

The Threat of Fiscal Harmonization



MASSIMILIANO TROVATO* • 2007

Many influential voices have, in the recent past, spoken in favor of the opportunity to give the European Union a coherent and centralized tax policy. The keyword used by these people is “harmonization”. They share the opinion that all member states should conform their own tax systems to the directions of Brussels bureaucrats – as already happens for VAT. Some of them have pushed the argument even further, to the point that the Union should be given the power to levy taxes on its own, and not just to tell member states how to do that. What if they succeeded? How likely is such prospect?

There are of course many serious obstacles to this process. According to a realist approach to the politics of European integration, one should not underestimate the extent to which people feel uncomfortable with the idea of European integration itself. As the tortuous path the European Constitutional Treaty is undergoing shows, citizens are indeed far less persuaded than their rulers in Brussels (or in their respective capital cities) that transforming what was originally conceived as a free exchange area in some kind of a superstate would be a brilliant idea.

The awareness that the farther the power is from its subjects, the less they will be able to control (and resist) it is of course rapidly spreading, but this is just part of the story. Much more comes into the picture: to begin with the sense that the European Leviathan, designed – as it is – as a gigantic and pachydermal welfare state, will be anything but a warranty of freedom: that is, it will possibly look more like the Soviet Union than like the free and prosperous Europe of the Middle Ages.

The question that immediately arise is: why should politicians favor a process of which people are so skeptical? Why is it in their self interest to ignore their electorates’ desires instead of seconding them in order to achieve greater consent – as we would rather expect? And, above all, why are they apparently so eager to abandon what is by nature their most appreciated privilege, that is to say the power to tax?

In the end, would they really be willing to accept and even promote something close to what happened in the United States after 1913, which Frank Chodorov described with the following words: «After 1913, however, and without either a war or a change in the law of the land, the states were gradually and almost

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imperceptibly rid of their sovereign position and reduced in importance to dependent subdivisions of the nation. It was done by the subtle arts of bribery and blackmail, made possible by the Sixteenth Amendment»¹?

Globalization and sovereignty

We are seemingly facing a real conundrum. Politicians willing to give up their thin slices of power, to create a much larger cake, of which many of them could eventually get only the crumbs. But things begin to get much clearer when one looks at the wider picture. How does globalization affects national sovereignty and especially fiscal sovereignty?

As is now being widely recognized the modern state is quickly losing control of the social reality. The awesome machinery invented by Jean Bodin and Thomas Hobbes already has merely crumbs left. Borders become more and more fading; capital and people flow in and out of countries with substantial ease. Technological evolution makes people living in different places incredibly closer to each other – thus enabling them to establish fruitful business relations. National governments can do very little if anything to prevent this all from happening².

A clear sense of how quickly the role of the state is getting more and more limited is given by the fact that in 1900 there were about 50 states in the world; they were around 90 in the 50's and are now almost 200, with 32 new states coming into existence since 1990.

Governments feel of course compelled to react to such tendency of power fragmentation. Therefore they behave, so to speak, like a poker player who has no good point at hand and go all in to upset his opponent. If tax bases are now so highly mobile and commercial transactions so fleeting, some politician might think, why not just follow them and call and raise on the geographical challenge? At the cost of losing their prerogatives, which globalization is however eroding, they gamble on the opportunity to get even larger ones – or at least to replicate the very same ones on a much larger scale. To them the bet should look like giving away almost useless powers now, to get virtually infinite ones in return tomorrow.

This power shift thus occurs, in some sense, out of the surviving instinct of politicians, who realize that the moment is critical to their own future as well as to that of their subjects. And the efforts of governments from high-tax countries, who have obviously far more to lose from the current trend, are directed towards the setting up of the much favored transition through the establishment of what the Cato Institute's Daniel J. Mitchell has labeled "an OPEC for politicians".

1 Frank Chodorov, *The Income Tax: Root of all Evil* (New York: The Devin-Adair Company, 1954), online at: <http://www.mises.org/etexts/rootofevil.pdf>, p. 64. In 1913 the Sixteenth Amendment modified the Constitution by granting the Congress the power to collect taxes on incomes.

2 This idea is getting very widely spread. A much influential author that has lately addressed the decline of modern states from a Marxist standpoint (!) is famous British historian Eric Hobsbawm.

In other words they are trying (somewhat successfully) to use international bodies like the EU itself, but also the OECD, in order to discredit and eventually stamp out their number one enemy: tax competition.

The case for tax competition

The case for tax competition is apparently pretty straightforward. Even though there are some exceptions to this (and French President Nicolas Sarkozy is a very prominent one³), competition is an extremely popular idea nowadays.

