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Double Income Taxation as a Response to Tax Competition in the EU

The following article discusses the undesired consequences of tax competition and presents a proposal for tax reform derived from a very general normative basis: the idea of exchange between governments and taxpayers and the principle of equality. The aim is to tie tax competition to jurisdictional competition in general and thereby maintain tax competition as a productive procedure instead of abolishing it by harmonising tax systems. Surprisingly, systematic double taxation of income, as factor income following the source principle and as citizens' income following the residence principle, is one element of the solution. The other is unitary taxation of business income.

The discussion in Germany on the "tax reform 2000" has so far been focused to a large extent on tax rates, the net reduction of the tax burden, the financing of this reduction, and on technical questions regarding the integration of corporate income taxation. Nevertheless, the issue of tax competition has always been present as well because tax reductions for firms have been demanded with special reference to the lack of "competitiveness" of the German tax system. The fact that the tax reductions resulting from the "tax reform 2000" are above all to the benefit of corporations, and among them those that have a relatively low tax burden anyway due to their ability to make use of international differences in corporate taxation, also points to the importance of tax competition in the debate.

In the following contribution, the issues of tax competition and its impact on taxation are addressed explicitly in order to develop a proposal for a fiscal reform that should yield considerable improvements for the members of the European Union, but also, in case of a unilateral introduction, for a single member state such as Germany. In the following, the problems of tax competition and several approaches to solving them are sketched. Subsequently, the elements of the reform proposal are presented and its effects discussed.

To date, there is no precise definition of the term tax competition. While the term "contest" implies the direct comparison of two or more individuals in a "parallel process", e.g. in sports, competition additionally comprises a "process of exchange" between the supply side and the demand side of a market,[1] to the effect that competitors face each other only indirectly. For example, the success of a specific firm depends on whether it meets the wants of its customers better than its competitors.

Tax competition is defined by the choice of means: in tax competition, as a part of competition among jurisdictions,[2] states face each other in trying to attract capital by offering favourable tax rules. The types of capital[3] to be attracted are

- foreign direct investment,[4] which in combination with immobile domestic factors can lead to welfare improvements,
- mobile financial capital, which can be used to finance real investments, to strengthen national financial markets, and to give comparative advantages to the government in providing financial services, especially in smaller countries, and
- financial flows within firms that can be channelled into the country by attracting those corporate functions that are used for the international shifting of profits.

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[1] E. Hoppmann: Wettbewerb als Norm der Wettbewerbspolitik, in: ORDO, Vol. 18, 1967, pp. 77-94 (here pp. 88-93).

[2] L. Gerken: Institutional Competition: An Orientative Framework, in: L. Gerken (ed.): Competition among Institutions, Basingstoke 1995, Macmillan, pp. 1-31; L. Gerken: Der Wettbewerb der Staaten. Beiträge zur Ordnungstheorie und Ordnungspolitik, 162, Tübingen 1999, Mohr Siebeck; W. Kerber, V. Vanberg: Competition Among Institutions: Evolution Within Constraints, in: L. Gerken (ed.): Competition Among Institutions, op.cit., pp. 35-64.

[3] The possibility of competition for citizens will not be considered here.

[4] For an overview of competition for foreign direct investment see the OECD report by C. Oman: Policy Competition for Foreign Direct Investment, Paris 2000.

Attracting capital, however, is not in itself an objective of governments. Rather, it results from governments' pursuit of various original aims such as increasing tax revenues, the creation of jobs or the growth of productivity and thus of wages. These goals, again, arise from politicians' motivation to realise their conception of good government and/or to ensure their re-election by increasing the affluence of their citizens.

The parameters of the tax system provide governments with a large set of instruments for tax competition. The various types of taxes and the specific elements of the tax system (tax-rate schedule, tax base, agreements regarding double taxation, negotiability of tax rates and bases, tax audits) as well as the opportunity to adjust these parameters to the tax laws of other countries result in complex national tax laws and in an international tax system whose complexity by far exceeds that of any national one.

The European discussion of tax competition focuses mainly on two problems that will be singled out here as well: double taxation and double non-taxation.

Double Taxation

National tax systems were designed for closed economies. It can therefore happen in the case of cross-border economic activities that the same income is taxed by both states, i.e. twice. The reason is usually that the investor's country of residence taxes the global incomes of its residents, according to the residence principle, whereas the country in which the income was earned taxes all incomes generated there, according to the source principle.

Under bilateral double taxation treaties, states split the right to tax either by granting tax exemptions in one country or by giving tax credits for taxes paid in the other country (or combinations thereof). They thus limit the tax burden of the taxpayer in order not to put cross-border economic activities at too great a disadvantage. It has been an aim of the European Union ever since the beginning of integration to fully eliminate the discrimination of foreign incomes through double taxation (Article 293 EC Treaty). This goal has not yet been fulfilled. Only if all EU members agreed on the application of one of the two principles, the residence principle or the source principle, would it be possible to avoid double taxation completely.[5] Such a solution is illusory because capital-exporting countries have an interest in applying the residence principle while capital-importing countries are in favour of applying the source principle, and because such a harmonisation would require a radical reform of all European tax systems.

Double Non-taxation

The current tax system is criticised not only for leading to double taxation of cross-border investments but also in a second respect that points in the opposite direction. Competition for foreign investment induces countries to give special privileges to foreign investors by granting tax breaks or lower rates, or by negotiating future tax dues with investors. These privileges are often designed specifically to allow foreign investors to make use of certain double taxation treaty specifications with the effect that neither the source country nor the residence country taxes the investor's income (double non-taxation).

