide system. The pressure probably will become stronger after the creation of the EMU. As to capital income taxation the harmonization issue is often debated under the headline of tax base erosion.

The paper discusses the question if it makes sense to harmonize the value added tax rates or the capital income tax rates in the EU. It is organized as follows: In an overview the most important tax rate differences between the EU countries are shown. The second section deals with the issue of VAT harmonization. The third section investigates the issue of capital income tax harmonization; differences in the taxation of labor income (wage income tax, contributions to social security (payroll tax)) will not be discussed.

A. Tax Rate Differences in Europe — an Overview

About 30 years ago, most of the European countries adopted a system of taxing net value added instead of gross sales of firms. Within the European Community (EC) respectively the European Union the VAT bases were adjusted to a large extent; the tax rate differentials became smaller in the course of time, tax rates still diverge, however (Table 1).

The European systems of capital income taxation are difficult to explain and to compare. Firms pay — depending on their legal status — assessed income tax or corporate income tax and often some other taxes (e.g. property tax). Apart

from the statutory tax rates many subtle and complex legal arrangements (e.g. rules for depreciation allowances) are important.

Table 1 — Value Added Tax (VAT) Rates in the European Union, 1998 (p.c.)

	Regular rate	Reduced rate(s)	Zero rate ^a
Austria	20	10; 12	—
Belgium	21	1; 6; 12	yes
Denmark	25	—	yes
Finland	22	8; 17	yes
France	20.6	2.1; 5.5	—
Germany	16	7	—
Greece	18	4; 8	—
Ireland	21	3.6; 10.0	yes
Italy	20	4; 10	yes
Luxembourg	15	3; 6; 12	—
Netherlands	17.5	6	—
Portugal	17	5; 12	—
Spain	16	4; 7	—
Sweden	25	6; 12	yes
United Kingdom	17.5	5	yes
EU15	18.5 ^b	—	—
EMU	18.3 ^b	—	—
Addendum:			
Switzerland	6.5	2; 3	—
Japan	5	—	—
Canada (federal)	7	—	yes

^aZero tax rate for specific sales (e.g. sales of newspapers in Belgium and Denmark) combined with a credit (against tax liability) of the amount connected with the purchases. — ^bWeighted by 1997 GDP shares.

Source: DATEV (1999); BMF (1998).

It is not possible to characterize the main features of the systems and to assess their attractiveness for investors in this paper. However, in order to give some information on the tax systems in Europe, the (statutory) corporate income tax rates for retained earnings are presented (Table 2).

Discussing the topic "tax harmonization" it is useful to have a look at the development of the tax rates in the recent decades. All over the world, tax rates for retained earnings had risen in the sixties and seventies. They started to

decline worldwide in the eighties (Koop 1993). Germany followed the development with some delay.

Table 2 — Corporate Income Tax Rates in the European Union, 1998 (p.c.)

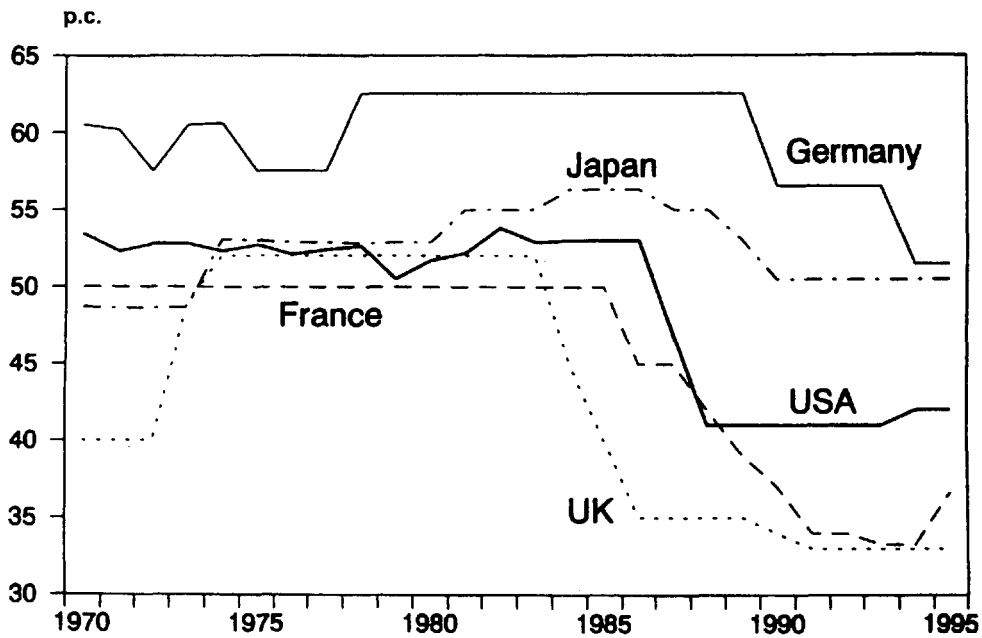
	Tax rate ^a	Taxation of dividends ^b
Austria	34	tax reduction
Belgium	40.17	"classical" system
Denmark	34	"classical" system
Finland	28	tax reduction
France	36.67	tax reduction
Germany	47.48	integration system ^c
Greece	35	tax reduction
Ireland	36	tax reduction
Italy	41.25	tax reduction
Luxembourg	31.2	tax reduction
Netherlands	35	"classical" system
Portugal	34	tax reduction
Spain	35	tax reduction
Sweden	28	"classical" system
United Kingdom	31	tax reduction
EU15	35.1 ^{d,e}	
EMU	36.3 ^{d,f}	
Addendum:		
Switzerland	8.5	"classical" system
Japan	43.98	tax reduction
United States (New York)	40.8	"classical" system

