Leif Mutén*

Taxation of Interest in the European Union

Having struggled for a number of years with formulating a directive concerning the treatment of interest payments from financial institutions in member countries to persons resident in other member countries, the ministers of finance of the EU countries reached a compromise in November 2000. Rather than being a solution, however, what is now on the table might well amount to the opening of a Pandora's box of new problems.

The traditional approach to income tax, long ago, used to be a schedular system under which different types of income were subject to different tax rules. The differential treatment would affect the computation of income as well as the rates. The different rules would be explained by typical features of the different income categories. Some incomes would lend themselves to taxation at the source, some required a sophisticated computation of profits whereas others facilitated a simpler treatment, as illustrated by the difference between the accrual principle and the cash principle.

In some cases, the differentiated tax rates took into account the quality of the tax base. This would be in the form of simplifying the tax base to include a gross amount – then the tax rate had to be correspondingly lower. It would also take the form of assuming that some incomes, particularly those constituting business profits, invited cheating or avoidance more than others. Such considerations made it seem fair to impose tax on business profits at a higher rate than that applied to, say, wage incomes. On these, the cheating was assumed to take less substantial proportions. Moreover, if there was no separate tax on net wealth, the schedular tax on income from capital was sometimes set a bit higher than on other incomes on the theory that funded income represents a higher ability to pay than unfunded income. The United Kingdom was one of the countries applying this system.

In many other countries, however, a schedular system of this kind was regarded as improper. Income as a base for taxation was meant to be an approximate measure of ability to pay. If the concept of income used for tax purposes should be relevant to the purpose of taxation according to ability to pay, it was essential to choose a concept of income serving as closely as possible as a measure of that ability. To this more modern school of thinking the schedular system did not seem adequate to serve the purpose of a tax imposed according to ability to pay. Only a global concept of income could do so.

Here, the concept of globality is used in a metaphoric way. The global concept of income includes all types of income. It is also, and here the word "global" is not metaphoric, a worldwide concept of income, in the sense that the taxpayer should be held to pay tax on all his income, be it derived from his country of residence or from abroad. Globality also includes taking losses as well as positive income elements into account.

The concept of taxable income is subject to other definitional problems, one of the trickiest of which is how to deal with capital gains and losses. Traditionally, income concepts have rested on definitions of income as meaning periodic receipts such as wages and salaries, interest and rent payments, and the current profits of business activities. Occasionally, some capital gains – or gains that in ordinary language have been called capital gains – have been included in the concept of income as representing the yield of a speculative activity.

Already in the 19th century, however, by David Davidson in Sweden in 1889 and Georg von Schanz in Germany in 1896 (followed in the USA by R. M. Haig in 1920 and H. Simons in 1938), the argument was presented that income for the purpose of measuring ability to pay had to include capital gains in general as

* Professor emeritus, Stockholm School of Economics, Sweden.

well as take account of capital losses. The issue was soon widened to include the problem of unrealized gains and losses.[1] The comprehensive concept of income that von Schanz had envisaged was seen by some as presupposing realization for gains to be taxable and losses to be deductible. Others felt that von Schanz could not be given credit for a logical and comprehensive concept of income unless his income concept was interpreted so as to include unrealized gains and losses.

This dilemma remains unsolved. The comprehensive concept of income envisaged by von Schanz as well as Haig and Simons was not only seen as less than comprehensive if unrealized gains and losses were disregarded. It raised the problem of what "realization" is. What is, for instance, the difference between using the value increase of real property as collateral for a loan and selling some shares? At the same time the idea of taxing temporary wealth increases does not seem very much sounder than the purchase of oysters and champagne in celebration of a higher quotation of one's stock. The gain may be reversed whereas the oysters and champagne are gone. The implications for the tax base of its including large fluctuations in stock values are obviously serious. Experience tells that governments facing fiscal shortfalls as a result of loss deductions tend to reconsider the wide income concept causing them.

Meanwhile, other influences have helped complicate things. One is inflation. Should inflation be taken into account or should one narrow the concept of income so as to exclude those types of income on which the distorting influence of inflation was particularly strongly felt? Obviously, rampant inflation could not be ignored. If inflation was not excessive, however, the nominal principle could be defended with arguments such as a reference to the relatively better position of those who have been able to preserve the real value of their assets, if compared to those placing their money in nominal values. It remained a problem, however, that a nominal income concept allowed nominal interest payments to be deductible, although inflation helped to pay off the real debt. It is a logical question whether it is fair or not to restrict deductions for interest paid with inflation referred to as the reason, if the system does not allow inflation adjustment on the positive side, say, by imposing tax on real interest only.

