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Why is there so little tax coordination? The role of majority voting and international tax evasion

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Abstract

It is a striking feature of EU tax policy that countries find it difficult to agree on capital tax coordination. This is in conflict with the prevailing theoretical view, according to which tax coordination is beneficial. This paper develops a political economy argument which may help to explain this puzzle. We consider a model of tax competition where fiscal policy decisions are taken via majority voting and tax evasion is possible but costly. It turns out that tax coordination agreements may fail to generate political support because middle income groups may lose from tax coordination, even if their capital income is below average.

Keywords: Tax coordination; Majority voting; Tax evasion

JEL classification: H24; H26; H87

1. Introduction

It is an important implication of the integration of international capital markets that the taxation of capital income becomes increasingly difficult. This holds in particular for the taxation of capital income at the personal level. These capital

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income taxes are usually raised according to the residence principle, and taxpayers may evade these taxes, for instance, by holding bank accounts in other countries and not reporting capital income to the domestic tax authorities. If residence based capital income taxes can be evaded at zero cost, optimal tax theory predicts that capital taxation in small open economies will vanish completely (see. e.g. Gordon, 1986). Therefore, many contributions to the theory of tax competition argue that countries should coordinate capital taxes.[1]

Interestingly, these implications of theoretical reasoning do not seem to be compatible with the tax policies actually pursued by most countries. Despite the possibility of international tax evasion, many countries do raise residence based capital income taxes. Of course, this may be explained by the fact that tax evasion is not costless, which implies that some room for residence based taxation of capital income remains. Another, more striking empirical observation is that, despite the theoretical case in favour of capital tax coordination, very little tax coordination actually takes place. In the European Union (EU), for instance, there has been a long debate on the possibility of introducing an EU-wide coordinated minimum withholding tax on interest income, but at least up to now, no such coordination has actually taken place. The same is true for the coordination of corporate income taxes.

In the literature, some arguments have been developed which may help to explain the absence of capital tax coordination. Firstly, it can be shown that, if countries differ in size, small countries may be better off under tax competition than in a regime with coordinated capital taxes (see e.g. Wilson, 1999). The reason is that, since small countries have less market power in the international capital market than larger countries (or no market power at all), they raise lower capital taxes under tax competition. Small countries therefore have a more capital intensive production and higher per capita output than larger countries; it may then not be in the interest of the small country to participate in a tax coordination agreement. Of course, this can only explain the absence of tax coordination if side payments are ruled out; if the large countries may make transfers in order to compensate the losers, tax coordination is again welfare enhancing for all countries.

A second explanation often put forward is that tax coordination will be restricted to a subset of all countries. In this case, capital may flow to third countries in response to (partial) tax coordination (see, e.g. Huizinga, 1994; Haufler, 1999).[2] Still, as long as the countries participating in the tax coordination agreement are large enough to significantly affect the interest rate in the

[1] See, for instance, Razin and Sadka (1991) or Bucovetsky and Wilson (1991).

[2] Moreover, one may argue that capital flight to third countries is only a viable option for the group of wealthier investors, such that those investors who have to bear the additional tax burden may be small savers, see Haufler (1999), p. 146.