In Europe such phenomenon can be quite easily observed, taking a look at the attention paid to, and the influence exerted by, the activity of Mario Monti, first, and Neelie Kroes, now. It could be argued that the office of European Commissioner for Competition is actually one of the more desired and relevant a European politician can be appointed to. At the same time the sense that competition is also crucial in the fiscal sphere, as well, is not really widespread. The question why this is so is a legitimate one.

There might be two different yet related answers to this: either tax competition can be deemed a somewhat different concept than competition in general, or – even though it is understood as belonging to the very same category – it may be considered undesirable for some other reason.

That the concept of competition is somewhat corrupted around Brussels may not be denied: the European way to competition looks like a board game for regulators, who think they are allowed to determine how many firms should compete in some arbitrarily defined market, how big they should be, how they should relate to each other, and so on and so forth. So it may not come as a big surprise that to many people fiscal competition is something basically different and even contradictory, in that it is not the result of any technocratic central planning.

I would therefore argue that a wrong approach to competition – as a state rather than as a process, as being designed from the top down, instead of freely evolving within the market – also hampers the understanding of such a process as tax competition.

The argument against tax competition

But tax competition is also and more fundamentally challenged on a different basis. There is a great deal of studies that consider it to be harmful for the economies of all countries involved – meaning, at least in the long run, both high-tax and low-tax countries.

³ He is, by the way, consistent enough to oppose all kinds of competition equally: in 2004 – as a Finance Minister – he explicitly called for the harmonization of tax systems at the EU level.

The argument goes as follows: in the absence of tax competition, governments set the amount of taxes to be raised (and spent) at the point where marginal cost equals marginal benefit. Tax competition forces them to lower tax rates and thus lead to an underprovision of public goods, ultimately reducing the overall welfare. Moreover, from a game theoretical perspective, lowering taxes is an individually rational but socially irrational strategy, and this originates a “race to the bottom” that will produce in the end the disappearing of any taxation at all. This argument is flawed in so many ways. We will try to enumerate some of them.

Beginning from the conclusion, this is just not happening. As we will see infra, tax competition seems to have some perceivable effect on the general level of tax rates. But this is still far from eradicating taxes all around the world, as some appear to believe. Of course, it could and should be noted that tax competition is not completely widespread, yet. But another important point to raise is that tax systems are not the only variable that individuals and firms take into account while choosing where to invest or to work, and perhaps it is not even the most important one.

A major fallacy of the argument is its trust in the Samuelsonian model of public goods production. First, it is absolutely untenable and even naïve to consider that governments can realize at which point $MC = MB$ (as we know from the legacy of the Austrian School) and that they would be willing to set the amount of taxes (and consequent spending) at that point (as we learn from the teachings of the Public Choice School).

More generally, an extremely weak link, if any, exists between taxes and expenditure in modern states (and this problem was made even worse by the appearance of modern democracies), as was easily acknowledged by classic public finance: it is commonly known that economists until the beginning of the 20th century considered taxation and spending to be two entirely different problems.

A clearer and more accurate characterization of the issue would be that the amount of taxes will be set at the highest point that the political reality makes feasible, while spending will be allocated in such a way to maximize support and consent by interest groups. The main (or only) causal relation between spending and taxes will then be due to the fact that it usually takes more money to buy one’s clients, than one could safely raise through taxation, and this leads to the necessity of running huge budget deficits and thus to the postponing of further taxation.

Tax harmonization efforts in the EU

Contrary to what is commonly believed, tax harmonization is already reality in the EU to a considerable extent. VAT has been regulated by the EU – that requires a minimum rate of 15% – for some forty years now and represents a substantial contribution to the Union’s budget. It should not be ignored that the VAT accounts for a third of total tax revenues. And Luxembourg – formerly the only country to keep VAT rate as low as 15% – had lately to accept that from now on sales taxes be levied at place of consumption, voiding any competition at all.

Moreover, many attempts to standardize the Corporate Tax Base across Europe are now on the way, and they are reported to be extremely popular among firms themselves, that apparently overlook the danger behind the simplification edge.

Finally, legislation such as the Savings Directive is promoting automatic mechanisms of information exchange among countries in and outside Europe. Leaving aside the privacy problem, this would substantially reduce the opportunities to benefit from tax competition without violating one's country legal framework.

Tax competition: what for?