Another influence of this discussion has been the dispute over the "double taxation of savings". Irving Fisher has had many successors up into modern times, sharing his idea that the taxation of saved income plus the interest collected on the savings represents a double burden that distorts the taxpayer's choice between saving and consuming his income. Already John Stuart Mills had similar ideas, and after Fisher scholars such as Lord Kaldor and Sven-Olof Lodin have put up for discussion the use of personal consumption as an alternative tax base.[2] The idea of an "expenditure tax" was, on Kaldor's advice, tested in India and Sri Lanka. That happened at a time when the tax administrations in both countries obviously lacked the resources needed to make even the small minority of taxpayers affected comply with the tax. The expenditure tax was a total failure where it was tried. In Europe, it has gained few proselytes. In particular the international adaptation has been seen as too much of a problem. The basic issue here is that people will be tempted to earn money and build up savings in a country with a low tax on income and a high expenditure tax and spend the same money, after retirement, in another country that does not tax dissavings.

Tax legislation may be influenced by fiscal considerations. If times are bad and capital losses more common than capital gains, the legislators may be less keen on letting the government take a share in the negative results. This situation can, of course, be met by restrictions on loss deductions in combination with full taxation of gains. Most countries, however, will find it difficult to defend such a "tails I win, heads you lose" system.

If taxpayers manage to realize their yield on capital investment in forms other than regular income from capital, whereas the tax law allows a full deduction for interest paid and possibly the emerging costs of administration of capital, the upshot can easily be that the taxation of capital is a deficit business as far as the fisc is concerned. Just as is the case with capital gains, this might be rudely remedied by stopping any deductions or credits for negative income items. Yet, a sensitive tax lawmaker unwilling to tax positive incomes while ignoring the negative ones may take the position that no tax on capital is a better idea than a tax with negative yield.

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[1] D. Davidson: Om beskattningsnormen vid inkomstskatten, Uppsala 1889; G. v. Schanz: Der Einkommensbegriff und die Einkommensteuergesetze, in: Finanzarchiv 1896, p. 1; R. M. Haig: The Concept of Income, in: R. M. Haig (ed.): The Federal Income Tax, New York 1921; and H. Simons: Personal Income Taxation, Chicago 1938.

[2] Nicholas Kaldor: An Expenditure Tax, London 1955, Allen & Unwin; Sven-Olof Lodin: Progressive Expenditure Tax – an Alternative?, Stockholm 1978, Liber.

Finally, in the search for a practical income concept, tax legislators in recent years have tended to take account of the cost to the taxpayers of compliance with, and to the fisc of enforcement of, the tax. In this regard, the concept of withholding at the source has been gaining ground, since it reduces the number of taxpayers the administration has to deal with directly. Moreover, in an international context withholding simplifies matters somewhat.

On another point, this approach leaves less unequivocal results. If we arrange for final withholding taxes, taxpayers may be tempted to realize their income in a form not affected by them. If, however, the withholding tax is effectively lower than the tax on other earnings, the taxpayer may be interested in showing that his income is derived from capital. A tax arbitrage between assets taxed differently will be profitable. The obvious case in point is the business firm, the profits of which can be said to represent on the one hand business profits, on the other hand yield on the capital invested. To do justice to this aspect, it might be important to establish a separation between business profits in the narrow sense and the estimated yield on the businessman's own capital.

Dual Tax Systems

Against this background, there has in recent years been a tendency to return to what is de facto a schedular tax system, namely the dual income tax.[3] Based on the experience of poor or even negative fiscal revenue from income from capital, and taking account of the convenience of a final withholding system, a growing number of countries have chosen the convenient road of a dual income tax. This means that income from capital is taxed separately from other income, often called "earned income". By this method, one has come to the somewhat paradoxical result that the tax on income from capital, far from including an additional element of tax on wealth, may now be lower than tax on earned income. The tax on income from capital is not necessarily lower than the tax on earned income, however. Particularly if the tax on income from capital is proportional and does not allow personal exemptions, the tax on earned income may be lower for low income taxpayers.