While using that system requires investment decisions by firms, there is an additional possibility of avoiding taxation which is not necessarily linked to investment in the traditional sense. More attention will be given to this second possibility in the following as it is often neglected in analyses of tax competition despite of its considerable economic importance.[6] Many multinational firms make use of the complexity of the international tax system by shifting their profits internationally so as to reduce their effective tax burden far below the level specified by the tax laws of the single countries in which they operate. The success of this strategy is enhanced by certain states, especially tax havens, that try to take advantage of profit transfers by making their tax systems attractive for multinational firms pursuing that strategy.

Worldwide economic integration provides firms with opportunities to lower their tax burdens in ways not intended by legislators. In particular, multinational firms can save taxes by transferring their profits internationally because taxation in the respective countries is not based on overall profits, but on the share declared in the particular country. Thus, there is an incentive for companies to design intra-company transfer prices charged between subsidiaries in such a manner that profits accrue in a low-tax country. For

[5] For this reason the Scientific Council at the German Federal Ministry of Finance (Reforming International Capital Income Taxation, Bonn 1999, p. 50) proposed aligning the German tax system consistently to either the residence principle or the source principle. Cf. also the report of the Ruding Committee (Commission of the European Communities: Report of the Commitee of Independent Experts on Company Taxation, Luxembourg 1992).

[6] C. R. Emmanuel, M. Mehafdi: Transfer Pricing, London 1994, Academic Press, pp. 56f.

instance, one subsidiary in a high-tax country can buy intermediate goods produced by another subsidiary in a low-tax country at excessive prices. Thus, profits in the low-tax country rise, while those in the high-tax country fall. The firm's total tax burden declines. In some cases, transactions between subsidiaries are created artificially solely for tax purposes. Additionally, immaterial goods and financial assets can be held in and moved to low-tax countries so that license fees and interest payments accrue there. To this end, firms found special subsidiaries in such countries and design their legal and ownership status so as to minimise the tax burden. Especially finance subsidiaries, whose task is to manage the financing of the multinational firm or part thereof, and base companies that direct the repatriation of profits via a third country serve such purposes.

States can, and do, react to these strategies of multinational firms in different ways. On the one hand, countries with relatively high tax rates, i.e. most industrialised countries, try to prevent firms from lowering their tax base by transferring profits. They therefore apply the so-called "arm's length principle".[7] This means that transfer prices are accepted by the tax authorities only if they are within the range of prices that are charged or would be charged by independent firms. Alternatively, the problem can be solved by basing a firm's tax dues on overall profits instead of profits accrued in the respective jurisdiction.[8] Smaller countries,[9] on the other hand, set deliberate incentives in their tax systems for multinational firms to transfer their profits to them. Such incentives can consist of the favourable treatment of holding or finance companies, infrequent tax audits etc.[10] Especially in the EU, this behaviour has been criticised as "unfair" tax competition because it represents an attempt by some states to increase their tax revenues at the expense of others.

One consequence of the strategies of multinational firms mentioned above is that, with the help of profit transfers, some incomes nearly or even fully escape taxation (double non-taxation).[11] Double non-taxation, just as double taxation, results in unequal treatment. While in the case of double taxation foreign incomes are taxed more heavily than domestic ones, the deliberate attraction of foreign capital and the attempt to keep domestic capital in the country have led to the introduction of tax privileges that favour owners of mobile capital over owners of immobile capital.[12]

Solution Concepts and their Weaknesses

Competition among jurisdictions, as observed in the area of taxation as well as in other fields of policy, has been discussed extensively by economists.[13] In analogy to competition among firms on goods mar-

[7] See OECD: Tax Aspects of Transfer Pricing within Multinational Enterprises, Paris 1993; G. Maisto: Generalbericht, in: International Fiscal Association (ed.): Cahiers de Droit Fiscal International, Deventer 1992, Kluwer Law and Taxation Publishers, pp. 141-206.

[8] This method is applied for example in some states in the USA. (H. J. Lischer: Income Taxation by the States of the United States: Unitary Apportionment of the Income of Multijurisdictional Businesses, in: H.-J. Vosgerau (ed.): European Integration in the World Economy, Heidelberg 1992, Springer, pp. 143-170, here pp. 161-169. Corresponding provisions can be found in German trade tax law (Gewerbesteuerrecht) for firms that have operations in several communities (paras. 28, 29 Gewerbesteuergesetz) and in German corporate tax law for firms operating in several Länder (para. 2 Zerlegungsgesetz). This approach is called "unitary tax" (S. Plasschaert: Introduction: Transfer Pricing and Taxation, in: S. Plasschaert (ed.): Transnational Corporations: Transfer Pricing and Taxation, London 1994, Routledge, pp. 1-21, here p. 5), "profit split principle" (C. R. Emmanuel, M. Mehafdi, op. cit., p. 78) or "Massachusetts method" (after the US state that first introduced it).

[9] In many cases these are not actually countries but territories of bigger countries that have a special status: Gibraltar, the Channel Islands, the Canary Islands etc.

