Introduction

Tax harmonisation in the European union has been talked about for many years. However politicians from most countries often shun the idea as the prospects of surrendering tax controls to the European Union (EU), for fear of the loss of more sovereignty and for many is another step down the road to a federal European state. More importantly it is an important source of revenue and is an important regulator of the economy and so the prospects of nations losing a degree of control over them are not politically favourable. However with the Euro currency now in place tax harmonisation is for many the next logical step to avoid what some view as harmful tax competition between member nations. The original aims of the EU were to create a single market with the free movement of goods, persons, services and capital. However different taxes across the union create distortions and so create an increase in the excess burden of taxation. In this paper I shall be examining the implications of implementing a common tax on all income across the EU. Income is broken up into three tax identities, corporation tax, savings tax (taxation of interest income) and personal income tax. I shall then analyse tax competition and evaluate whether this is a better alternative to the implications caused by a common tax on income.

Corporation tax

In 1992 the Ruding report made several proposals for harmonisation of corporate taxation, including a recommendation of a minimum corporate tax rate of thirty percent. The EU has still not taken up these proposals, however in 1997 the EU did agree to a 'Code of conduct' which aims to eliminate tax concessions that are viewed discriminatory. The aim of a common corporate tax is to avoid distortions in the

allocation of capital across the EU and the transfer of paper profits in multinational firms across borders. Currently there is concern amongst some in the EU that the different tax rates in the member nations is causing firms to relocate and invest in lower tax countries. Nations such as Germany and France are becoming particularly frustrated with nations such as Ireland and to a lesser extent the UK, which have, lower corporation tax. Ireland with significantly lower rates of corporation tax has generated massive amounts of inward investment as a consequence and now has GDP rates averaging at around 7% annually. Lower taxes abroad has also lead to firms relocating for example Ericsson a Swedish maker of mobile phones moved its headquarters to London to avoid high taxes in Sweden, many firms in Germany are also threatening their government with similar consequences if they don't lower there business rates. If there is not a common tax on corporations it could lead to tax competition among nations in the EU as nations are forced to lower tax rates as capital and corporations are relocated to lower tax nations as many forms of capital are relatively fluid. However is tax competition really a bad thing? I shall be addressing this issue later in the paper.

Savings tax (Taxation of interest income)

Taxation of interest income is even more sensitive than that of corporation tax as savings are even more liquid therefore savings are even more sensitive to changes in tax. When there is full international capital mobility any tax rate on capital will be fully reflected in the gross interest rate of that country. Since capital is an elastic good due to its high mobility it is not productive to tax it, as investors will simply take their portfolios elsewhere. The OECD realised this in 1977 and recommended the residence

principle of taxation for interest income where the investor is subject to taxation only in his resident country. However this is not an ideal model as Germany found out the hard way in 1988 as Haufler states, they imposed a withholding tax of 10% on interest income from both foreign and domestic investors and subsequently caused a massive capital flight out of the country of four times the normal rate. The German government was forced to turn back on its policy in 1989 due to this capital flight. However in 1993 the German government bought back a withholding tax of 30% but this time the tax did not apply to foreign investors, consequently the capital flight was no where near as great as in 1998. The EU and the OECD is fully aware of this and the EU in 1998 proposed that each member state be required to levy a minimum 20% withholding tax on all interest income on EU residents making it an even playing field across the EU. However investors may not be as mobile as first stated since if they were then almost all capital will be invested in countries such as Luxembourg and non EU members, such as so called tax and regulation havens as Switzerland. It is therefore argued that there is a degree of bias in an investor's decision to his or her home nation, this would also explain Germanys experience of less capital flight in 1993. There are also other reasons against the idea of perfect capital mobility such as transaction costs, which are a particular problem to small investors. However for large investor's transaction costs are relatively lower as they can spread the cost against their larger income and are not as sensitive to transaction costs. The risk of exchange rate fluctuations in foreign nations also is a factor in a persons investment decision as a persons wealth could diminish very quickly if the foreign currency devalued on the world markets, if they invested abroad to avoid high taxes. However if the EU did have a common interest income tax, although there are arguments for efficiency gains, it would cause a lot of redistribution particularly being at a loss to London and its