This dual system, in turn, has implied a new approach to tax avoidance. Whereas owners of closely held companies once were tempted to take out exceedingly high salaries to get around the higher tax on dividends, the situation now is the opposite. And whereas owners of proprietary firms could let their capital work in the firm, its yield forming part of the business profits, they now have a motive for showing part of the profit as a yield on capital invested. In the opposite case, a negative yield on capital should not be allowed to reduce the business profit but should rather be treated according to the restrictive rules for losses on capital account.

The legislation in countries with dual income tax accordingly provides for a separation of income from capital and business profits. The way to establish such separation may vary. Common to all systems is complication. If the separation starts by establishing a suitable salary level for the owner or owners, and perhaps even for their next of kin, it seems logical to apply the residual to the income from capital. Yet, it can equally well be argued that applying the current interest rate, the official discount rate, or some other percentage figure to the amount of capital invested should result in a proper tax base for income tax on capital.[4] Once this has been computed, the remaining business profit should be dealt with as earned income.

An additional problem is how to deal with the capital gain when the business is sold. That gain might be seen as exclusively being income from capital. It can be argued, however, that the same gain should be seen, wholly or partly, as the deferred compensation to the owner of the business for his work in the firm. In the former case the tax rate for income from capital should apply. In the latter case, the capital gain represents earned income and should fall under that tax regime.

The lower tax rate on income from capital may be defended with regard to inflation. If the nominal interest rate is 10 per cent and the rate of inflation 4 per cent, leaving a real interest rate of 6 per cent, a 30 per cent tax on the nominal interest will correspond to a 50 per cent tax on the real interest. If 50 per cent is seen as a desirable rate, then, under these assumptions, the 30 per cent rate on nominal interest is just right. But then, of course, if inflation is higher, or if the real interest rate is lower because the nominal rate is not much higher than the inflation rate, then the

[3] For more on this see Leif Mutén, Peter B. Sørensen, Kåre P. Hagen and Bernd Genser: Towards a Dual Income Tax? Scandinavian and Austrian Experiences, Rotterdam, London 1996, Kluwer Law International.

[4] In Sweden, where this method is applied, even a fraction of the payroll sum is added to the estimated income from capital realized by the proprietor. One is free to see this as a recognition of Karl Marx' theory of surplus value.

effective real tax rate may turn out to be very high, whereas with no inflation the real tax rate will be as low as the nominal one. Therefore, it is difficult to draw any general conclusions from the inflation argument as to the appropriate level of the nominal tax rate on interest. Even for that reason, it is realistic to expect that the development of tax rates on income from capital will be strongly affected by international considerations.

The interplay between taxation of income from capital and the taxation of net wealth may, as we have seen, take different forms. Net wealth and the income from capital may be taxed separately, or the taxation of net wealth may be modified with respect to the income yielded by the net wealth or the taxable income from capital increased by a fraction of the net wealth. The last case is taken to the extreme by the new Dutch rule, under which the net wealth tax is abolished and a deemed income from capital computed at a standard percentage rate applied to the net wealth.

Which Country Should Tax?

Internationally, the crucial issue is whether it is the source country or the country of residence that should rightly collect the tax on income of capital crossing a border. The obvious conflict of interest is between capital-importing countries and capital-exporting countries. For purely fiscal reasons, the former should be more interested in source country taxation, the latter in taxation in the country of residence. There is a clear difference here between the OECD model tax convention and the UN model; the latter aimed at suiting the interests of less developed countries concluding treaties with industrial countries.

The issue is not a black and white one, however. A capital-importing country might well come to the conclusion that a source country rule for tax on interest will in fact be a burden on its own taxpayers, the interest on their debt being fixed in terms net of tax.[5] Therefore, there are many countries, both developing and industrial ones, that abstain from tax on interest payments to foreign creditors.

It is less common for dividend payments to be exempted in the source countries. They are regarded as part of the profits accrued in the source country and as such rightly subject to tax there. A similar attitude is often taken to royalties. Both the OECD model and the UN model sympathize with the former claim, but only the UN model with the latter.

