Capital Mobility and Tax Competition

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Introduction*

Tax competition and co-ordination is one of the most pressing issues for tax authorities in modern economies. It is also a highly controversial subject. Some argue that tax competition is beneficial by forcing governments to impose efficient tax prices on residents for the provision of public services [83]. In other words, if tax competition leads to less use of source-based taxes (such as taxes on businesses), this would improve the tax policy in competitive economies. Further, some argue that tax competition is also beneficial by limiting the power of governments to levy taxes [14, 52].

Others take a different view. Taxes levied by jurisdictions can impose spillover (or fiscal externality) costs on other jurisdictions [64, 30]. This can take the form of "tax base flight" whereby a jurisdiction's tax results in mobile factors fleeing to low-tax jurisdictions [93]. Alternatively, unco-ordinated taxes can result in "tax exportation" whereby a government shifts the tax burden of financing local public services onto non-residents (e.g. taxes on foreign corporations).

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Therefore, in a world without co-ordinated tax policies, governments choose sub-optimal levels of public services financed by inefficient taxes that are either too high or too low by ignoring spillovers imposed on other jurisdictions.

In recent years, the OECD and the European Union have become increasingly concerned about tax competition. Historically, the OECD developed a model "tax treaty" to limit tax avoidance and reduce "tax exportation" arising from double taxation of income earned by a multinational parent with operations in a capital importing country. A recent OECD project, controversially named "harmful tax competition," is intended to reduce the scope for "tax base flight" externalities by removing incentives to shift tax bases to low-tax jurisdictions. The European Union has not only been looking to implement a "code of conduct" to limit the scope of tax competition but the member countries have also been forced to adopt limitations on tax exportation that discriminates between foreigners and domestic owners of capital.[1] Agreements to limit tax competition have not been easily achieved. Even in the latest round of negotiations, some countries like Luxembourg and the United Kingdom have objected to EU or OECD attempts to limit tax competition.

The purpose of this survey is to draw out the most important issues of un-coordinated tax policy at the international level for cross-border transactions. The discussion focuses on mobile tax bases, specifically in relation to investment and financial transactions. Two important caveats are thus in order. The first is that, even though labour is mobile to some degree, there is still relatively little labour mobility

[1] European court cases in recent years induced EU countries to revise their tax systems for the integration of corporate and personal taxes. Most governments only provided a dividend tax credit for domestic shareholders as an offset for corporate taxes paid on income prior to distribution to shareholders. However, a German company operating in Britain argued that the dividend tax credit should also be extended to German shareholders to avoid discrimination against other members of the European Union. The court determined that a tax credit should be paid to shareholders in other European countries. Rather than try to pay credits to foreign shareholders, the United Kingdom changed its existing system to integrate corporate and personal taxes by abolishing the a corporate level tax on distributions and reducing personal taxes on dividends to a level so that the combined corporate (30%) and personal tax rate (10%) on dividends was approximately equal to the top rate on salary and other income (40%). Other countries followed with France recently changing their system in light of these court cases.

at the international level [43]. Thus, we concern ourselves with tax competition in relation to mobile capital and finance.[2] The second is that investment and financial transactions are taxed at the business level and household level. Although there is certainly some significant concern on part of authorities that individual residents can escape taxation on income by investing wealth in low-tax offshore jurisdictions, the most substantial problems arise with respect to business income and financial transactions taxes since most cross-border transactions involve companies and financial intermediaries.

Our main issue for consideration in this survey is whether taxation of income, specifically capital income will survive, how border crossing investment is taxed relative to domestic investment and whether welfare gains can be achieved through international tax coordination. The survey should be seen as complementing related contributions which include Keen [50], Wilson [91], Wellisch [85], Gresik [37], Haufler [39], Wildasin and Wilson [92]. One difference to these surveys is that our paper attempts to derive some of the key results on the taxation of international investment in variants of one model of multinational investment, which we develop in Section 2. Moreover, we put emphasis on the problem of tax competition and financial arbitrage, an issue which is somewhat neglected in the existing surveys.

The outline for the paper is the following. The paper consists of two major parts. The first part (Section 2) deals with the implications of tax competition for national tax policy. Section 2.1 begins with a discussion of some basic results for the optimal taxation of border crossing direct investment. In the following sections, we extend our analysis to include the role of double taxation agreements (Section 2.2), public goods provision (Section 2.3), portfolio investment (Section 2.4) and transfer pricing (Section 2.5). Section 2.6 deals with the role of the financing decisions and financial arbitrage for investment and tax policy under tax competition. The second major part of the paper (Section 3) deals with the problem of tax coordination. We start with the basic idea that tax competition leads to an underprovision of public

[2] On fiscal competition with household mobility see Richter and Wellisch [76], Wellisch [85] and Wildasin [87]. Kessler et al. [54] investigate the interaction between capital mobility and household mobility.

goods (Sections 3.1 and 3.2) and then consider the role of residence-based capital income taxes (Section 3.3), labour taxes (Section 3.4), and redistributive income taxation (Section 3.5). Section 3.6 discusses reasons why taxes may be too high rather than too low under tax competition. Finally, Section 3.7 focuses on the problem of regional versus global tax coordination. Section 4 concludes the survey.

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