^aIncluding taxes of states and local governments. — ^bCorrection at the firm or shareholder level in order to avoid double taxation of distributed profits. — ^cFor corporate and personal income taxation. — ^dSimple average of tax rates. — ^e38.58 p.c. weighted by 1997 GDP. — ^f40.69 p.c. weighted by 1997 GDP.

Source: DATEV (1999).

In order to obtain comprehensive (statutory) tax rates, estimates of the average rate of local or state corporate taxes have to be taken into consideration (Rimbaux 1996, Appendix C). The (statutory) rates for Germany, France and the United Kingdom fell in the 1970–1995 period (Rimbaux 1996: 93). A breaking point occurred in the mid of the eighties (Figure 1). A phase of rate decline started when the United Kingdom lowered its rate from 52 to 35 p.c.

Figure 1 — Legal Tax Rate Including Local Taxes



Source: Rimbaux (1996: 93).

between 1984 and 1986; at the same time expensing (immediate write-off) as a rule for measuring depreciation allowances was abolished. France followed rapidly. Germany, however, only reacted with a delay of about five years. The tax rate differentials between Germany and the United Kingdom and between Germany and France — both in the range of 10 percentage points in the seventies and part of the eighties — even increased somewhat because the rate cut in Germany was relatively modest.

Nowadays, capital income — at least in the form of retained earnings of corporations as an important part of it — seems to enjoy a more favorable treatment than in the seventies. However, looking at the definitions of the tax bases leads to a modified picture for many countries.

B. Is VAT Rate Harmonization Necessary?

1. The Main Elements of Value-added Taxation

The value-added tax employed in Europe (and elsewhere) is of the invoice-and-credit type (Bradford 1995). This means that the selling firm pays a tax on all sales, noting the amount of tax on the sales invoice. A taxable firm making a purchase is allowed a credit against its tax liability of the amount shown on the invoice. A sale from one business to another thus gives rise to simultaneous payment of tax by the seller and equal credit taken against the tax by the buyer. There is no net tax paid to the government until the point of sale to a buyer other than a taxable firm. Typically this is a private household, a non-profit organization (e.g. a church or a political party) or an institution belonging to the public sector.

Basically, the aggregate tax base is the aggregate of sales by business to non-business or aggregate consumption. Outlays by a firm for investment purposes (to add to inventory, to the stock of buildings or of machinery and equipment) are deducted immediately. Exports are not taxed whereas imports are taxed at the domestic rate in the European VAT systems. The so-called destination principle is applied; the rules for taxing tourists' purchases abroad are somewhat different. The VAT system was not changed when the internal market was completed in the EU in the beginning of 1993. However, tax borders were shifted into the firms giving rise to complicated administrative problems.

2. Is the Integration of Markets Impeded by Tax Rate Differentials?

As to the VAT (as well as to the important excise taxes e.g. on tobacco) it is often argued that the integration of the markets in Europe is impeded by the tax rate differentials and that competition is distorted by these differentials. In addition, the system is considered to be difficult to administer.

The prevailing VAT system actually leads to some distortions. This is due to the fact that the destination principle does not hold for consumers' purchases abroad, esp. for tourism sales (Sinn, H.W., 1997b: 679–680). These purchases are taxed according to the origin principle. This results in tax arbitrage as to the sales concerned (BMWi 1994: 68).

The destination principle implies an international adjustment of net-of-tax prices (BMWi 1994: 67) whereas the origin principle leads to an adjustment of gross prices (including the VAT). As the sales for which the destination principle is valid are much more important than the purchases of consumers abroad, net-of-tax prices do adjust and there is an incentive for consumers to buy in low tax rate countries. These countries receive additional tax revenues.