[10] Favourable conditions for holding companies are traditionally found in Switzerland and Luxembourg. Belgium focuses on so-called cash management centres, the Netherlands mainly on finance companies. So-called tax havens are the Channel Islands, Andorra, Singapore and the Dutch Antilles. An exact categorisation of tax havens is impossible due to the complexity of international tax law. With each change in tax law in one of the states involved, the advantageousness of the various forms of financing changes worldwide. Cf. M. Günkel: Standortauswahl unter europäischen Staaten. Belgien – Großbritannien – Luxemburg – Niederlande, in: Institut der Wirtschaftsprüfer in Deutschland e.V. (ed.): Bericht über die Steuerfachtagung 1993, Düsseldorf 1994, IDW-Verlag, pp. 39-87; M. Günkel: Aktuelles zur Standortwahl für Holdinggesellschaften, in: Institut der Wirtschaftsprüfer in Deutschland e.V. (ed.): Bericht über die Steuerfachtagung 1996, Düsseldorf 1997, IDW-Verlag, pp. 103-137; A. Vögele, J. Zimmermann: Finanzierung über die Schweiz, in: Blick durch die Wirtschaft, Vol. 49, 1993, p. 7; D. Krüger: Standortauswahl unter europäischen Staaten. Dänemark – Österreich – Schweiz, in: Institut der Wirtschaftsprüfer in Deutschland e.V. (ed.): Bericht über die Steuerfachtagung 1993, Düsseldorf 1994, IDW-Verlag, pp. 89-156; G. Steven: Zur Bedeutung ausländischer Finanzierungsgesellschaften für die Finanzierung ausländischer Tochtergesellschaften deutscher multinationaler Unternehmen, Frankfurt/Main 1995, Peter Lang; B. Hohaus: Steuerwettbewerb in Europa, Frankfurt/Main 1996, Peter Lang, pp. 206-210.

[11] T. Menck: Der internationale Wettbewerb der Steuerrechte und der Standort Deutschland, in: Internationales Steuerrecht, Vol. 2, 1993, pp. 565-567, therefore speaks of a "phantom level" of taxation, which results from the interaction of the different national tax systems.

[12] For example, in Luxembourg, the privileges of "1929"- or "1990"-holdings are granted only to those holding companies that manage the investments of foreign companies (cf. M. Günkel: Standortauswahl unter europäischen Staaten, op. cit., p. 41). In Ireland, foreign companies are clearly privileged as well. Cf. C. Pinto: EU and OECD to fight Harmful Tax Competition: Has the Right Path Been Undertaken?, in: Intertax, Vol. 26, 1998, pp. 386-410, here pp. 397f.; M. Walsh: Ireland, EU Agree to Major Changes in Irish Tax Regime, in: Tax Notes International, 3.8.1998, pp. 282-284. This behaviour by states is sometimes called "tax dumping" because tax rates for international investors are below those for domestic firms (H.-H. Härtel: Steuerdumping oder Steuerwettbewerb?, in: Wirtschaftsdienst, Vol. 77, 1997, p. 492; H.-G. Grigat: Verlagerung von Unternehmensgewinnen in das Ausland und Steuerdumping, in: WSI Mitteilungen, Vol. 50, 1997, pp. 404-414).

kets, the competitive interaction of governments has been regarded as beneficial mainly in three respects:

☐ Competition as the control of power. The option of investors to choose among several countries and thus among several tax systems is said to reduce their vulnerability to exploitation by the state (Leviathan[14]) and therefore to provide the essential control of government power.[15] However, this argument is problematic in that it contains a wrong analogy between competition among firms and that among jurisdictions.[16] While unsatisfied customers can not only switch to other suppliers but also decide not to buy the respective product at all if all offers appear unsatisfactory, firms as well as citizens only have the choice among different countries of residence. They cannot totally refrain from residing in any state. Thus, they remain exploitable by governments. Furthermore, it is frequently overlooked that the presumed control of power is effective at most for those who own mobile resources, while, conversely, the owners of largely immobile resources (e.g. employees and small firms) remain exploitable to the same or even to a larger extent than without interjurisdictional competition for mobile resources.

☐ Competition as a "discovery procedure".[17] The diversity of tax systems and the ability of investors to choose among them are assumed to constantly generate new tax regulations and test them immediately. In other words, knowledge about desirable tax systems is created. Here, too, the problem is that the selection among these systems is biased.[18] In particular, knowledge is generated about how to attract mobile capital, whereas knowledge about a tax system that is favourable for immobile resources is not created.

☐ Competition as an incentive mechanism. Competition in the supply of public services is said to lead to incentive structures that align the supply of these services to the interests of the demand side, just as firms gear their products to the desires of consumers. However, according to the neoclassical criticism of this argument, which is linked to the term "race to the bottom", there is a danger of distorted incentive structures leading to a welfare loss due to undesired income distribution.[19] This can especially be the case if users of public services can systematically avoid taking part in their financing so that there is no incentive for the state to provide public services.

In view of the problems related to jurisdictional competition in the area of taxation, proposals for the harmonisation of tax systems in the EU have been made in politics[20] as well as in academia.[21] It is suggested that specific important parameters of the tax system, and only these, be excluded from competition through their harmonisation. However, given the existing rivalry for scarce mobile capital, it is most likely that competition would switch to parameters where its effects are even more "harmful", for example to the frequency of tax audits.[22] Also, the ability of citizens to influence decisions is even smaller at the European level than at the national level. Thus, government actions would probably reflect citizens' wishes to an even lesser degree.[23]

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[13] Prompted by C. M. Tiebout: A Pure Theory of Local Expenditures, in: Journal of Political Economy, Vol. 64, 1956, pp. 416-424, different variants of the basic concept of competing jurisdictions have been developed. For an overview cf. L. Gerken: Der Wettbewerb der Staaten, op. cit.

[14] T. Hobbes: The Leviathan, or the Matter, Form, and Power of a Commonwealth Ecclesiastical and Civil, London1651/1839, John Bohn.