As is true of competition in general, tax competition is not good (or bad) in itself: more precisely, it should be pointed out that it simply is not an end in itself. Its appeal lays on whether it be conducive to desirable tax policies, based on the views one hold on 1) the effect of taxes on the economy and 2) the ideal form of a tax system – according to (point 1 plus) some canons of justice in taxation. While there are of course many works in the public finance literature dealing with the positive aspects of the matter, economists (and other social scientists) have traditionally neglected to elaborate a general normative theory of taxation; this is also true for authors in the classical liberal and libertarian tradition, with some notable exceptions⁴.

This is clearly not the place to restate the whole debate on the economic function and influence of taxes or to fill in the gaps in the efforts to apply moral categories to fiscal policies: we need to address, however, these issues, albeit very briefly, in order to clarify what is the framework according to which to evaluate the goods and bads of tax competition.

Taxation and welfare

As Murray Rothbard put it, «Taxation always has a two-fold effect: (1) it distorts the allocation of resources in the society, so that consumers can no longer most efficiently satisfy their want; and (2) for the first time, it severs “distribution” from production. It brings the “problem of distribution” into being»⁵. While the issue under (2), although of the utmost importance, is outside the scope of our considerations, the problem under (1) is critical to assess the effects of taxation on the economy.

In this regard, the fundamental element is of course the global level of taxation, which reduces the total amount of resources available for any use. But the distortionary effect of taxation makes it also less convenient to work or invest. This

4 These may include Murray N. Rothbard, *Power and Market. Government and the Economy* (Menlo Park, CA: Institute for Humane Studies, 1970), ch. 4, “Binary Intervention: Taxation”; and Pascal Salin, *L'Arbitraire Fiscal* (Geneva: Slatkine, 1996).

5 Murray N. Rothbard, *Power and Market. Government and the Economy* (Menlo Park, CA: Institute for Humane Studies, 1970), p. 86.

is particularly evident when it comes to the topic of capital formation, which is crucial to economic development and welfare. Any kind of income taxation, but especially taxes on capital and corporate income reduce the remuneration for capital, endangering the marginal investments.

Thus we can plainly say that a tax is the best for the economy which taxes the least – and with some consideration for capital accumulation.

Taxation and justice

In the great words of Alexander Pope, «Whoever hopes a faultless tax to see / Hopes what ne'er was, is not, and ne'er shall be». This is simply true because there is no just way to carry out some inherently unjust activity.

As Murray Rothbard brilliantly showed taxation is nothing but legalized theft: the taking of citizens' resources by the use or threat of violence. There is no point – the argument, to put it very grossly, goes on – in trying to figure out a legitimate way to steal other people's money.

But this is only true to some extent, I am inclined to believe: Rothbard seems to neglect that we are not just talking about a gang of thieves that grab the money and run: in fact, this money – like it or not – is first raised and next spent, on a regular basis, in some given society: in order to assess the situation, one must also turn to the expenditure side of the coin.

To give a different formulation, Rothbard builds upon John C. Calouhn's great intuition that individuals in a society can be divided into two classes: taxpayers and tax-consumers. But this is a merely static approach to the issue. The truth to be told, (almost) all of us fall alternatively in both categories, and calculating the net result of such schizophrenia is not sufficient to give a detailed account of the situation.

A more accurate description would draw upon the idea – shared by Bruno Leoni and Bertrand de Jouvenel – that the democratic process ultimately leads to a legal *bellum omnium contra omnes*, Hobbes' forecasts notwithstanding. Another way of stating this is to reference to Frederic Bastiat's well known quote, according to which «The State is the great fiction through which everybody endeavors to live at the expense of everybody else».

In sum, all of us pay taxes to some extent; and all of us to some extent benefit from public expenditures⁶. We may agree that this can hardly raise ethical issues, indeed, since everybody has to live his moral life in the real world, imperfect as it is. But it is completely different to maintain that this has no relevance whatsoever concerning the justice of taxation – as if bridges, schools and subsidies popped out of thin air.

⁶ Many, it should be noted, are in fact damaged by public expenditure which they may have contributed to: think about a criminal put in jail (provided that he has completed and paid his tax returns, of course) or the competitor of some publicly financed businesses. Should they fall, *ceteris paribus*, into the tax-consumers or the taxpayers group?

Unfortunately, justice is clearly not a matter of degree. Perhaps injustice is, I would argue. Second and third bests have nothing to do with justice. But neglecting them when one cannot achieve real justice may well be called unjust. Therefore, all we can say is that some tax systems look more unjust and exploitative than others.