This is one of the reasons why many politicians and some economists favor tax rate harmonization.

In July 1996, the EU Commission published her proposal for a new VAT system (Mueller 1996). The main elements are

- the (formal) abolition of the destination principle,
- the introduction of a clearing mechanism which is to compensate those countries which lose tax revenues because of the switch to the new system and
- a kind of smoothing of the VAT rate differentials prevailing in the European Union.

The EU Commission and the governments of some countries want to introduce what they call the origin principle. This means that the invoice-and-credit method of value-added taxation is applied independently of the location of a firm in the EU, i.e. across the borders of the EU countries. As to the relations to non-EU countries no change is intended.

If the tax borders were abolished, i.e. if the invoice-and-credit type of the VAT was realized across the borders of the EU countries, the trade flows would not change assuming that tax rates are given. However, tax revenues would be distributed quite differently (Boss 1989). Net export countries would gain revenues, net importers would lose. In addition, high tax rate countries would realize more tax revenues, low tax rate countries would be the losers. Finally, each country would be able to exploit the other countries by increasing its VAT rate; because of the taxation of the exports (apart from domestic consumption) the increase of the VAT rate would result in higher revenues without (due to the invoice-and-credit method) affecting exports whereas tax revenues of the import country would decline. These consequences, i.e. the shifts of tax revenues,

would be avoided if (as proposed by the EU Commission) a clearing mechanism would be created.¹

The original distribution of revenues, i.e. leaving aside the effects of the clearing mechanism, may be seen to be fairer if the tax rate differentials are abolished or at least reduced. This might be the reason why the EU Commission is so strongly in favor of tax rate harmonization.

From an economic point of view, it would be better to adopt a (consumption type) VAT system of the subtraction-method (Boss 1989). This means that the difference between sales and purchases of a firm is taxed. It is taxed by the rate decided upon by a single country and there is no adjustment of tax rates if goods and services are exported or imported. Whereas the existing VAT system is based on the destination principle, the new system is a VAT system characterized by the origin principle (correctly understood); it is a "tax-included export system" (Salin 1994: 8). A country receives tax revenues if production (excluding investment) takes place in that country. Tax rate competition would occur.

The introduction of the system requires "real exchange rate" changes brought about by an adjustment of nominal incomes (prices and wages) in the EU member countries (Feldstein and Krugman 1990); the alternative of changing nominal exchange rates is not any longer feasible after the introduction of the EMU in 1999. The price and wage levels would adjust if the origin principle as an element of the new system was introduced. Thus, tax rate differentials would not impede the market integration. The differentials (differences between weighted average tax rates in the case of several rates in a country) would be

¹ Insofar, the administration would become easier for the firms. However, if the shift of tax revenues is to be compensated exactly, the clearing authority would need exactly the same data which are currently necessary in order to control the tax declarations of the firms. The firms would not realize lower costs. The main effect of introducing the Commission's system might be the creation of a new European bureaucracy (Homburg 1997: 306).

compensated by changes of the "real exchange rates" in the EMU resp. the EU. However, the adjustment would probably need some time.²

The new system would lead to a different distribution of VAT revenues between the EU member states. Net export countries would gain, the other countries would lose tax revenues. Of course, it would be possible (although not necessarily necessary) to find a compensation scheme when the system is introduced. However, the attribution of tax revenues to a country according to the share of value added in that country can be considered to be an equivalent to the government's services for firms (BMW 1994: 69); at least it would be in line with what the term VAT suggests.

The advantages of tax competition (made possible by the introduction of the (correctly understood) origin principle) are twofold: A Leviathan government is punished by tax revenue losses. High tax rates would only be sustainable if they were connected with high levels of government services; the outcome might be benefit taxation. The final tax rates in the EU on average probably would be lower than the average rate decided upon by politicians in an effort to harmonize tax rates. Thus, tax competition is a substitute for constitutional constraints for a government. In addition, tax competition would help to find improvements of the tax systems; it could be useful in inventing the tax rate structure which is optimal. Competition might lead to an optimal solution which politicians do not know and thus cannot implement even if they are benevolent dictators.

Apart from the differences between the regular (standard) VAT rates there are divergencies as to the reduced (or zero) rates. The number of these rates and the kind of products (sales) which are taxed differently diverge. The transition to

² In technical terms: The "real exchange rates" within EMU or EU would be unchanged after the adjustment to the new system; in relation to non-member countries, nominal exchange rates would also have to change in order to have constant real exchange rates.

the subtraction-method type of VAT would mean that firms in countries with high rates are discriminated whereas low tax rate countries' firms are the winners. However, this does not mean that the rates have to be adjusted by a political decision in the EU. On the contrary, harmonization probably would result from a market process and it would possibly stop before complete adjustment would be reached. This might be the case because there are different government services which are related to the different tax rate levels. In addition, transaction costs may be important as a factor preventing complete adjustment of tax rates.

