Tax Harmonization and Financial Liberalization in Europe

Proceedings of conferences held by the Confederation of European Economic Associations in 1989

Edited by

Georg Winckler
Professor of Economics
University of Vienna

M
St. Martin's Press

First published in Great Britain 1992 by
THE MACMILLAN PRESS LTD
Houndmills, Basingstoke, Hampshire RG21 2XS
and London
Companies and representatives
throughout the world

This book is published in association with the Confederation of European Economic Associations.
General Editor: A. P. Thirlwall

A catalogue record for this book is available from the British Library.

ISBN 0-333-54858-2

Printed in Great Britain by
Billing and Sons Ltd
Worcester

First published in the United States of America 1992 by
Scholarly and Reference Division,
ST. MARTIN'S PRESS, INC.,
175 Fifth Avenue,
New York, N.Y. 10010

ISBN 0-312-07516-2

Library of Congress Cataloging-in-Publication Data
Tax harmonization and financial liberalization in Europe : proceedings of conferences held by the Confederation of European Economic Associations, 1989 / edited by Georg Winckler.
p. cm.
ISBN 0-312-07516-2
1. Taxation—European Economic Community countries—Congresses.
2. Financial institutions—European Economic Community countries–
–Congresses. 3. Europe—Economic integration—Congresses.
I. Winckler, Georg, 1943- . II. Confederation of European Economic Associations.
HJ2599.55.T39 1992 91-34311
336.2'0094—dc20 CIP

The Case for European Tax Harmonization

by Hans-Werner Sinn

published in:
G. Winckler (Ed.):
“Tax Harmonization and Financial Liberalization in Europe.
Proceedings of Conferences held by the Confederation of European Economic Associations in 1989”,
St. Martin’s Press: Basingstoke 1992, pp. 3-7.

1 The Case for European Tax Harmonization

Hans-Werner Sinn

There can be no doubt that freedom of movement within Europe will come about before the economic and tax systems are harmonized: where there is no external pressure the national governments are not going to undertake such major reforms. There can also be no doubt that freedom of movement will be followed by harmonization. Those governments unwilling to work out formal agreements will find that the anticipated gains from an integrated Europe will turn out to be actual losses.

Europe's internal barriers are to be dismantled on New Year's Day 1993 and a new era of prosperity is supposed to commence. Free movement of capital, goods and services will, it is hoped, trigger off major reorganization of production and induce a strong surge in growth. The much-quoted Cecchini report estimates that, without barriers, real European output will exceed every year what it would have been with barriers by around 4 per cent to 6 per cent.

The estimated gains can only be achieved if reorganization is based on comparative cost advantage and not on comparative tax advantage. It would make no sense to transplant Europe's production to Iceland and Luxembourg simply because those countries have low tax rates. It also makes no sense, as this comment will show, to sit back and wait for competition between Europe's governments to harmonize their tax systems.

Economic decisions are not all affected in the same way by tax rate differentials. Money capital and international trade in goods react most strongly to such differentials, followed by firms' direct investment and location decisions. Households' decisions about place of residence are also affected, though to a lesser degree. Only the allocation of land is completely insensitive to tax differences.

Up to now, policy directed towards avoiding misallocation of goods and money capital caused by their sensitivity to tax differentials has relied on two protective measures. One is the destination principle for indirect taxation. Value added tax (VAT), the most important indirect tax, has been dealt with by 'border adjustment'. Goods exported are freed from VAT when they leave the exporting country. In the importing country, however, VAT is levied at this country's rate. Border adjustment ensures that international competition between producers is on the basis of net-of-tax prices and thus distortion of the international division of labour by tax differentials is avoided. The other protective measure, recommended by the 1977 OECD Model Double Taxation Convention, is the use of the residence principle for interest income. Regardless of where an investor's interest income is generated, it is subject to tax only in his country of residence. Ideally, a country with high tax rates should not experience capital flight as income from domestic and foreign investments are taxed at the same rate. The residence principle is supposed to ensure that international capital movements are directed by before-tax interest rates and that money capital will be used where it is most productive regardless of tax differentials on interest income.

Alas, neither of the protective measures works as it should. The burnt fingers West Germany suffered when it attempted to impose a withholding tax on interest income indicate how ineffective the residence principle really is. The withholding tax should not have induced huge capital outflows but it did. Tax evasion combined with secrecy laws severely weaken the effectiveness of the residence principle. Unless the European Community sets up a system of tax auditing, perhaps along the lines of the American model – but even then there would still be Switzerland – the residence principle cannot ensure an efficient allocation of capital. Tax rates on interest income will have to be harmonized.

It is even less likely that the destination principle will be complied with when there are no border controls. Border adjustments cannot be made in the absence of these controls and the rush will be on to buy goods from the low tax countries. The European Commission has suggested a new system to replace border adjustment – tax rebates will be allowed for goods bought in foreign countries and a central clearing house will be set up to give each country the tax due to it under the destination principle. This could be workable for goods traded between firms, but would be ineffectual in the case of cross-border shopping by consumers and tax-exempt institutions. This is so regardless of whether the purchases are made through mail-order houses, by taking shopping trips, or by making use of carrying firms or the countless intermediaries that are sure to spring up like mushrooms after 1992. The detailed measures proposed by

the Commission for enforcing the destination principle in the case of direct purchasing, for example special controls on mail-order houses, are not exactly convincing as a solution to the problem. Competition in future is more likely to be at the level of tax inclusive prices, and distortions in the international division of labour resulting from VAT differences appear more than likely.