When it comes to capital gains, the country of residence normally prevails, except for cases of capital gains directly related to a permanent establishment. In many countries these will not fall under the general definition of capital gains but rather fit under the business profit label.[6] Another exception is capital gains on real property. These are normally referred to the situs country, and often this is also the case with shares in corporations, the main assets of which are real property.

The real issue comes to the fore with respect to shares in general. Here, it is a temptation for the country where the corporation is domiciled to take the position that capital gains on its shares should rightly fall under the same treatment as its dividends. Traditionally, however, this attitude has not been reflected in the tax laws. The reason has mainly been administrative. The liability to tax has been limited with reference to how difficult it is for the domicile country of the corporation to impose an effective tax on these gains. Some countries have tried, though, and the matter is far from closed.

To many countries, the main issue is less one of a fair distribution of the tax base than one of ensuring that tax is at least paid somewhere. There is a horror vacui, a reaction against the prospect of double taxation being avoided at the price of no tax being levied at all. For these reasons, exemptions such as for inter-corporate dividends or for dividends paid to individual shareholders in an integrated system that makes them exempt, are offered only on the condition that in some sense normal taxation has applied to the underlying profit in the source country.

Likewise, it is regarded as desirable that interest income be taxed at least once. If that does not happen in the source country, it is seen as important that the country of residence is informed about the income so as to be in a position to impose its own tax. If tax exemption is offered in the country of source, and if no assurance is given to the country of residence of the investor that its authorities will be

[5] If the foreign creditors can enjoy a tax credit for the interest at source, they may, paradoxically, be interested in a source tax being levied, provided that this tax is a burden on the debtors and not on the creditors. Brazil is a case in point, where pleas from American banks at one time caused the Brazilian government to reintroduce the withholding tax once abolished. Since a subsidy compensated Brazilian borrowers, the IRS found fault with the arrangement, however, and refused a foreign tax credit.

[6] Germany is a case in point, where gains made on "Betriebsvermögen" (business capital) are in principle always taxed, whereas gains relating to property that does not enter as business assets, "Privatvermögen", are exempt provided the holding period is long enough. Too often, it is stated that Germany has no capital gains tax, but the fact is that a considerable part of what is called capital gains in the USA is taxed in Germany as business profit.

notified about the income, this might erode the tax base of the latter country.

Here, one aspect of the modern concept of harmful tax competition comes into the picture. The residence country sees its tax base jeopardized if savers move their accounts to countries that neither impose a tax on the yield, nor agree to exchange of information.

Harmful Tax Competition

The issue of harmful tax competition has come to the fore in recent years, although the existence of tax havens (an eschatological term comparable to the "paradis fiscaux" in French, whereas in German the perspective is closer to earth with the word "Steueroasen") has been worrying lawmakers ever since the 1930s. There are a number of aspects to this issue that has been dealt with in recent years both by the OECD with its reporting on harmful tax competition and the EU, which has been active both by issuing the Primarolo report and by setting up a code of conduct.[7] Moreover, the EU has been struggling for a number of years with formulating a directive concerning the treatment of interest payments from financial institutions in member countries to persons resident in other member countries. We shall deal with this matter below.

The definition of harmful tax competition is a matter of intense discussion. The OECD is keen on pointing out that low tax rates in themselves are not an example of harmful tax competition. What the organization is driving at are abuses, such as "ring-fencing", when foreign investors are invited to establish their offshore activities in a country at low or zero tax rates, under the condition that no activity is directed towards the home market in the host country. Another critical point is transparency, and a related issue is the absence of information or any cooperation between the host country and the investor's country of domicile.

The main attack against this concept has been led by those who maintain that lower taxes are always better taxes.[8] Critics talk about a "high tax cartel" and feel that the concept of harmful tax competition stands for protecting the high tax rates in OECD countries, whereas in their opinion lower taxes are a prescription for faster economic growth.

No doubt, taxes may well be too high in some countries, and excessive taxation has certainly retarded economic growth, particularly in times when tax rates were higher than they are now. Still, it is obviously necessary to query whether the experience that tax reduction from an extremely high level promotes growth must necessarily imply that reducing taxes to zero is still a growth-promoting policy. Most people would agree that the ideal lies somewhere in between, at a level where the tax rates are not extreme, yet high enough to allow the financing of a reasonably extended public sector, one that offers security under the law, social security, including satisfactory health care as well as reasonable pensions, and a functioning school system. If we apply the Rawls' criterion, under which that kind of state is preferable in which we would choose to live if we had to make the choice not knowing whether we would be rich or poor, the state with extremely low taxes would get few votes indeed.