Different VAT rates in the EU countries are not only unproblematic, they are also efficient. According to optimal taxation theory, the optimal structure of a tax system depends on a lot of supply as well as demand elasticities. These elasticities probably are not the same for every country. Thus, harmonization of VAT rates would lead to efficiency losses. It would not at all increase welfare in the European Union.

This means that there is no need for VAT rate harmonization. On the contrary, tax competition would help to keep the tax rates in the EU small; possibly a kind of smoothing of tax rate differentials would occur. Tax competition can be seen to be especially helpful because there are no constitutional limits of taxation.

C. Does Harmonization of Capital Income Taxes Make Sense?

1. The Problem

Many economists are sceptical as to tax competition because it is connected with (fiscal) externalities and thus leads to inefficient results. Competition in the field of capital income taxation is often seen to be especially harmful (Sinn,

H.-W., 1995, 1997a). Facing international capital mobility every country in competition is said to strive to reduce its tax rates in order to attract new capital or not to lose capital allocated in the country. According to some observers, this might end in zero tax rates for capital income everywhere.

It is argued that the increased capital mobility — at least in the EU — tends to end in a “race to the bottom” and thus makes it impossible to tax capital income. The consequence might be that the immobile factors of production, esp. labor, have to be taxed stronger and/or that the supply of public goods or publicly provided goods might be inefficiently small and/or that the government transfers or similar redistributive measures have to be reduced or even to be given up.

In order to avoid these consequences tax harmonization is seen to be necessary. Politically, there are initiatives to introduce minimum taxes on capital income. Besides, there are negotiations as well as some results on a European tax codex etc. (Mueller 1998).

2. The Theoretical Background of the Harmonization Argument

In a world of capital mobility savers and investors act on an international (world) market. Assuming a fixed world market interest rate (i.e. a small open economy) domestic savings and investment are completely decoupled — the difference being capital exports or capital imports.

If a country taxes the returns on investment by a corporate income tax (or other taxes including those on the capital stock), the capital cost increases (by the tax rate), investment shrinks and net welfare decreases despite of the additional tax revenues. Taxation is inefficient; it would be superior to tax immobile factors of production (such as land or — more or less — labor) instead of mobile capital.³

³ A large country can influence the world market interest rate by its tax policy (Gordon and Nielsen 1997). However, this case seems to be not very relevant for the European countries.

If a country reduces its tax rate, the net-of-tax return of investment increases, capital imports go up or capital exports decrease until the gross rate of return has shrunk far enough to be equal to the international net-of-tax rate of return (Sinn, H.-W., 1997b: 676). Labor will benefit from such a development because real wages as well as employment increase (Sinn, H.-W., 1997b: 676).

So far, the conclusion for national tax policy is apparent. If the source principle of taxation (taxation of investment) prevails, it is unwise to have withholding taxes on capital income or a normal corporate income tax on the return to domestic investment. If such taxes exist, it is reasonable to abolish them.

This result is confirmed by considering what happens if savings instead of investment (respectively their returns) are taxed. Theoretically, tax competition is not inefficient if taxing savings (according to the pure residence principle⁴) is feasible, i.e. enforceable (Huber 1997). However, this precondition cannot be met in reality. The domestic tax authorities suffer from a lack of information as to the residents' savings abroad because taxpayers may not be honest. In addition, foreign countries aim at attracting savings from abroad by favorable taxation and thus are not interested in giving information on capital income away to the authorities of the countries where the receivers of this income do live (Huber 1997). Thus, the attempt to apply the principle of taxing world income (residence principle) normally turns out to be a taxation of domestic capital income only. And this is an inefficient outcome for a single country.

Consequently, as to a small open economy the taxation of savings actually is nearly as inefficient as the taxation of investment. Thus, in the case of capital mobility tax competition eventually leads to a race to the bottom. According to

⁴ Typically, savings are taxed according to the residence principle. Tax has to be paid independently of the location in which the income was earned. Under the residence principle, shifts of the residence of the taxpayer have to be taken into account.

the opponents to tax competition, this consequence of tax competition is harmful, at least from a national perspective.