[15] Cf. among others S. Sinn: The Taming of Leviathan: Competition Among Governments, Kiel Working Papers, No. 433, Kiel 1990, reprinted in: Constitutional Political Economy, Vol. 3 (1992), pp. 177-196; J. Kincaid: The Competitive Challenge to Cooperative Federalism: A Theory of Federal Democracy, in: D. A. Kenyon, J. Kincaid (eds.): Competition Among States and Local Governments. Efficiency and Equity in American Federalism, Washington DC 1991, The Urban Institute Press, pp. 87-114; W. Kerber, V. Vanberg, op. cit.; H. Siebert: Ein Regelwerk für eine zusammenwachsende Welt, Kiel Discussion Papers, No. 251, Kiel 1996; W. Kerber: Zum Problem einer Wettbewerbsordnung für den Systemwettbewerb, in: Jahrbuch für Neue Politische Ökonomie, Vol. 17, 1998, pp. 199-230; V. Vanberg: Globalization, Democracy, and Citizens' Sovereignty: Can Competition Among Governments Enhance Democracy?, in: Constitutional Political Economy, Vol. 11, 2000, pp. 87-112.

[16] L. Gerken: Der Wettbewerb der Staaten, op. cit., pp. 55-57.

[17] F. A. v. Hayek: Individualism and the Economic Order, Chicago 1948, University of Chicago Press; F. A. v. Hayek: Competition as a Discovery Procedure, in: F. A. v. Hayek: New Studies in Philosophy, Politics, Economics and the History of Ideas, London 1978, Routledge & Kegan Paul, pp. 179-190, first published in: F. A. v. Hayek: Kieler Vorträge, Neue Folge, No. 56, Kiel 1968.

[18] L. Gerken: Der Wettbewerb der Staaten, op. cit., pp. 35-43.

[19] E.g. H.-W. Sinn: Tax Harmonization and Tax Competition in Europe, in: European Economic Review, Vol. 34, 1990, pp. 489-504; H.-W. Sinn: How Much Europe? Subsidiarity, Centralization and Fiscal Competition, in: Scottish Journal of Political Economy, Vol. 41, 1994, pp. 85-107; H.-W. Sinn: Das Prinzip des Diapositivs. Einige Bemerkungen zu Charles B. Blankart, in: Wirtschaftsdienst, Vol. 76, 1996, pp. 92-94; H.-W. Sinn: Das Selektionsprinzip und der Systemwettbewerb, in: A. Oberhauser (ed.): Fiskalföderalismus in Europa, Berlin 1997, Duncker & Humblot, pp. 9-60. For an overview and critique of neoclassical tax competition theory see M. Streit, D. Kiwit: Zur Theorie des Systemwettbewerbs, in: M. Streit and M. Wohlgemuth (eds.): Systemwettbewerb als Herausforderung an Politik und Theorie, Baden-Baden 1999, Nomos, pp. 13-48.

[20] Cf. the report of the Ruding Committee, op. cit.

[21] E.g. H.-W. Sinn: Tax Harmonization..., op. cit.; H.-W. Sinn: How Much Europe?..., op.cit. For an opposing argument, again from a neoclassical point of view, cf. C. Fuest: Interjurisdictional Competition and Public Expenditure: Is Tax Co-ordination Counterproductive?, in: FinanzArchiv, Vol. 52, 1995, pp. 478-496.

Since neither unregulated competition nor full harmonisation are adequate solutions, the OECD, the UN, and the EU have developed model double taxation treaties and codes of conduct with respect to tax competition. In principle, it would be conceivable for this procedure to lead to a system of rules that enables tax competition to become effective as an instrument of control of power, as a discovery procedure and as an incentive mechanism. However, the concrete design of these international agreements raises doubts. The "Package to Tackle Harmful Tax Competition in the European Union"[24] lacks a precise idea of what tax competition is and which elements are to be regarded as harmful.[25] The same holds for the OECD-Study "Harmful Tax Competition – An Emerging Global Issue".[26]

A Proposal for Tax Reform

The theory of taxation has established a number of desirable properties of tax systems. Among them are neutrality with respect to capital exports and imports, transparency, continuity, efficiency, and elimination of double taxation.[27] It is reasonable, however, not to judge tax systems by these principles, which are partly contradictory and cannot be realised at the same time,[28] but by their underlying normative content. In this respect, two principles seem to us to be fundamental: the exchange principle and the principle of equality. The former is concerned with the market side of tax competition (the state as a provider of locational services); the latter refers to the exercise of sovereignty by the state in tax competition (the state as the authority that levies taxes).

The exchange principle[29] is a fundamental principle of competitive processes. It states that the supplier of a product or service must be able to claim a quid pro quo from the users of the product or service. It does not imply that the two goods exchanged are necessarily equivalent. Indeed, the valuations of the respective goods cannot be compared with each other on an objective basis, only on a subjective one. Therefore, the size of the quid pro quo, i.e. the exchange relation, is irrelevant with respect to the exchange principle. However, if the ability to demand a quid pro quo is lacking, there is no incentive to provide a good at all. In this case, a competitive structure of society is not viable.

In Western societies, the idea of equality has evolved gradually.[30] Today, it not only forms the basis of the rule of law in national constitutions but also plays a prominent role in international agreements such as the GATT (non-discrimination according to Articles I and III of the GATT) and in EU law (Article 12 EC Treaty). The levying of taxes represents an encroachment by the sovereign upon the property of citizens. Hence, the state is especially obliged to

[22] For example, a north-south gradient in tax auditing can be observed among the German Länder (H. J. Kröger: Betriebsprüfung und Steuerfahndung 1997 im Ländervergleich, Bremen 1999, Arbeiterkammer Bremen). Even though this is largely due to the Länderfinanzausgleich (the German interregional redistribution mechanism), it points to the danger in harmonising tax rates. On the EU measures against "harmful" tax competition cf. Commission of the European Communities: Towards Tax Co-Ordination in the European Union: A Package to Tackle Harmful Tax Competition, COM(97), 495final, 1997; Commission of the European Communities: First Annual Report on the Implementation of the Code of Conduct for Business Taxation and Fiscal State Aid, Luxembourg 1998.