It is also only natural that citizens of a functioning social state look askance at those who enjoy the benefit of health care for children, free schools and other benefits, and then get out of the country to make money, coming back in their old age to benefit from the home country's extended care for the old. Many of us feel reluctant to put a stop to this by way of a "Reichsfluchtsteuer" or by applying the Soviet model of charging emigrants with the costs of health care and education incurred for them by the state. We must also reject Jagdish Bhagwati's proposal against brain drain of charging an additional tax in the host countries for remittal to the countries of origin of the immigrants.[9] Expatriation taxes are charged to emigrants in countries like Canada to ensure that capital gains taxes cannot be avoided by emigration, but even a limited measure like this requires complicated rules as well as extremely difficult coordination with the tax systems in the new country of residence. Some capital gains tax systems, as was noted above, extend to emigrants during the first years after emigration. And finally, we can study the US efforts first of all to tax citizens wherever they are resident, and second to go after them if they give up their US citizenship. The former rule has been a failure in countries imitating it and less than a thundering success for the USA itself. If it has worked at all, it is mainly a product of what must be called extra-

[7] OECD: Harmful Tax Competition: An Emerging Global Issue, Paris 1998; Report from the Code of Conduct Group (Business Taxation) to the ECOFIN Council on 29 November 1999 (Primarolo Report).

[8] For an extensive account of these critical points of view, see Daniel J. Mitchell: An OECD Proposal to Eliminate Tax Competition Would Mean Higher Taxes and Less Privacy, in: Tax Notes International, 16 October 2000, pp. 1799-1821.

[9] Apart from the complication, just think about the feelings of immigrants from inhuman dictatorships, if their tax money were used to feed the dictators they had fled from!

territorial exercise of administrative power, something that other countries might have great trouble getting away with. Quod licet Iovi, non licet bovi. (What Jupiter may do, the ox may not.)

Against this background, it is easy to understand why the argument that tax competition is always useful meets with strong resistance. The prospect of tax competition leading to a "race to the bottom" may be a hope for some but is genuinely felt as a source of fear by those who believe that the state, and the public sector in general, has an important role to play for the well-being of society.

Harmful tax competition is most clearly defined with respect to offshore activities. Soliciting foreign investment to promote the host country's economic development may constitute tax competition and may, indeed, sometimes imply that employment and economic growth is promoted in the host country at the expense of employment in the investor's home country. Yet, promotion measures of this kind have been given a friendly reception in most countries, even though a certain fatigue has been noticeable in recent years. Until recently, most countries, with the important exception of the USA, were ready to accept and support the incentives offered by developing countries. If the tax treaties with these countries did not provide for a territoriality rule, the effectiveness of the tax incentives was normally ensured by tax-sparing clauses.

International opinion has changed somewhat with regard to this. First of all, it is noted that some countries offering incentives to foreign investors have grown to a point where they are no longer seen as in need of support. It is seen as superfluous to offer tax saving to countries like Korea and Indonesia. Second, the negative attitude to tax sparing that once was characteristic of the USA and not many more states has affected thinking in the OECD.[10] Third, the incentives of some countries have been directed towards offshore activities of doubtful value to the real economic development of the countries offering them, but rather falling into the category of harmful tax competition. The tendency is to be more selective when offering the benefit of a tax-sparing clause.

The main direction of international action against harmful tax competition concerns these offshore activities. If states are in a position to attract foreign investors, not for the purpose of developing the economy of the host country but for the purpose of offering a tax base broad enough to provide a meaningful contribution to the host country's treasury even at a tax rate close to zero, it is felt that the system is in jeopardy.

The globalized economy may imply that real business activities are moved from one country to another. This is in the spirit of free trade and means that relative production advantages are taken care of.