The liberal economists in Kiel assure us that going over to the origin principle for VAT will have little significance economically because the overall effects can be compensated by exchange rate appreciation in the low tax countries. This assurance would be comforting if VAT fell equally on all final products, yet the system does not work like this. While it is possible to ignore the multitude of individual exemptions from full tax liability, it is certainly not possible to ignore the fact that VAT is designed to fall only on consumption goods and not on investment goods. Even though, as the Kiel economists correctly assert, the rush to buy consumer goods in the low tax countries when the borders are opened will cause these countries' currencies to appreciate the market position of their investment goods producers will deteriorate. West Germany, which has low VAT levels, must expect a structural shift in the composition of output from investment goods to consumer goods.

The arguments for harmonization based on the flaws in the residence and destination principles are reinforced by the fact that not only firms' location decisions are sensitive to tax differentials: potentially at least residence decisions of households are too. In the long term, immigration into the low tax countries seems a distinct possibility and neither the source nor the destination principle can be of any help here. The only way to avoid harmonizing tax structures would be to introduce taxes based on nationality or place of birth – a far less practicable idea.

If, as appears to be the case, harmonization will be needed in Europe 1992, the question of how it is to be attained arises. Can the individual countries be allowed to make separate decisions about their tax systems? Or is it better to make a collective decision at the community level?

The knee-jerk reaction of a liberal economist would be to prefer the competitive solution, in line with the Tiebout model where it is found that, under certain circumstances, letting people vote with their feet results in an optimal solution. This would ensure that, for mobile factors of production, tax liability could not exceed the benefit received from public goods and each country would therefore be concerned to supply the optimal amount of these goods. However, disappointing as it may be for the liberal economist, this result has redistributive implications, which should put a dampener on his enthusiasm.

A direct implication is that the tax burden would fall disproportionally on those immobile factors that have no way of escaping it. Landowners in particular should be wary of the competitive solution. There is no way they can transport their land to Luxembourg or declare it to be part of the Grand Duchy. Landowners are the natural losers in any competition between tax systems.

Apart from putting the heaviest burden on landowners, there is no way for a government to implement a redistribution policy. Owners of capital and suppliers of labour would not accept a net tax burden – they would just leave – and net benefits would result in an influx of claimants from all over Europe. No welfare state can cope with long-term immigration of the poor – the New-York-city effect is inescapable.

The wrecking of the welfare state would please those who see redistribution simply as a manifestation of Leviathan's greed. But this is far too simplistic a view of the function of redistribution in a modern welfare state. Redistribution makes an important contribution to social peace and the preservation of social order, and helps prevent the criminalization of groups on the edges of society. In addition, redistribution can be seen as a form of insurance. All insurance involves redistribution. A person who takes insurance cover pays a premium and thus agrees in advance to a redistribution from those whose luck is good to those whose luck is bad. Surely twenty-year-olds who do not yet know what the future has in store for them will accept the redistribution policy of the welfare state as an insurance device? Surely the idea of solidarity, to which politicians of all parties frequently swear has connotations of insurance? It is not possible to brush aside the implications of these questions. The fact that successful fifty-year-olds, who already know they are among the lucky ones, would like to opt out of the welfare state in no way invalidates the insurance interpretation. After all, a buyer of private insurance cover would like to get his premium back when it is clear that he will not be making a claim but the fact that he can't, and knows in advance that he can't, does not make him refuse to buy insurance cover. Social insurance contracts are no different from private insurance contracts in this regard.

If the insurance interpretation of redistribution has a nub of truth,

then even those taking an extreme liberal position will have to reject unlimited competition between tax systems. Such competition would only make sense if firms' production location decisions and households' residence location decisions had to be made in the ex ante phase, that is, before it was known how the dice were going to fall. Such a requirement would, however, not only be impracticable, it would also involve an unwarranted reduction in personal freedom of movement. The initiators of the movement towards a barrier free Europe certainly did not intend that the ability to vote with your feet would end up by wrecking the welfare state, and the future generations who will be the beneficiaries of that freedom of movement cannot want this either.

To sum up: without harmonization a barrier-free Europe will experience a reorganization of production on the basis of comparative tax advantage instead of comparative cost advantage. West Germany, because of its high direct taxes and low indirect taxes, must expect a capital outflow and a relocation of its firms in other countries. It must further expect a reorganization of production in a way detrimental to its investment goods industry. The invisible hand of competition between systems can certainly bring about harmonization, but an inferior kind where welfare states necessarily degenerate into 'night watchman' states. Only harmonization agreed on collectively at the level of the European Community can prevent the potential benefits of integration turning into actual losses; only this kind of harmonization can stop the devil taking the hindmost.