3. What Happened to Corporate Income Taxation?

Facing this kind of reasoning, the question arises if a race to the bottom really occurred. The corporate income tax rates which are at the center of the discussion about the necessity of tax rate harmonization declined in the 1985 to 1992 period in most of the EU countries (as well as in other industrialized countries); thereafter the tax burden on average did not change significantly (Figure 2). The effective marginal tax rates decreased in many countries in the recent two decades (Huber 1997, footnotes 14 and 15; Rimbau 1996). However, the decrease is not at all dramatic. It is not justified to interpret the development of the tax rates as a race to the bottom.⁵ Nevertheless, some politicians exactly do this.

There is another indication against the hypothesis that capital income taxation in the EU or in other countries is eroded by tax competition. The share of the (most relevant) corporate income tax revenues (in the OECD definition) in total tax revenues generally did not decline in the recent years (Table 3); it even increased in the EU on average. Correspondingly, the relation of taxes on corporate income to nominal GDP increased, too. Obviously, tax competition was not at all as fierce as some theoretical considerations seem to imply.⁶ There are only weak indications of what is called a "race to the bottom". However, there seems to be one exception: Germany.

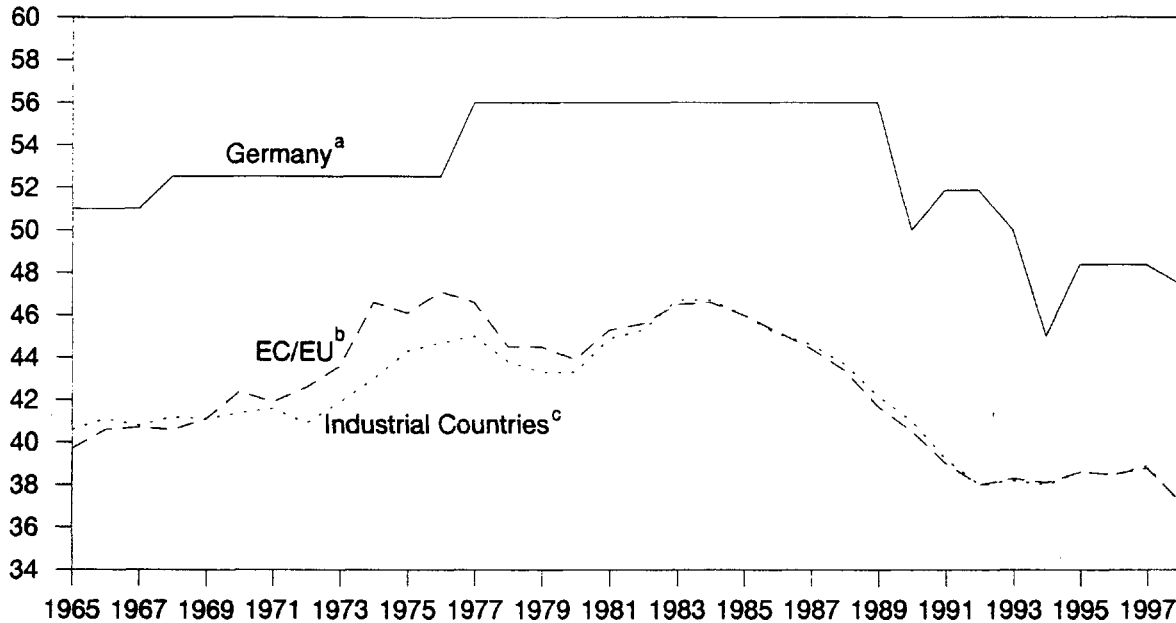
⁵ It has to be kept in mind that it is not true that there is evidence for more tax competition only if tax rate differentials decrease in the course of time (Kitterer 1995: 195).

⁶ There are some reasons explaining why capital income taxation did not at all disappear — contrary to the "race to the bottom"-hypothesis. These reasons cannot be discussed in this paper (see Huber 1997).

Figure 2

Corporate Income Tax Rate for Retained Earnings in the European Community/Union and in Selected Industrial Countries

p.c.



^a Including surcharges (e.g. "solidarity" surcharge). - ^b Average rate for 12 countries (EU 12). -

^c Average rate for EU 12, Switzerland, Japan, United States.

Source: Koop (1993). - German Ministry of Finance (1996). - DATEV(1999). - Own calculations.