[23] The European Union has been named a "tax cartel" (C. E. McLure: Tax Competition: Is What's Good for the Private Goose Also Good for the Public Gander?, in: National Tax Journal, Vol. 39, 1986, pp. 341-348, here p. 346; G. Larbig: Perspektiven des europäischen Steuerwettbewerbs, in: Wirtschaftsdienst, Vol. 78, 1998, pp. 743-749, here p. 745), a "harmonisation cartel" (B. S. Frey, R. Eichenberger: To Harmonize or to Compete? That's Not the Question, in: Journal of Public Economics, Vol. 60, 1996, pp. 335-349, here p. 341), and a "fortress" in tax competition (B. Huber: Der Steuerwettbewerb: Gefahr oder Chance?, in: List Forum für Wirtschafts- und Finanzpolitik, Vol. 23, 1997, pp. 242-256, here p. 254).

[24] Commission of the European Communities: Towards Tax Co-Ordination..., op.cit.

[25] For the criticism of the EU policies towards tax competition see G. Larbig, op.cit.; and C. Pinto, op.cit.

[26] Therefore, the critical assessment of Switzerland and Luxembourg is not surprising (OECD: Harmful Tax Competition: An Emerging Global Issue, Paris 1998, Annex II, pp. 73-78). Severe criticism also by Pinto and A. W. Wright: Review: OECD Harmful Tax Competition Report Falls Short, Harmful Tax Competition: An Emerging Global Issue, in: Tax Notes International, 17.8.1998, pp. 461-463. Approvingly, however, J. Francke: The 1998 OECD Report on Harmful Tax Competition: Just Right, in: Tax Notes International, 28.9.1998, pp. 979-981; and E. Osterweil: In Defense of the OECD Report on Harmful Tax Competition, in: Tax Notes International, 21.9.1998, pp. 895-896.

[27] E.g. R. A. Musgrave: The Theory of Public Finance, New York 1959, McGraw-Hill.

[28] For example, the realisation of both capital export and capital import neutrality is only conceivable in the case of a complete harmonisation of all parameters of all tax systems worldwide. The multitude of double taxation treaties has not only led to a very complex international tax system but has also had the consequence that foreign incomes are regularly not taxed similarly to domestic incomes. Cf. the discussion about the necessity of introducing the most favoured nation status in order to align bilateral treaty law to the EC Treaty, e.g. A. J. Rädler: Most-Favoured-Nation Concept in Tax Treaties, in: M. Lang (ed.): New Developments in International Tax Law, Vienna 1997, Linde, pp. 1-14; M. Lang: Kein Verstoß von Doppelbesteuerungsabkommen gegen die Grundfreiheiten des EGV?, in: Internationale Wirtschaftsbriefe, Vol. 14, 1996, pp. 667-670; M. Lang (ed.): Multilateral Tax Treaties: New Developments in International Tax Law, Vienna 1997, Linde.

[29] See L. Gerken, J. Märkt, G. Schick: Internationaler Steuerwettbewerb, Untersuchungen zur Ordnungstheorie und Ordnungspolitik, 40, Tübingen 2000, Mohr Siebeck, pp. 14f., 215-223, for a detailed discussion of this aspect.

[30] Cf. L. Gerken: Von Freiheit und Freihandel. Grundzüge einer ordoliberalen Außenwirtschaftstheorie, Untersuchungen zur Ordnungstheorie und Ordnungspolitik, 39, Tübingen 1999, Mohr Siebeck, p. 152.

assure equal treatment in the area of taxation. Properties of tax systems such as the benefit principle, the ability-to-pay principle, capital export or import neutrality, and the avoidance of double taxation, which have traditionally been regarded as desirable, are in the end specific, and partly controversial, manifestations of the principle of equality. In its general form, this principle merely demands that equal cases be treated equally and that unequal cases be treated differently. Within the context of tax competition, the principle of equality postulates that the government should tax equivalent economic affairs equally.

The proposed solution to the above-mentioned problems of double taxation and double non-taxation, which violate both the exchange principle and the principle of equality, consists of two elements: double income taxation and unitary taxation.

Double Income Taxation

As a consequence of globalisation, especially on capital markets, national tax systems are increasingly confronted with taxpayers whose country of residence is not identical to the country in which they earn their income. Both the pure source principle and the pure residence principle, as well as mixed systems with tax exemptions,[31] systematically have the consequence that individuals and firms can benefit from public services without having to contribute to their financing. This is the case both for domestic residents earning their income abroad and for foreign residents earning their income domestically. If foreign income tax payments are credited towards domestic tax payments,[32] it depends on the foreign tax system whether a domestic resident who earns his income abroad is taxed at home or not. Likewise, if no taxes are levied on a foreigner's domestic income, say interest payments on a government bond, he is a free-rider on domestic public goods like the law system. With regard to the exchange principle this situation is unacceptable.

The problem can only be solved if – with correspondingly lower tax rates – a double income tax is introduced that consists of a citizens' income tax, to which all residents are subject, as well as a factor income tax, to which all incomes generated in the

[31] I.e. incomes earned abroad are excluded from the domestic tax base.

[32] In the case of tax credits, taxes paid abroad are subtracted from the domestic tax liability (in German income tax law such provisions can be found in paras. 34c EStG, 26 KStG). Tax credits are usually given only to the extent of the domestic tax liability so there are no refunds for taxes paid abroad.