The attraction of tax bases such as holding companies is obviously a different matter. If a tax haven country attracts that type of corporation, the purpose is not one of developing its own economy and making use of its productive resources, but just to gain access to a tax base broad enough to be profitable at a minimum tax rate. The situation seen in the perspective of the countries losing the migrating tax base may be likened to the case of thieves stealing precious jewelry only to melt it down and cash in the metal value. In the new host country, the potential value of the offshore corporations as a tax base is not realized – if it were, the corporations would not dream of establishing themselves there. In the country where the corporations have their original base, the loss of them as part of the tax base is much greater than any gain flowing to the new host country.

Of course, this perspective is not that of the investors. To them, the situation is rather that the corporation has chosen its tax jurisdiction on the basis of the interest of itself and its shareholders, finding the low-tax country more attractive than the high-tax country. There is no unanimity with respect to the question of the moral right of the original country of domicile to the tax base represented by the corporation.[11] In a globalized economy, it is not always easy to establish whether a moral right to tax is enforceable or even morally recognizable. If a corporation has shareholders in many countries and activities in many countries, its commitment to its country of domicile may sooner or later turn into a question of profitability rather than to one of patriotism.

If we want an objective answer to the question whether tax competition is harmful, we are in for a delicate problem. We must establish who is hurt and who is benefiting. We must likewise establish whether or not the harm to one party is outweighed by the benefit to the other party or to the world in general.

[10] OECD: Tax Sparing: A Reconsideration, Paris 1998.

[11] It was an illustration of this when the spokesman of a major US corporation, heard by a senate committee earlier this year, said that his corporation if once again given the choice of domicile, would have selected Cayman Islands. A number of senators and others let it be known that they regarded this statement as unacceptably unpatriotic.

And finally we have to establish the relative worthiness of competing interests.

With respect to tax competition forcing down the tax rates in general, we might take a positive attitude to this effect in cases where the tax rates are excessive. A race to the bottom, on the other hand, cannot be useful, and if states imposing normal taxes are losing tax bases as a result of tax competition, it is legitimate to regard this effect as harmful.

The benefit of the race goes in the first place to the prospective taxpayers who get off with much lower tax than they would have had to pay but for the competitive tax measures. Again, we have to take account of the alternative of staying home and declaring the income there. If the home country tax is excessive, the relative advantage of the low tax regime in a state engaging in tax competition might be significant. On the other hand, a broader perspective on the situation of the investor might well imply some reflection on the public service standard, the infrastructure, the general stability etc. that may influence an investor's choice of location. Freedom from tax may well be combined with an obligation by foreign investors to accept financial burdens that normally lie on the shoulders of the country's treasury.

The gain is more unequivocally on the side of the investor in those cases where the investor has no real connection with the tax haven state. In that case, the investor might well regard it as outside his sphere of interest whether the social services and the infrastructure in the host country are up to standard or not.

It is at this point that we come to the weighing of relative advantages and disadvantages of the home country and the host country. We mentioned the example of the jewelry thief. A tax haven country that grossly underutilizes the taxpaying potential of corporations it has attracted by tax haven conditions may benefit from the registration fees or miniscule taxes paid by the offshore corporations, but not in proportion to the loss incurred by their normal-tax home countries.

Again, weighing benefits and losses, we have to be alert to the fact that the question of corporate domicile is anything but straightforward. We may stick to the rights of the country of registration, but aren't we also ready to take note of the beneficial ownership of the shares? Or we may establish corporate domicile in the country of actual management, only to stumble over the fact that the managers may move to an obscure tax haven to make the big decisions. Countries with normal tax systems may find a solution to this problem through tax treaties or through discussions between the competent authorities. Tax havens normally abstain from concluding tax treaties and their authorities are rarely ready to make deals with authorities in countries with normal taxes.

Before the Subpart F legislation entered the Internal Revenue Code (IRC) in 1962, many of us were doctrinaire on this count, rejecting the measure as implying extra-territorial taxation, a violation of the host country's sovereignty. This attitude is not quite as easy to maintain after a great number of countries in turn have adopted similar controlled foreign corporation (CFC) legislation. Note also that a growing number of states have established limitation on benefits clauses in their tax treaties with the purpose of avoiding treaty shopping, but with the obvious implication that the domicile of a corporation may not tell the full truth about where its profits should primarily be taxed. This approach may also lead us to the conclusion that a corporation may be seen as an instrument of its beneficial owners, which in turn gives the state where they or a majority of them are domiciled a legitimate interest in the tax treatment of the corporation.