Table 3 — Taxes on Corporate Income as Percentage of GDP and of Total Tax Revenues in the European Union and in Some Other Industrialized Countries

Country	Year	GDP	Tax revenues
Austria	1980	1.4	3.5
	1985	1.5	3.5
	1990	1.5	3.6
	1996	2.1	4.7
Belgium	1980	2.5	5.7
	1985	2.6	5.5
	1990	2.4	5.4
	1996	3.1	6.8
Denmark	1980	1.5	3.2
	1985	2.4	4.9
	1990	1.6	3.2
	1996	2.4	4.6
Finland	1980	1.4	3.9
	1985	1.4	3.5
	1990	2.1	4.6
	1996	3.2	6.7
France	1980	2.1	5.1
	1985	2.0	4.5
	1990	2.3	5.3
	1996	1.7	3.8
Germany	1980	2.1	5.5
	1985	2.3	6.1
	1990	1.8	4.8
	1996	1.4	3.8
Greece	1980	1.1	3.8
	1985	1.0	2.7
	1990	2.0	5.5
	1996	2.6	6.3
Ireland	1980	1.5	4.5
	1985	1.2	3.2
	1990	1.7	5.0
	1996	3.2	9.6
Italy	1980	2.4	7.8
	1985	3.2	9.2
	1990	3.9	10.0
	1996	4.0	9.2
Netherlands	1980	3.0	6.6
	1985	3.1	7.0
	1990	3.4	7.5
	1996	4.1	9.5

Table 3 continued

Country	Year	GDP	Tax revenues
Luxembourg	1980	6.9	16.4
	1985	8.3	17.7
	1990	6.9	15.9
	1996	7.2	16.0
Portugal	1980	n.a.	n.a.
	1985	n.a.	n.a.
	1990	2.5	8.0
	1996	3.3	9.5
Spain	1980	1.2	5.1
	1985	1.5	5.2
	1990	3.0	8.8
	1996	2.0	5.9
Sweden	1980	1.2	2.5
	1985	1.7	3.5
	1990	1.7	3.1
	1996	2.9	5.6
United Kingdom	1980	2.9	8.2
	1985	4.6	12.3
	1990	4.0	11.1
	1996	3.8	10.5
EU15	1980	2.2	5.8
	1985	2.6	6.3
	1990	2.7	6.8
	1996	3.1	7.5
Switzerland	1980	1.7	5.8
	1985	1.8	6.0
	1990	2.1	6.7
	1996	1.9	5.6
Japan	1980	5.5	21.8
	1985	5.8	21.0
	1990	6.8	21.6
	1996	4.7	16.4
United States	1980	2.9	10.8
	1985	2.0	7.5
	1990	2.1	7.7
	1996	2.7	9.6
Canada	1980	3.7	11.6
	1985	2.7	8.2
	1990	2.5	7.0
	1996	3.3	8.9

Source: OECD (1998: 84).

4. Germany: A Special Case

In Germany, the share of corporate income tax revenues in total tax revenues declined significantly, esp. in the nineties. It was only 3.8 p.c. in 1996. However, this is mainly due to specific factors, not to enforced tax competition.

Firstly, undistributed profits taxed at 56 p.c. in the second half of the seventies or in the eighties were distributed because of specific tax law incentives created in 1993; this reduced corporate income tax revenues (due to the lower tax rate for dividends) but raised — though to a somewhat smaller extent — withholding taxes on dividends and (with a delay) had an effect on assessed income tax revenues.⁷ Secondly, the very generous investment incentives for East Germany led to significant revenue losses (accompanied by additional revenues — in case of profitable investment — in the future).

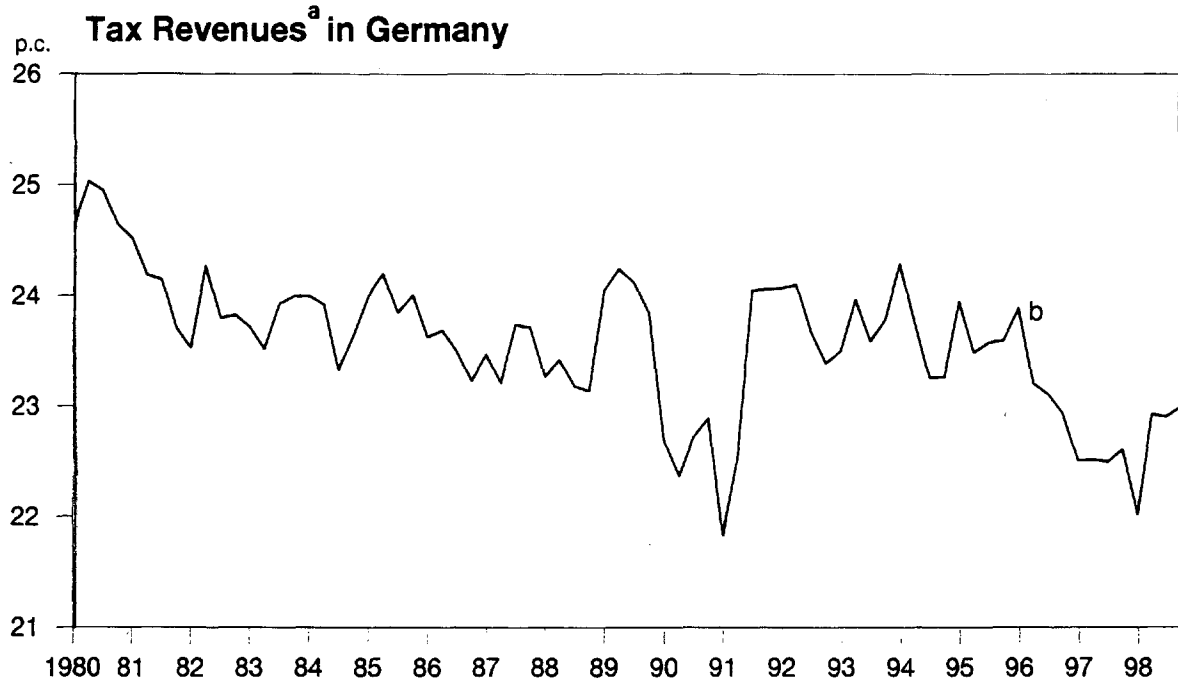
Quite in line with the explanation presented, corporate income tax revenues recovered in 1997 and 1998. The share in total tax revenues was 4.0 p.c. respectively 4.1 p.c. (1.5 p.c. respectively 1.5 p.c. of GDP). Thus, the situation in Germany is not so much different from that in other industrialized countries. By the way, total tax revenues (in relation to GDP) rebounded strongly in the course of 1997 and 1998 (Figure 3).