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The European Union

A compact guide for business-government-relations

Economy and politics are closely linked to each other. In order to succed in the daily business life it is crucial to understand the economic processes in theory and practice and to look behind the curtains of politics and administration.
The European Union is not only a political idea. It influences the European and even the worldwide economy in many aspects. The market environment has altered dramatically in the last years, particularly on the European market. Since the EU had launched a programme to put the Internal Market into force the continent's market and competition policies have changed substantially compared to the late seventies and early eighties. Inter alia, the Internal Market Programme included a new competition law, a totally modified state aid regime, and a revised regime for public procurement. To be able to compete on this market the industry needs to know where and how decisions are being taken.
This book shows several aspects of the European Union, going back to its historic roots, explaining the institutions and their role in the policy cycle, unveiling the decision making process, and scrutinising those EU policies with major business impact. This EU-related information is supplemented with practical recommendations for successful lobbying and negotiations.

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country are subject. Both taxes have to remain completely separate, i.e. neither tax exemptions nor tax credits are possible. With this tax system, taxes can be levied on all firms and individuals who are able to use domestic public services.

Obviously, the double income tax leads to double taxation of domestic residents who earn their incomes in the country. The domestic owner of domestic factors is burdened twice for the same object of taxation (income earned domestically) with a direct, revenue-based tax: on the basis of the citizens' income tax as well as on the basis of the factor income tax. Thus, at first sight, there seems to be a conflict between respecting the state's right to claim taxes under the exchange principle on the one hand, and avoiding double taxation under the principle of equality on the other hand. However, contrary to what the current debate on tax policy suggests,[33] double taxation is not undesirable in itself, but rather the unequal treatment of taxing units that goes along with it. Consequently, double taxation can be justified also with regard to the principle of equality, provided it reduces existing cases of unequal treatment rather than creates new ones. This is the case with double income taxation. For unlike foreigners with domestic income and domestic residents with foreign income, the taxpayers affected by double taxation can use public services both as citizens and as owners of factors of production while foreigners with domestic income and domestic residents with foreign income cannot. And the public services provided for citizens and those provided for factors are indeed different. For the proposed system it is irrelevant whether the revenues from the citizens' income tax are equivalent to the benefits citizens draw from the public services they finance. The same is true for the factor income tax. It is not the equivalence of service and quid pro quo which underlies the system of double income taxation, but the possibility of a "process of exchange".

This system is appropriate no matter how cross-border transactions are taxed abroad. It may occur that a foreign country does not tax certain incomes generated on its territory at all. In this case the total tax burden to be carried by domestic residents for the use of factors in that particular country is relatively low. But this only concerns the foreign country and may not entail that those domestic residents who thus gain their income be charged additionally by the domestic tax authorities. For only the financing of domestic public services must be the aim of domestic taxation. If and to what extent foreign countries levy taxes is irrelevant in this context.

[33] Scientific Council at the German Federal Ministry of Finance, op. cit.

Factor Income Taxation

The proposed factor income tax as one component of double income taxation is levied by the domestic tax authorities on all incomes generated in the home country through the employment of any factors of production. These are – in the usual economic classification – labour, capital and land. One can hence speak of a payroll tax as the tax on wages, of a capital income tax as the tax on returns to capital investments, e.g. in financial markets or as direct investments, and of a land tax as the tax on returns to land ownership.[34] Subject to taxation are all individuals who earn an income or profit by employing factors domestically. It is irrelevant whether the owner of a factor is a domestic or a foreign resident.

The rationale for the factor income tax is – in line with the exchange principle – that all owners of factors of production who can use domestic public services in earning their incomes also have to take part in their financing. The factor income tax is always levied at the source of incomes, i.e. the payroll tax is paid by the employer, the capital income tax on financial assets by the borrower, and the capital income tax on company profits by companies. To be precise, not domestic corporations as such are subject to the taxation of profits but the domestic and foreign owners of domestic corporations, e.g. the shareholders of a stock company. Profits are nothing but the return to capital invested into the firm by its owners. By paying capital income tax to the domestic tax authorities, the company merely acts for its owners.

Citizens' Income Taxation

The second component of double income taxation is a citizens' income tax, i.e. a personal income tax. The tax base is the incomes of all residents no matter whether they are earned at home or abroad.[35] All individuals who are residents of the country are taxed.

[34] Translated into the classification of German income tax law, the factor income tax covers all incomes from agriculture and forestry, from trade, from wage work and self-employment, from capital assets, and from rental and leasing. Evidently, these types of income cannot be matched to the three economic categories of factor incomes without overlapping. However, since all incomes are to be taxed uniformly, the following discussion can be based on the economic classification without restrictions.

[35] This includes incomes that do not result from the employment of factors of production, e.g. lottery prizes or discoveries of treasures.

Stock companies and other corporations are not taxed on the basis of the citizens' income tax. Otherwise, a triple taxation of domestic shareholders would result by these being taxed as residents on the basis of the citizens' income tax in their home country, as owners of capital on the basis of the factor income tax in the source country and via the citizens' income tax liabilities of the corporation in the source country. The reason for the citizens' income tax is – in line with the exchange principle – that all citizens who, due to their presence in the country, can use domestic public services must also take part in their financing.

The citizens' income tax may (but does not necessarily have to) be designed progressively, as is often demanded with reference to the ability-to-pay principle.[36] According to this principle every individual should make the same (relative) sacrifice. This sacrifice is defined as the loss of utility derived from income. It is postulated, firstly, that the utility function is identical for all citizens and, secondly, that marginal utility decreases continuously with increases in income. From this set of assumptions the necessity of progressive income taxation follows.

