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Comment on Sørensen: Tax coordination in the EU: what are the issues?

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In his paper, Sørensen gives a clear and thorough survey of some important theoretical and practical issues regarding tax coordination in the EU with respect to indirect and direct taxes. Its most original contribution to the discussion on tax policy lies in the quantitative estimation of the welfare gain of the harmonisation of corporate taxes, however. In this comment, we will therefore focus only on that part.

Sørensen argues that there is a good case for a fully harmonised corporate tax with a formula-based apportionment of the revenues across member states as the long-run goal of EU tax policy. This eliminates tax distortions in the location of economic activity within the single market and almost completely removes the incentive for tax competition between countries. He estimates that this would yield a welfare benefit of 0.4 per cent of GDP.

However, tax harmonisation has important implications that go beyond the efficiency of the capital market. As the author notes, tax competition may serve as a healthy constraint on the ability of governments to overtax citizens (and companies). But tax competition also forces countries to offer high-quality public goods. Furthermore, under tax harmonisation, countries lose the opportunity to tax location-specific rents, thus making the tax system less efficient. Before concluding that tax harmonisation should be the long-run goal of EU tax policy, all benefits and costs should be balanced against each other. Given the magnitude of the benefits—which, in Sørensen's own words, are disappointingly small—it is not obvious that the benefits of tax harmonisation will outweigh the costs of abandoning tax competition.

The case for tax harmonisation would be stronger, however, if the growing mobility of capital forces countries to undercut each other's tax rates in order to retain or expand their tax bases. But is there such a "race to the bottom"? Sørensen notes that labour taxes have risen

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by a non-trivial amount, while capital taxes have, on average, hardly risen at all, thereby suggesting that the growing mobility of capital has induced many governments to shift a larger part of the overall tax burden to the less mobile factor of labour. An alternative interpretation of this is, however, that the rise in the tax wedge on labour income is caused by the rise in social security premiums due to the rise in unemployment and various non-employment benefits. It is no coincidence that these benefits are financed by levying a premium on labour income: unemployment and disability benefits can be seen as insurance arrangements for workers. It is neither inefficient nor unfair if they pay for the corresponding costs.

In general, the evidence in favour of a race to the bottom with respect to corporate taxes is rather weak. First, there is no uniform downward trend in the effective corporate tax burden at the firm level in the EU, as should be expected if tax competition were important. In fact, the EU average is virtually stationary.[1] Second, the overall corporate tax revenue in the EU (as per cent of GDP) actually showed a structural increase from 6.4 per cent in 1985 to 8.7 per cent in 1998.[2] There is some convergence of (effective) tax rates in Europe, but certainly no race to the bottom. On the contrary, there seems to be "a race to the top" because the convergence comes from low-tax countries raising their taxes and not from high-tax countries lowering their taxes.[3] These observations are clearly at odds with models predicting that tax competition forces countries across the board to set excessively low corporate tax rates.

Baldwin and Krugman (2000) present an alternative model that can explain these trends. In their model, there are two kind of countries: countries in the core (Benelux, France, Germany and Italy) that do benefit from agglomeration benefits and those in the periphery (Greece, Ireland, Portugal and Spain) that do not. The agglomeration benefits give the former the opportunity to set higher tax rates than the latter. Cheaper transports, lower cost of communication and liberalisation can make it less important to be in the core, thereby making it less unattractive to locate a firm in the periphery. This gives countries in the periphery the opportunity to gradually increase their tax rates, as we see in reality.

[1] See CPB (2001).
[2] See OECD (2000).
[3] See Baldwin and Krugman (2000).

It might be asked whether tax harmonisation is still beneficial in the presence of agglomeration benefits. In the alternative model with an agglomeration effect, the effects of tax harmonisation are quite different than in the standard model. In the latter, tax harmonisation is beneficial, because it eliminates negative externalities. In the former, a harmonised "split-the-difference" tax rate makes the core and the peripheral countries worse off. The higher tax rate in the periphery exacerbates the regional disadvantage. At the same time, it makes countries in the core worse off because they are unable to tax the location-specific rents due to their agglomeration benefits. This model not only illustrates that tax competition does not necessarily trigger a race to the bottom, but also that positive welfare benefits are not guaranteed.

As the European economies become increasingly integrated, more tax coordination is inevitable. As shown by Sørensen, the tax system distorts the working of the internal market in too many ways. However, it is not certain whether complete tax harmonisation is a satisfactory and feasible solution. The discussion above shows that the welfare effects may be more complicated than previously thought. Furthermore, as long as the distribution of the benefits over the member states is so skewed as found by Sørensen, it is doubtful whether the EU members will decide to give up their tax sovereignty in the foreseeable future. For the time being, the EU might benefit from less ambitious forms of coordination, like the Code of Conduct against harmful tax competition, rules preventing capital from escaping taxation, and rules harmonising the tax base. If one wants to prevent a future strong downward pressure on tax rates, the introduction of minimum tax rates could be considered.

References

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