This may apply, for instance, to deeply progressive (or deeply regressive, which may be desirable for efficiency reasons, but are just indifferent from the moral point of view) tax schemes, which appear at first glance more unjust than flat tax systems. (But then again, to provide another demonstration of the difficulty of the issue, how about the loopholes that would be abolished?)

The same way one cannot measure weight with a measuring tape, it is absurd and self-contradictory to try to get more than extremely loose suggestions on the justice of an injustice. We could then add that flat tax systems seem more unjust than poll taxes, and the latter more unjust than some kind of tax intended to resemble the working of market prices, however this may be performed.

More generally, I would conclude that a sound moral approach to taxation would basically privilege the benefit approach over the ability-to-pay approach⁷; keeping in mind that only in the free market is the benefit approach pushed to its genuine consequences.

The effects of tax competition

How likely is tax competition to bring about the lowering of tax rates that we have identified as the only genuinely substantial effect that would both increase overall prosperity and satisfy some minimum justice requirement? This can and indeed is widely debated.

An otherwise very favorable observer of tax competition, Richard Teather⁸, tends to minimize its effects: according to him, all tax competition managed to achieve was to slow the growth of tax rates. It must be conceded that, as of now, the amount of taxes as a percentage of the GDP in Europe is not observing substantial reductions.

But the evidence provides interesting results. We have summed up in the following table the level of Personal Income Tax rates in 1995 and 2005 in all of the current EU members, sorted according to the date of their admission into the Union.

Top Rates on Personal Income Tax in EU, 1995 and 2005

| <i>Member State</i> | <i>Accession</i> | <i>1995</i> | <i>2005</i> |
|---------------------|------------------|-------------|-------------|
| Belgium | March 25, 1957 | 64 | 55 |

⁷ A brief yet good overview of the debate over the foundations of taxation is to be found in the "Introduction" to Richard A. Musgrave and Alan T. Peacock, *Classics in the Theory of Public Finance* (London: McMillan, 1967).

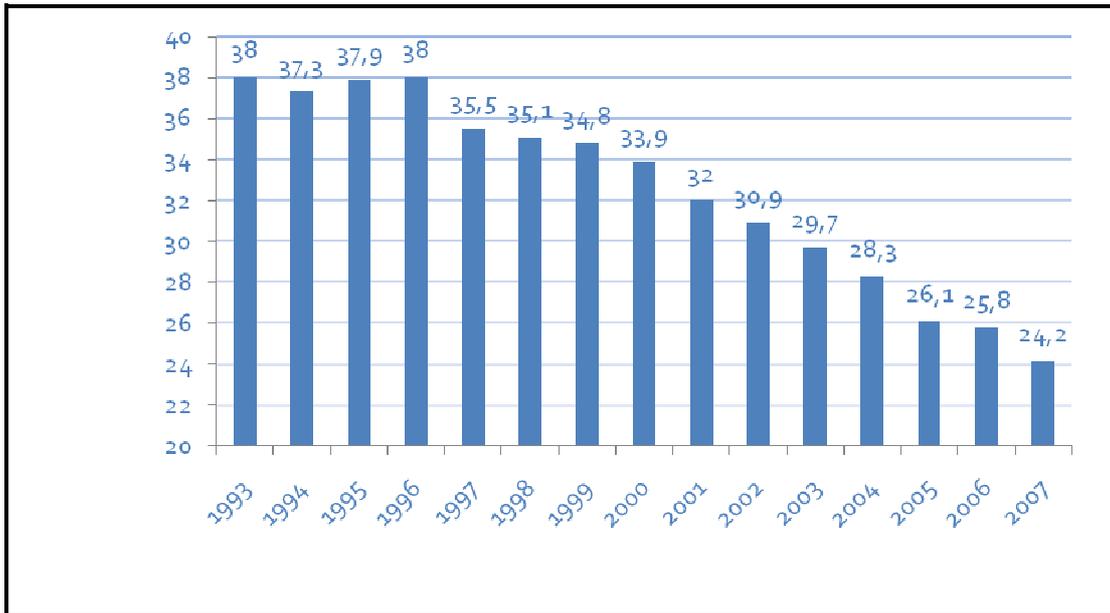
⁸ Richard Teather, *The Benefits of Tax Competition* (London: Institute of Economic Affairs, 2005).