As is widely known, this argument does not stand up to critical scrutiny. Firstly, utility can by no means be measured, and secondly, if it could, utility functions would not be identical for every citizen. Thirdly, it cannot be taken for granted that marginal utility decreases as income rises. However, most politicians and probably the majority of citizens, at least in European countries, tend to regard progressive taxation as compatible with the principle of equality and even as necessary for distributive reasons or as a realisation of benefit taxation. This can be reflected in the design of the citizens' income tax and indeed only of this tax. For in the context of factor income taxation, socially motivated redistribution through a progressive scale of taxation cannot take place for two reasons. Firstly, utility is not an appropriate concept for the income of a factor, but for that of an individual. Therefore, the individual level of utility, and thus the tax burden, can only be defined for an individual and over total income. Secondly, redistribution can at most be justified within an existing social community, i.e. a coherent group of individuals that is defined, if not by nationality, then by residence. Hence, factor incomes should be taxed proportionally. Indirect progression by means of tax allowances should not take place.

Utilizing the citizens' income tax as an instrument for socially motivated redistribution has several consequences. Firstly, the subsistence level can only be guaranteed through the citizens' income tax and not through the factor income tax. This can either be achieved via a general tax allowance or via a negative income tax.[37] For the following reason the latter alternative is preferable. The proportional factor income tax is levied on every single unit of income. Due to this factor income tax burden even on low incomes, a general citizens' income tax allowance cannot serve its purpose of guaranteeing the subsistence level properly. A second consequence of organising redistribution through the citizens' income taxation is that only citizens, but not factors can benefit from redistribution. Redistribution in favour of specific factors, e.g. tax rebates on capital inputs, are thus not permitted.[38]

Uniform Factor Income Taxation

The taxation of the immobile factors labour and land should be linked to the taxation of capital. Uniform taxation of all factor incomes is important for several reasons. Firstly, factor prices, just as other prices, reflect scarcity, and heterogeneous taxes on factor returns distort relative prices. Secondly, the different factors are by far not distributed uniformly over citizens. Indeed, there is a correlation between an individual's income level and his drawing of certain factor incomes, especially of capital returns. Differential taxation of factors could therefore neutralise or even overcompensate the intended redistributive effects of the citizens' income tax through the back door. Thirdly, uniform factor taxation eliminates considerable practical problems regarding the otherwise necessary distinction between factors. Fourthly, and above all, uniform taxation prevents governments from granting tax rebates or even tax exemptions to mobile capital at the expense of immobile factors. As jurisdictions compete for capital, they are induced to lower taxation on capital income, keep or increase the amount of public goods benefiting capital owners, and shift the burden of financing these to immobile factors. In the light of the equality principle this is not acceptable. This tendency of shifting the tax burden to immobile factors can be observed in recent tax reforms in Sweden, Austria and – until now to a

[36] Others argue that progressive taxation can be defended on the grounds of benefit taxation (e.g. K. Wicksell: Finanztheoretische Untersuchungen nebst Darstellungen und Kritik des Steuerwesens Schwedens, Jena 1896, Gustav Fischer, p. 113. This argumentation is not challenged by the following critique of the ability-to-pay principle as a foundation for tax progression.

[37] On negative income tax see OECD: Negative income tax: an approach to the co-ordination of taxation and social welfare policies, Paris 1974.

[38] Subsidies to specific factors would have to be prevented as well.

lesser extent – Germany, where tax rates on capital returns are lower than tax rates on labour income.[39] Linking the taxation of the income of immobile factors to the taxation of capital returns lowers the scope for the exploitation of immobile factors by the state to that for the exploitation of mobile factors. Every change in the factor tax rate induced by international competition for capital has to be granted not only to these factors but to immobile factors as well. Political strategies for evading this rule via the expenditure side of the budget, especially by subsidising capital in order to attract it, have to be prevented correspondingly.

Uniform taxation of factor returns means for once that there must be only one uniform tax rate for all factors. But it also means that tax bases have to be defined so as to meet the goal of uniform taxation. This leads to considerable practical problems, for the definition of the different tax bases poses different questions for each factor. Realistically, complete uniformity of taxation is therefore not feasible.[40] However, this pragmatic insight does not imply that one should not strive for uniform taxation to begin with. Rather, one should also try to achieve uniform taxation with regard to tax bases to as high an extent as possible.

Unitary Taxation

The strategies of tax avoidance that are at the disposal of multinational firms are rooted in the fact that these firms operate internationally or even globally while taxation takes place at a national level. Multinational firms can take advantage of this structural bias by designing transfer prices or taking other measures so as to make profits accrue in those countries where profit and capital income taxes are especially low.

States generally try to solve this problem by applying the arm's length principle. This method adheres to profits accrued domestically as the basis for taxation. For this reason, it does not come up to the current problems of globalisation in two respects. Firstly, a fictive price set by tax authorities will only by chance equal the true intra-firm price.[41] Secondly, by setting transfer prices, the arm's length principle only tackles part of the problem; it can reduce the incentive for transfer price manipulations for existing intra-firm transactions, whereas tax liabilities can still be reduced through the creation of additional intra-firm transactions or the deviation of existing ones, e.g. by booking immaterial assets in low-tax jurisdictions or by transferring profits via finance or holding companies in order to make use of specific double taxation treaty provisions (treaty shopping). The arm's length principle is therefore merely a discretionary crutch intended to guarantee a minimum level of tax revenue.

The principle of unitary taxation, by contrast, is not a crutch. It explicitly takes the incentive structure of multinational firms, i.e. global profit maximisation, into account. It is therefore superior to the arm's length principle. In each country where the multinational enterprise maintains permanent establishments corporate income taxation is based on overall global profits, thereby eliminating any incentive to artificially design intra-company activities for tax purposes.