If this line of thinking cannot be effectively pursued in forming the international tax system, we must face the alternative of corporate profits gradually leaking out of the systems of normal tax countries into a universe of tax havens. It is unlikely that citizens around the world, paying by their taxes for what they regard as necessary functions of civilized states, will accept as competitors, suppliers, and employers anonymous, homeless, and unaccountable international enterprises with addresses in states refusing cooperation. Or are the flags of convenience in shipping just a foreboding of what is to come with respect to business in general?

The Proposed EU Interest Directive

Slowly, the ministers of finance of the EU countries have worked out a compromise with respect to the proposed directive for the treatment of interest payments by EU countries. This is only one aspect of the tax competition issue, but already this issue has proven to be extremely difficult to solve, and even after the compromise dated November 27, 2000, it is fair to ask whether what is now on the table is a solution or the opening of a Pandora's box of new problems.

Basically, the question is how we can combine the common wish for a general income tax, including tax

on interest income, with the two countervailing tendencies: one, the principle of bank secrecy; the other, the idea that interest payments to foreign lenders or depositors should be left tax-exempt with a view to avoiding the shifting of the tax burden to the domestic borrower.

The wish for a general income tax is common. In the German case it has been emphasized by the pronouncement of the Constitutional Court that income tax would be unconstitutional if not extended to interest income. In this situation, lawmakers have seen a remedy in withholding taxes. These are particularly needed in those countries where bank secrecy is observed and prevents regular information returns from being issued by the banks to the tax authorities. Experience has shown, however, that the public may well react to withholding taxes by moving their accounts to foreign banks located in countries where neither withholding tax, nor information to the domestic tax authorities, prevents the foreign investor from enjoying his interest yield without tax.

The first German effort to introduce a withholding tax on interest met with such a general exodus of savings to Luxembourg that the tax had to be repealed. A new tax was required by the constitutional court but is provided with a basic exemption large enough to make the tax ineffective against most savers. In other countries, withholding taxes are often more general.

At any rate, the introduction of a withholding tax at home has still the effect of making savers look for better conditions elsewhere. Of course, the law may prescribe that tax must be paid on all interest payments received, be they domestic or foreign. Without a functioning information system, such legal bidding will have little result. A country like Sweden may prescribe registration of all foreign bank accounts with the tax authorities and, to boot, an obligation of the registrant to present to the Swedish tax authority a commitment of the foreign bank to provide the Swedish authorities with all the particulars Swedish banks are supposed to provide them with. Apart from the fact that some foreign banks would violate their countries' bank secrecy acts if complying, the eagerness of Swedish taxpayers to make them comply and to register their bank accounts is very limited indeed. Only few Swedes have registered, and the legislation is for all practical purposes a flop.

Therefore, it is important to countries wishing to have an effective and general income tax to deal with the problem of other countries' opening opportunities to tax-exempt or easily hidden interest income. Here is the reason for the European effort to achieve a general tax on capital, payable in all EU countries, and at best in all other countries as well. Alternatively, an information system is sought that would make a worldwide taxation of interest possible for countries interested in applying such a tax.

The first hurdle to take was the United Kingdom with its Eurobond market. The problem here was, specifically, that the Eurobonds are issued at a guaranteed interest rate after withholding tax. If such a tax is imposed, it is for the borrower to pay. If the borrower is hit by a withholding tax, however, the conditions for the normal Eurobond allow the borrower to renegotiate the loan. Given the historically high interest rates at which many Eurobonds were issued, and the rather low present rates, the borrowers would gain by this condition being applied. Correspondingly, the present value of most Eurobonds would drop considerably, if the renegotiation clause were applicable. Hence the stubborn opposition of the United Kingdom to a directive prescribing a withholding tax.

At the same time, the UK has shown some flexibility with respect to the alternative approach to the problem, the information system. This system, however, does not square well with the bank secrecy rules in countries such as Luxembourg and Austria. In Austria, the authorities have been remarkably successful in regaining Austrian savers by offering them a tax amnesty and the opportunity to open anonymous accounts. To the Austrians, a low withholding tax would seem much more palatable than any information system.