5. The Arguments Against Harmonization

According to the evidence presented, there seems to be tax competition, however weak competition. Possibly, it might increase due to the creation of the EMU. Thus the question is: Does competition — if sufficiently strong — lead to an inefficiently low level of capital income taxation? Is tax rate harmoni-

⁷ A similar effect came true in 1998 due to a similar change of the rules of taxation (reduction of the corporate income tax rate from 50 to 45 p.c. in 1994 combined with the option of tax-favored distribution of profits until 1998).

Figure 3



^a In relation to nominal GDP. ^b Adjusted for a change in the accounting procedure (treating specific family allowances as negative tax revenues) in 1996.



zation necessary in order to avoid this? There are some very strong counterarguments:

1. If tax rates are cut in a process of competition then the government expenditures have to be reduced, too. This helps to avoid waste and inefficiencies in the public sector; possibly subsidies for ailing industries would be cut. It helps to tame Leviathan (Sinn, S., 1992). Tax reductions and expenditure cuts would foster economic growth and employment (Heitger 1998).

Many models used in tax competition analysis do not take into account government expenditures or take them as given. Of course, these models "cannot explain how the tax system works in order to restrain governments" (Kitterer 1995: 196).

2. Competition between governments does not exclude the supply of infrastructure etc. by the states. Insofar as the governments provide services for firms, the marginal productivity of capital is affected and taxation of firms is possible. Thus, there is a lower bound for the fall of the capital income tax rates (Siebert 1990b). It is defined by the value of the services that the governments offer (e.g. by infrastructure). The level of taxation will not fall short of the marginal costs of infrastructure (or the marginal cost of protection of property rights provided by the government) even in case of perfect capital mobility (BMWi 1994: 65). Tax competition might end in a system of benefit taxation in this sense (or user charges financing roads, ports, airports etc. or — equivalently — differentiated prices for immobile private goods), not in a system of zero taxation (Siebert 1990b).

There are different views on the question if under such circumstances tax revenues would be sufficient to finance the governments' expenditures for infrastructure. It is argued that there would be a problem especially in the case of increasing returns to scale in using the services; there are doubts that supply would be efficient and there are fears of unfavorable distributional effects, i.e. of a system with taxes on labor income only.

There really is a problem if there are increasing returns to scale in the production or provision of public goods or services (Sinn, H.-W., 1995, 1997c). Under these conditions tax revenues are insufficient to cover the public sector's costs (Sinn, H.-W., 1995). This can — though not necessarily — result in an underprovision of public goods. However, this is not a very relevant case. Most of the publicly provided goods actually do not share the characteristics of public goods; they are private goods in an economic sense (BMWi 1994: 66; Blankart 1996), not genuine public goods (for a discussion see Blankart 1996). If zero taxation would be the result of tax competition because there is no counterpart to the tax, then there should not be any complaints about this outcome. In addition, in the case of public goods a centralized supply, not tax harmonization is adequate.