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|----------------|-----------------|---------|-------|
| France | March 25, 1957 | 51 | 48 |
| Germany | March 25, 1957 | 57 | 44 |
| Italy | March 25, 1957 | 67 | 43-45 |
| Luxembourg | March 25, 1957 | 50 | 41 |
| Netherlands | March 25, 1957 | 60 | 52 |
| Denmark | January 1, 1973 | 63 | 59 |
| Ireland | January 1, 1973 | 48 | 42 |
| United Kingdom | January 1, 1973 | 40 | 40 |
| Greece | January 1, 1981 | 45 | 40 |
| Portugal | January 1, 1986 | 40 | 42 |
| Spain | January 1, 1986 | 56 | 45 |
| Austria | January 1, 1995 | 50 | 50 |
| Finland | January 1, 1995 | 54 - 59 | 50-56 |
| Sweden | January 1, 1995 | 46-53 | 52-59 |
| Cyprus | May 1, 2004 | 40 | 30 |
| Czech Republic | May 1, 2004 | 43 | 32 |
| Estonia | May 1, 2004 | 26 | 24 |
| Hungary | May 1, 2004 | 44 | 38 |
| Latvia | May 1, 2004 | 35 | 25 |
| Lithuania | May 1, 2004 | 35 | 33 |
| Malta | May 1, 2004 | 35 | 35 |
| Poland | May 1, 2004 | 45 | 40 |
| Slovakia | May 1, 2004 | 42 | 19 |
| Slovenia | May 1, 2004 | 50 | 50 |
| Bulgaria | January 1, 2007 | 50 | 24 |
| Romania | January 1, 2007 | 60 | 16 |

Source: 2007 Economic Freedom of the World

In the graph below, we present the trend of the average Corporate Income Tax rate in the EU, and the results are equally significant.

Top rates on Corporate Income Tax in EU, 1993-2007



Source: KPMG Corporate and Indirect Tax Rate Survey 2007

Of course the entering of new members, mainly from the former Soviet bloc, has brought about a considerable change. But it is interesting to observe that 1) all countries but Sweden have cut their PIT rates – some substantially – between 1995 and 2005, so that the “old members” are now approaching the 1995 level of the “new members”; and 2) that the downward trend of CIT rates was established well before 2004, even though the entering of new members certainly reinforced it.

It is also worthy noticing that the data presented cannot shed full light on the whole process, which is still going on. Some of the mentioned countries are again lowering their tax rates, as is the case of Bulgaria – which is introducing a 10% flat tax on personal as well as corporate income, beginning January 2008.

And some others, which are not currently part of the European Union, but are not that far geographically and perhaps culturally, and might thus be willing and qualified to enter it (and whose competition is not – we must add by the way – negligible) are following the same path. Just think about Russia and Ukraine (both have a 13% flat tax) or the young Republic of Montenegro, which has even set a single-digit income tax rate (as little as 9%).

Of course, rates themselves are not the only element to be taken into account. In Estonia and other countries, for example, dividends are taxed only when they are distributed: this clearly reduces the tax base, and thus the level of taxation, and positively affect the pool of capital available for investment.

The call for harmonization in domestic fiscal policies around Europe, which would ultimately lead to the establishment of a uniform and centralized tax system,

may also be characterized as an example of what I would call “fiscal protectionism”. In fact, tax harmonization has a twofold effect: on the one hand, of course, it prevents taxpayers from eroding a jurisdiction’s tax base; also, on the other hand, it voids the opportunity to drain resources from high-tax jurisdictions to low-tax jurisdictions, making them available for investment in competing businesses.

This clearly holds strong relations with the growth path of less developed countries. According to the United Nations Conference on Trade and Development’s 2007 World Investment Report Foreign, Direct Investment inflows in 2006 were 38% higher than in 2005, totalling \$1,306 billion and approaching the peak of \$1,411 billion reached in 2000. This is a huge amount of money that can make, and is indeed making, a difference. Along with favorable tax systems, and other institutional reforms⁹, it has brought about impressive GDP growth rates in the last few years. A not-to-be-neglected effect of tax harmonization would be to deprive developing countries of such flow of capital, to keep poor people poor.

Conclusion

There is so much at stake in the debate around tax harmonization in Europe. As the history of mankind repeatedly proved, taxation is often the key element in shaping and reshaping political regimes. The modern state’s attempts to regenerate itself through its transformation – under a veil of romanticism – in a greater threat to individual liberty finds in such a powerful liberalizing force such as tax competition its natural opponent. The struggle has just begun, and will not be a short one.

Tax competition has often been characterized by its opponents as a race to the bottom. The real race to the bottom would take place if the efforts to erase tax competition and to centralize tax policy decision-making at the EU level were successful: a race to the bottom in terms of freedom, prosperity and ultimately civility.

⁹ Namely, the protection of property rights, the warranty of a reliable legal system and the enlargement of the scope of the free market.

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