On the part of Luxembourg, some understanding for a general withholding tax has been noted, but with the condition that something be done about foreign competition. Luxembourg has not seen the value in a common European move that would have as its only result that savers, who once fled to Luxembourg, will now leave Luxembourg for the tax haven countries in the English Channel, for Switzerland and Liechtenstein, or for some tax haven in the Caribbean. Luxembourg might have a reputation for tax sheltering inside Europe, but it would find it a symbolic action for little purpose if its financial system were subjected to drastic change only to see the funds now taken care of in Luxembourg dispersed into other countries outside the EU.

Therefore, it is a condition for the application of the proposed directive that Europe comes to terms with a number of important tax havens. The reason is

obvious, and the resources, particularly if the EU and the USA work together, might be seen as awesome and might well bring around at least a good many of the countries involved. (The OECD home page, incidentally, brings optimistic bulletins about the combined success of the efforts by the OECD, EU, FATF (set up by the Group of Seven) and other groups.) The difference is great, however, between an official proclamation of willingness to cooperate and the actual pursuit of each and every foreign investor coming in to enjoy the good financial climate of a tax haven.

As far as Sweden is concerned, with its 30 per cent tax rate on all income from capital, the country will not be likely to attract many investors if it maintains its withholding tax at that level and extends the tax to the now exempt non-residents. To preserve its revenue, the country must favour an information system.

Weak Points of the Proposed Directive

Critics have been quick to note that the November 27, 2000, agreement as well as its predecessor made in Feira, Portugal, in June must be seen as incomplete. The agreed rate, 15 per cent to begin with, 20 per cent later, is lower than many countries now apply. The revenue interest of the home countries is not fully satisfied with the 75 per cent share promised. This is even less so, given the expected practical problems meeting the identification of depositors and the establishment of their country of residence for tax purposes.

It has also been noted that the proposed directive is supposed to cover interest only. Dividends and investment fund yields are not included; yet it is believed that a majority of those trying international tax evasion invest mainly in shares.

What is perhaps as fatal, the concept of interest is seemingly not defined in the agreement. Zero-coupon bonds may in some countries be regarded as offering an interest yield realized at redemption. In other countries the same amount is treated as a capital gain. Even more difficult is the treatment of compensation for accrued interest received by the seller of a financial instrument. Moreover, the really great complication is the treatment of gains on the disposal of zero-coupon bonds before redemption. Here, the gain realized by the seller cannot be seen as accrued interest, since the value of the bond may also have been influenced by shifts in the market interest rate and changes in the solidity of the debtor. How could a distinction be made between one element and the other, when all that is accounted for, if any accounting takes place, is the difference between the emission price and the price paid at the disposal of the financial instrument.

A further complication, on which nothing has been said in the press releases, is the practical application of an information system. Even with names and addresses in perfect order, a TIN (taxpayer identification number) is a necessary condition for making a general information system work. The Swedish banks have made it clear early on that their computers as presently programmed would reject foreign TINs. Issuing Swedish TINs to foreign savers would not be helpful. Just providing information by name and address would cause the tax authorities more work than the matter is worth.

To add insult to injury, the forms of names differ between countries. A Swedish married woman normally (but not always) carries her husband's name, but in Belgium, if she moves there, she will be on the tax rolls under her maiden name. In Spain, the middle name will often be regarded as the first part of the family name, and such a simple mistake makes it close to impossible to identify the person on whom information is offered.

In this context, some lessons might be drawn from the US experience of "qualified intermediaries", in other words foreign banks authorized to screen investors in US securities, establishing who belongs under the US tax net and who does not.[12] The complication of that operation gives a hint of what the European countries might be in for, if they want a watertight solution to the problem of ensuring a complete tax coverage of all income from capital realized by their residents.

In other words, we have a long way to go. Some will find the road so difficult and the problems we shall meet along the road so horrifying that they will opt for no tax at all on income from capital. Others, like this writer, may find the generality of the tax and the principle of taxation according to ability to pay so important as to be worth a good deal of political and administrative effort. What we will not be well served by, however, will be a system that may be a trap for the unwary but will leave the big evaders free to go on as before.

[12] Cf. T. D. (Treasury Decision) 8734, issued in 1997 and containing regulations on a considerable number of sections of the Internal Revenue Code, notably Sec. 1441. Note that this bulky document of around 400 pages just sets out the principles of ensuring the US tax claim. It has been followed by detailed agreements with regard to the mode of operation of the bank system in each particular country.