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Information sharing and tax competition among governments

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Abstract

The residence-based principle has been proposed as a second-best measure to the full international coordination of capital tax policies. This system requires that tax authorities have full information about the foreign investments of their residents. However, the degree of information transmission among governments can be considered as a strategic variable. We show that under some features of the tax system there will not be any information sharing, while there are institutional arrangements under which governments may transmit partial information for strategic purposes. We also show that full information sharing is not necessarily a Pareto optimum.

Key words: International tax competition; Information sharing

JEL classification: F20; F42; H77

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1. Introduction

The growing integration of international capital markets is rendering the issue of international taxation prominent among policy-makers and academics. On the one hand, the coordination or harmonization of capital tax policies ranks high on the agenda of several international forums, for example the European Community. On the other hand, both international economics and public finance academics are giving increasing attention to the differences in capital taxation among countries and to the possible strategic use of these taxes by governments. In recent years, numerous authors have used a game-theoretic approach to examine this issue.[1]

Previous analyses have shown in particular that the institutional setup for taxation strongly influences the strategic incentives of governments. For example, when countries apply the source-based principle of taxation, competition among tax authorities is much fiercer and, under some conditions, tax rates may be driven to zero. On the other hand, when the residence-based principle is applied, competitive incentives are limited and tax rates are higher and closer to their optimal level. For this reason several authors recommend the residence principle as a second-best measure to the full coordination of tax policies.[2]

However, several problems arise in the implementation of the residence-based principle.[3] In particular, a basic requirement for this system to work is that tax authorities have full information about the foreign investments of their residents. Nevertheless, it is generally difficult or legally impossible for a government to monitor investment abroad by its residents. Therefore, for the assumption of full information to hold, either domestic residents truthfully report their investments abroad or foreign authorities provide the information to the domestic government. Given that tax evasion is so widespread, it is unlikely that information will be provided directly by taxpayers and full information thus requires the participation of foreign authorities.

The complete sharing of information, however, does not seem to come as a natural thing and the degree of information transmission among governments can be considered as a variable used strategically in the same way taxes are. Therefore, when examining the strategic interactions among tax

[1] They include Giovannini (1989), Razin and Sadka (1989, 1990 1991a,b), Mintz and Tulkens (1990), Ghosh (1991), and Gordon (1992). See Giovannini (1990) for a survey.

[2] This is also the system recommended by the OECD Model Double Taxation Convention on Income and Capital, 1977, Another reason in favor of the residence principle is interpersonal equity, as it allows for the progressive taxation of worldwide capital income.

[3] One of the problems is that, in general, the residence-based principle is not a Nash equilibrium. Therefore, governments have a tendency to deviate from this system. See Mintz and Tulkens (1990) or Bacchetta and Caminal (1991) for a proof.