Eurobond market and Luxembourg. It taxes are levied at to high a rate it could even lead to capital moving out of the EU and into other tax havens such as Switzerland. This unsettling redistribution of interest income could result in job losses and therefore decreased tax revenue, as jobs are lost as a consequence as labour does not follow the capital due to labour immobility. These concerns as well as possible resulting national income changes mean the EU will be pressured into compensation packages for those at loss which will run into measurement difficulties as well as political difficulties as it may not be very popular with voters.
Competition and capital flight should even out gross interest rates, (which includes capital tax rates). With the introduction in the financial world of derivatives markets as a form of investment which is tax-free, (as derivative market investments are so hard to tax). Therefore means that any interference in the world market in the EU by the EU commissioners in an already competitive elastic market could lead to an overall loss in tax revenue for the EU. It would also cause the harmful redistribution, which may occur from attempts to harmonise tax on interest income.

Personal Income Tax

The implications of a common tax on personal income would not be that great as labour within the EU is currently very immobile. Of course if this were a paper on North America then this section would be a lot different, as migration there is relatively high and more efficient than in the EU. Personal income tax is very different across the EU however there is little migration across member nations. There is a small amount of migration with people who are highly educated and can probably speak different languages. This is one of the main barriers to people migrating, there

are many different languages and cultures across Europe making it very difficult for people to migrate therefore the costs of migrating out way any small benefits of lower taxes. There are of course many other factors making labour immobile, the potential loss of friends and family, differences in public services for example Sweden obviously has better public services than Greece. This means that tax competition is unlikely to take place here and also helps contribute to the fact that Labour is relatively inelastic which means it is efficient to tax according to the guiding principles of the Ramsey tax problem. As in the medium term it is unlikely much labour mobility will occur national governments can tax at will and reap in the tax revenues for the country.

However this leads to another argument. There is a lot of debate in the literature on optimal taxation, is it is more efficient, or is there less dead-weight loss created on the economy if tax on personal income is small and should be shifted on to indirect taxation such as consumption tax as recommended by Hyman. Since efficiencies could be gained from reducing taxation on income as tax on income does effect peoples decision on how much to work. It is argued these efficiency gains would be larger than those subsequently lost by taxing consumption more heavily. There is also literature on optimum taxation that suggests taxation on income cause inefficiencies as taxing income whether directly or indirectly taxes savings therefore potential savings are decreased, which is effectively a tax on future consumption. These theories all point to there being less dead weight loss to society if there is a lot less taxation on all income and increased taxation on indirect sources such as consumption taxes. Therefore perhaps the EU should have a common rate of tax on all income at a very low rate and increase levels of indirect taxation so to lessen the dead weight loss

caused by taxation. However there are assumptions and limitations to the theories on optimal taxation, which however this paper does not give scope to discuss.

Tax Competition

The main reason for having a common tax rate across the EU is to prevent tax competition. Why is it that government ministers are so concerned about the prospects of tax competition? Which will of course be more active in the EU with the introduction of the Euro.

Governments are concerned that differing tax rates across the Europe will lead to capital and to a lesser extent Labour flowing out of high tax countries and into low tax countries. There is some evidence of this as Ireland has very low tax rates on corporations, which has generated a lot of inward investments as a result. Indeed in 1998 the Irish under pressure from the EU especially France agreed to scrap their special low rate tax corporate tax of 10% on manufacturing by 2003 to a slightly higher rate of 12.5%. (Economist July 30th 1998.)