Overall profits are divided among the countries in which the company operates on the basis of a general apportionment formula determined ex ante. One possible choice of an apportionment formula is the share of equity held in each country, for it is the return to equity that is the relevant tax base. The part of overall profits that is taxed in the home country is then the domestic share in the total equity of the firm. This has the disadvantage, however, that it restricts the effect of unitary taxation to preventing short-term, static shifting of profits, that is when the structure of capital is given, while dynamic shifting of profits in the medium term, when the capital structure is variable, remains possible. Thin capitalisation in high-tax countries could result. This suggests that total capital, i.e. the balance sheet total, should be chosen as apportionment formula. Multinational firms would then no longer have the incentive to place their equity strategically. Nevertheless, not all dynamic strategies of tax avoidance are eliminated this way either. In particular, it is conceivable that domestic subsidiaries would increasingly base their business on activities like leasing, which do not increase the balance sheet total, or – if the definition of the tax base is left to source countries – would shift assets to where generous allowances for depreciation are granted. Similar caveats can be raised for the wage sum or the revenues generated in the corresponding jurisdiction

[39] J. Märkt: Verändert der Steuerwettbewerb systematisch das Steuersystem?, Diskussionsbeiträge des Walter Eucken Instituts, Freiburg 2000.

[40] E. Wenger: Gleichmäßigkeit der Besteuerung von Arbeits- und Vermögenseinkünften?, in: Finanzarchiv, Vol. 41, 1983, pp. 207-252; E. Wenger: Warum die Finanzwissenschaft bei der Suche nach einer theoretischen Basis für die Einkommensteuer erfolglos bleiben mußte?, in: C. Smekal, R. Sendlhofer, H. Winner (eds.): Einkommen versus Konsum, Ansatzpunkte zur Steuerreformdiskussion, Heidelberg 1999, Physica, pp. 37-63.

[41] The administrative transfer price is too high if market prices are used as a reference because internalisation advantages are neglected. It is too low for enterprises that realise above average profit margins if tax authorities deduce the price from production cost adding a sector-specific profit margin.

as apportionment formula. Alternatively, several criteria could be combined to an apportionment formula, e.g. a weighted average of capital, revenue and wage sum, as is done in some US states. However, such a combination would represent a further departure from the idea that taxation of profits under the factor income tax is taxation of returns to capital (equity). This discussion shows that, with respect to the choice of the apportionment formula to determine the domestic share of the overall profits of a multinational firm, there is no objectively correct solution. Nevertheless, unitary taxation is without doubt superior to the arm's length principle because it substantially reduces the incentive problem of the transfer of profits.[42]

Effects of the Proposed Solution

Taxation on the basis of the proposed reform affects tax competition in several respects. Firstly, it ties tax competition to jurisdictional competition regarding the provision of public services. In the current situation, especially multinational firms are able to use public services in a country while systematically avoiding taxation there. Factor income taxation of the type presented prevents this (within the limits set by the revenue-based nature of taxation). The consequence is that tax competition turns into competition in the sense of a real exchange of service and payment. Multinational firms invest in a country if the state provides attractive services and if the corresponding tax burden in that country does not overcompensate the advantages resulting from these services. Consequently, tax competition works as a discovery procedure and forces countries to provide public services efficiently and in a user-oriented manner, but does not put them at the risk of not receiving tax payments despite an efficient and user-oriented supply of services. In other words, the proposed tax system prevents the harmful effects of tax competition among states but does not impede the beneficial ones.

Secondly, the tax burden cannot be shifted towards the owners of immobile factors. In unregulated tax competition, there is a tendency for capital taxation to be eroded while the burden on immobile factors increases correspondingly. Factor income taxation of the type presented, with a uniform tax rate on all factor returns, not only prevents this but also extends the efficiency enhancing effects of tax competition from capital taxation to the taxation of immobile factors, which means that these factors profit from lower capital income taxes as well. Obviously, measures must be taken to keep politicians from circumventing the uniformity of the factor income tax rate by switching to the design of tax bases as a new battlefield in the competition for capital. This can be achieved through a constitutional self-restraint by politicians, through appropriate court rulings by the judiciary including the constitutional court or through international agreements.

Thirdly, the outflow of financial capital to tax havens is not harmful. These countries have specialised in the needs of investors of financial capital and levy, in correspondence to the cost of their specific public services, a capital income tax on a very low level. This illustrates that financial capital does not require the rich bundle of public services that are offered by a highly industrialised country. Within the traditional, one-step tax systems, this development has led to considerable losses in tax revenue. But, in order to yield a return at all, financial capital has to be employed somehow and somewhere in the real economy, in particular in the production process. For this, a level of public services – education and training, traffic infrastructure and the like – is evidently required that is higher than that offered by tax havens. Such a level of service is available in industrialised countries. Not least for this reason, real economic activity is concentrated in these countries. To a large extent, the internationally mobile financial capital therefore flows back from low-tax countries to industrialised countries where it is employed in real economic activities. Capital returns are hence generated in the industrialised countries and, by means of the factor income tax, these returns can be taxed there as well. Consequently, it is not so important for an industrialised country to retain financial capital, if it is successful at attracting real capital by creating attractive locational conditions at a low tax rate on factor incomes. This is the realm of jurisdictional competition among states, more precisely among the industrial countries.

The citizens' income tax is only of limited relevance to tax competition, because the central prerequisite for tax competition, high mobility, is only rarely met in the case of citizens. Of course, mobility and the level of income are positively correlated. The consequence is that, even though there is no fierce tax competition for high-income citizens, there are limits to the redistributive design of tax rates.

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[42] For a discussion on different apportionment formulas cf. U. Johannemann: Entwicklung und Stand der Unitary Taxation Method, Münster 1997, Lit, pp. 58-104.