Tax competition models with endogenous government expenditures often lead to the conclusion that there is an underprovision of public goods. However, the high levels of government expenditures at least in the EU are preliminary evidence against the predictive power of these models. Besides, models of tax competition that include an adequate design for competition (between governments) for mobile capital do not imply that tax harmonization is necessary. On the contrary, “there is no reason to expect that public services will be underprovided, at least insofar as the principle of fiscal equivalence underlying the idea of benefit taxation is realized” (Kitterer 1995: 197).

3. It is true that tax competition is a danger for income redistribution. However, only inefficient redistributive measures are under pressure in case of competition (SVR 1998).
4. Capital income taxes impede capital formation (Huber 1996). They are harmful even in a closed economy. Tax competition is an instrument to reduce these distorting taxes. Thus it is a blossom, not a curse. This is true even if government expenditures are not affected (i.e. reduced) by tax competition.

5. Tax harmonization is often advocated in order to avoid tax distortions and thus deadweight losses. However, the aim of avoiding tax distortions “does not necessarily require that corporate income tax rates be harmonized” (Kitterer 1995: 195). “Under the source principle, ... capital mobility will tend to equalize net interest rates, so that savings will be efficiently allocated across countries. ... International investments will be inefficiently allocated across countries” (Kitterer 1995: 195). However, “As has been shown by Sinn (1990), this kind of tax distortion can be eliminated by changing the tax base to allow ... immediate write-off. Then there is no need to harmonize tax rates. The allocation of investment across countries is efficient even if tax rates differ” (Kitterer 1995: 195).
6. There might be incentives to increase taxes and thus to export part of the tax burden (by taxing foreign direct investment).⁸

Competition with respect to capital income taxes is not inefficient. It avoids the exploitation of the taxpayers by a Leviathan government and helps to find better tax systems. Maybe, it would help to implement a system of cash flow taxation in the EU which is probably superior to the prevailing systems of capital income taxation.

6. Harmonization of Taxes on Interest Income in the EU?

For about ten years, there are efforts to harmonize capital income taxation and to create “fair” tax competition in the EU. Recently, the EU Commission proposed a “model of coexistence” for taxing interest income (Mueller 1998). This means that the EU countries have to either withhold a 20 percent minimum tax on interest income (including zero bonds and euro bonds) earned by foreigners or to inform the foreign tax authorities about the interest income paid.

⁸ The argument is developed in Huber (1997).

Obviously, the proposal aims at strengthening the residence principle of interest income taxation. Using the residence principle is efficient, if it is really enforced;⁹ savings would be allocated — as to the EU region — without tax distortions because income from abroad would be taxed in the same way as domestic income. In addition, capital income taxation is adequate in a system of comprehensive income taxation. However, taxing interest income means that savings are discriminated. If the tax rate on interest income in the EU on average goes up as a consequence of implementing the Commission's proposal, the extent of discrimination even increases. Anyway, the realization of the proposal would mean a step away from a system of taxing consumption which presumably has to be preferred to a system of basically taxing income; of course, a tax on consumption also leads to distortions of economic decisions, but savers are not punished. In addition, capital might flow abroad because tax rates on interest income are smaller in non-EU countries than in the EU; eventually, private households would emigrate as a consequence of an enforced interest income taxation.

It is open to doubt if the proposal will really be decided upon; the decision has to be reached unanimously. Luxembourg wants to combine the decision with a new legislation on taxes on dividends and on tax oasis; some countries think that the 20 percent rate is too high. Besides, there will be quarrels on the distribution of the additional revenues potentially arising if the "model of coexistence" is decided upon. Moreover, the system of introducing a minimum withholding tax would create another problem. Each non-taxing or low-taxing country could increase revenues by raising the rate up to the level prevailing in the residence country; the individual saver abroad would not be hit because the tax would be completely offset in the residence country. The probability that such a consequence would be accepted by every country seems to be small; by

⁹ Otherwise, taxation according to the residence principle is similar to taxation according to the source principle which implies for a single country that a reduction of tax rates in order to attract mobile capital is efficient.

the way, the exploitation by other countries might be reduced if the average tax rate on interest income was raised in the process of harmonization.

D. Concluding Remarks

There is no good reason for tax harmonization in Europe (or in the world). What is necessary is more neutrality of the different tax systems. Tax reforms and tax rate cuts are more probable if there is tax competition. Competition is an incentive for reforms and for searching for new solutions of old problems (von Hayek 1968). Competition might help to abolish inefficiencies in the political decision process and thus to reduce government expenditures. "Therefore, there is no need for tax harmonization, but there is a need for better tax systems" (Salin 1994).

To say it more generally: "Governments learn from the policy failures and successes of others. Thus, support of policy competition need not rely on the view that government behavior is best described by the Leviathan paradigm. All one needs to assume to advocate policy competition is that governments are not omniscient" (Sinn, S., 1990: 169).

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