If there is no common rate of tax nations will be forced to continually cut taxes and undercut one another as they compete for capital and labour. This will create a so-called 'race to the bottom' in taxes. Which will result in low tax revenues for government meaning lower social expenditure meaning public services will deteriorate with social policy being undermined as nations compete with one another creating a degree of social dumping in Europe. There also may be a degree of unemployment as corporations relocate to lower tax nations which all could be avoided by a common tax across the EU.

However this argument has a lot of assumptions as “everything else is not constant” there are many other factors that determine capital and labour ‘flight’. There are many other costs and benefits for firms and workers alike to consider when moving to other nations other than just tax. There are of course moving costs legal and financial complications. Language and culture barriers, proximity to suppliers, labour productivity, public services, education, infrastructure, a clean environment to name but a few. It is argued that capital is more mobile than labour however capital still has a degree of immobility with ‘sunk costs’. For example once a factory is built in a nation it cannot simply pick the factory up and move it to another nation it has to be rebuilt. Therefore capital and labour are not very mobile especially within the EU. Therefore the problem may not be as bad as some may fear, even if capital and labour were perfectly mobile governments could still tax them to provide public goods such as good roads for which they are willing to pay for. A paper by Baldwin and Krugmen also agrees that there are many other factors that play a part in an investor’s decision to move or invest capital. They argue that capital agglomeration is the most important factor in an investor’s decision making. A cluster of capital nearby is more useful than dispersed capital, forming supply chains, obtaining services and strengthening infrastructure bringing costs for firms down. This occurs best when economies are integrated, but not completely, integrated, the authors argue which is where the EU is at the moment. They suggest the EU is currently in two groups the core and the periphery, with France Germany and the Benelux countries being at the core of capital agglomeration and at the periphery are Spain, Italy, Greece and Portugal. Because of the agglomeration benefits of the core they can have higher taxes then the periphery without the worry that capital might flee. In 1965 the gap in tax rates between the core and the periphery was 12% which rose to a high of 16% in 1978. After which there

was further integration and the gap began to narrow to 7% in the 1990's. The first wave of integration makes capital agglomeration feasible whilst the second makes it more competitive and the core starts to loose its advantage over the periphery. If these benefits of agglomeration are accepted then this is an argument against tax harmonisation. If there were the same tax rates for the whole EU firms would not move because of capital agglomeration. If there were a common rate firms on the periphery would lose their advantage of lower tax rates, which attract types of firms that don't benefit from capital agglomeration. Whilst firms in the core may have to cut taxes and receive worse public services as a result. However there are arguments against the argument for capital agglomeration. As developments in Information technology continue and transport costs fall and integration continues the benefits of agglomeration may disappear. However it is more efficient to leave decisions to market forces than bureaucratic governments.

Conclusion

There are of course many benefits to be had from tax competition. It could keep down taxes in the EU, which is thought to be to high anyway. Since the treaty of Rome in 1965 taxes have risen significantly so the common market has not created sufficient competition. Even with the mass globalisation occurring taxes have still been rising even since 1990 especially in Germany, France and Italy. With the introduction of monetary union however this may change and a few rounds of tax competition may not be an adverse event for the EU, as it would force governments to be more efficient. If there was a common tax agreed upon within the EU capital and labour could still move to non-EU countries for tax reasons, as EU nations do not solely trade with one another but the rest of the world as well. It could make the EU

inefficient as the rest of the worlds tax systems become more efficient whilst the EU stands still within its own agreement. Making a common tax almost impotent, therefore income tax harmonisation within the EU does not solve any possible problem. Therefore the implications of implementing a common tax on income is more inefficiencies and so dead weight loss to society. Therefore the EU should leave income tax to a more efficient approach of tax competition which will harmonise income taxes more efficiently as well as making government more efficient. The EU should also concentrate more on harmonising indirect taxation which is a more efficient tax base and try to make labour more mobile which is difficult however making wages more flexible is not. This would increase tax competition in personal income tax as well as having other benefits to the EU such as a better ability to cope with asymmetric shocks.

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