COMMENTS ON SESSION III: TAX COMPETITION AND TAX HARMONISATION

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Let me start by commenting on the paper by Kastrop. It is an interesting and stimulating paper because it underlines the importance of considering the institutional framework, which we often disregard in our economic analyses. Constitutional arrangements are very important in shaping the behaviour of governments. I do not want to address the German case, with which I am not sufficiently familiar, but Kastrop's conclusions and suggestions seem to me appropriate in terms of general policy indications. Kastrop has the merit of reminding us of the importance of some basic results that stem from public choice literature. Namely, the coherence principle and the financial autonomy of governments, as well as the importance of accountability and transparency in tax collection and decision making in general. He also has the merit of stressing the role of equalisation when jurisdictions differ in the level of economic development and natural endowments. Equalisation, *i.e.* inter-jurisdictional redistribution, is a necessary feature of inter-governmental financial relations. Particularly so when constitutions grant their citizens specific rights, as in the case of health, education, social assistance and the like. Constitutional "imbalances" can arise when constitutions grant citizens social rights, but do not make explicit provision for equalisation and inter-jurisdictional redistribution. Where this is the case, jurisdictions may end up with very different levels of satisfaction of citizens rights, so different that the principles of equality among citizens may be violated.

Kastrop has also made some very telling remarks on the EU budget. The European budget is very peculiar from the constitutional point of view because the European Parliament votes the expenditures, but not the revenues. European citizens pay for the European budget, but they contribute in an opaque fashion. They pay taxes to their home-states and then each member state transfers resources to Brussels from the expenditure side of its budget. The financing of the EU budget is agreed and decided on the basis of a purely inter-governmental procedure: it is the result of decisions taken by governments. It is true that in voting their national budgets the member states' parliaments also vote EU financing, which is one of the expenditure items. But national parliaments merely ratify decisions taken by governments. One of the merits of Kastrop's paper, in my opinion, is that it highlights these shortcomings, draws attention to this important transparency and accountability failure in the current institutional and constitutional setting of Europe. There are different possible ways to address this issue: one would be quite straightforward, although it is unlikely: the European Convention, which is currently preparing the draft Constitution of Europe, could consider the desirability of giving the Union powers to tax European citizens. As I just said, this is a rather unlikely outcome:

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very few of the participants in the Convention would dare to give the Union the right to tax its citizens. Yet, this would be a straightforward solution in terms of accountability, transparency, coherence and financial autonomy.

Let me now turn to the second paper. Professor Boothe reminds us of a very important point. A properly designed federal system may increase efficiency, with respect to a centralised government, in part because it may be able to reflect local preferences more accurately. Boothe describes an interesting case study and draws his conclusions from it. It is worth noting, in his paper, the stress on administrative and compliance costs. In policy making, we have to keep in mind that taxpayers have the right to be taxed in a fair, but also in a simple and clear way. In addition, the reduction of administrative costs linked to taxation may improve overall economic efficiency. This is also an important starting point for the recent proposals to modify corporate and business taxation in Europe. In November 2001 the Commission put forward proposals aimed at moving towards an internal market without tax obstacles. The Commission also underline the need to reduce administrative and compliance costs, which stem from the very existence of fifteen different tax systems.

Boothe's analysis shows that, besides reflecting local preferences more accurately, the greater autonomy Canadian provinces have enjoyed since the end of the Nineties has resulted in a decrease of tax rates, both average and marginal. I have some questions for Professor Boothe on this issue. I am curious to know whether tax allowances and tax credits at provincial level have been modified and, if this is the case, whether they have been reduced or increased, in order to compensate (at least partially) for the fall in tax rates. Or do Professor Boothe's estimates of tax rates already take into consideration tax credits and allowances?

Boothe told us that in 1997 the federal government wanted to introduce tax cuts. The fact that the federal government and the provinces reached an agreement to change the institutional arrangements can perhaps be interpreted as a "deal" in which the provinces allowed the federal government to carry out the proposed tax cuts, in exchange for more tax autonomy. But it might also be that the provinces simply wanted to share the political benefits of tax cuts with the federal government. I would be interested in Professor Boothe's views on this issue.

Boothe has told us that all the provinces reduced their tax rates, as the federal government had proposed. Was there a "necessity" to reduce taxes? And if so, what was it? Was there an issue of tax competition, not so much among the provinces themselves, but with respect to other countries? Obviously, the reference is to the neighbouring United States. But I also raise the question of whether NAFTA played a role. I mention NAFTA because my impression is that when we talk about tax competition and mobility we should qualify mobility. Mobility is not simply a global phenomenon. Mobility – intended in a broad sense, not just as mobility of capital, but also as mobility of labour and of goods and services – is likely to increase more in regional areas. It has probably increased more within NAFTA and the European internal market than elsewhere and worldwide. The decision by firms to locate in a specific area is strategically driven by the fact that that location is within a market, an integrated market.

Let me now turn to the paper by Ederveen and de Mooij. This is also a very interesting paper, a good and accurate review of different measures and definitions of tax rates. In my opinion, it also provides a good and accurate review of the literature on the relationship between tax rates and foreign direct investment (FDI), which, in the end, is the main issue for this section of our conference. In short, do taxes really matter for investment decisions? Or, in other word, is there an economic reason for states to engage in tax competition? Using the meta-analysis, the authors conclude that the answer is positive, that there is evidence of a significantly negative relationship between tax rates and FDI. So, we feel reassured, as economists, that our conventional wisdom seems to be confirmed.

But this result leads to a second question. Did governments effectively use tax rate reductions to attract foreign investment? Is there any evidence of tax competition having occurred in the last few years? The issue is dealt with by the paper by Briotti, which is included in Session 4. She reviews some interesting literature on this issue, showing that there is evidence that in the last two decades tax rates, using different definitions (statutory, marginal, backward and forward looking), have effectively decreased. But there is no evidence of a "race to the bottom". This is an important result, and leads us to the following question: why did a race to the bottom not happen?

There are some possible tentative answers to this question.

One is provided by Vidal and Catenaro, who presented a very elegant paper. They introduce some simple and clear assumptions in a standard game theory model and reach the conclusion that there may be a cooperative solution, with positive taxation and no race to the bottom, simply introducing repeated strategies in the model, conditional on the fact that countries are symmetric (*i.e.*, neither too large nor too small). This interesting paper shows that, by introducing some change in the model and bringing in new simple assumptions, it is possible to reach results that are significantly different from the standard results we are used to reading in the literature.

Catenaro and Vidal also have the merit, in my opinion, of underlining and questioning, from the point of view of realism, the conventional assumption of selfish governments, that are commonly assumed to be solely revenue maximisers. This assumption is really at odds with the facts. If we look at the experiences of the Nineties (for instance, at the G7 initiatives against harmful tax competition, the OECD project in the same area, the EU Code of Conduct on business taxation), there is evidence that governments are interested in taking action against "abuse". If we look at these initiatives in conjunction with similar initiatives in the fields of money laundering and financial stability, we can easily see that governments are concerned with and interested in preserving the social public good of globalisation. Governments are interested in creating a level playing field; they pursue efficiency and growth; they want to guarantee financial stability; they want to repress economic criminality; and they want to avoid “harmful”, or “unfair”, tax competition.

There are also other reasons to explain why a race to the bottom in taxation did not occur. Governments may have taken some national countermeasures against aggressively competitive jurisdictions. In this area, it seems appropriate to make reference to CFC (controlled foreign company) legislation, thin capitalisation legislation and similar provisions.

There are also economic reasons which may explain why the race to the bottom did not occur. The mobility of factors, in reality, may be far from the perfection that is usually assumed in the economic literature. Even capital markets, where the highest mobility is usually assumed, are far from perfect. Even after liberalisation and globalisation, many segmentations and imperfections still exist, which leave governments room for manoeuvre in taxation.

Economic reasons may also explain the indesirability of racing to the bottom. The existence of location specific “rents” (extra-profits) may be a valid reason for taxing profits, at least those stemming from foreign investment. This assertion is to be seen in connection with my previous considerations on the European internal market and NAFTA. Wherever governments create areas of enhanced mobility, they create a public good which offers the opportunity to extract “rents” to those who invest within those areas. Hence, it is appropriate to tax these “rents”.

My final remark is that Vidal and Catenaro’s conclusions are dependent upon the symmetry hypothesis between large and small countries. This argument gives me the opportunity to make a digression into the future, namely into the prospects of EU enlargement. Some small countries are entering the EU. Estonia is entering without a proper corporation tax. The Channel Islands may soon eliminate their existing corporation taxes. It cannot be ruled out that the EU will enter a new phase of tax competition, of enhanced tax competition, with specific regional characteristics. In fact, the absence of corporation taxes cannot be dealt with by other member states with traditional anti-abuse measures, such as CFC legislation. CFC legislation, like other national anti-abuse provisions, may conflict with the principles of the internal market and, hence, not pass the scrutiny of the European Court of Justice.