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Is partial tax harmonization desirable? ☆

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Abstract

We consider a setting in which capital taxation is characterized by two distortions working in opposite directions. On one hand, governments engage in tax competition and are tempted to lower capital tax rates. On the other hand, they are unable to commit to future policies and, once capital has been installed, have incentives to increase taxes. In this setting, there exists a tax that optimally trades off the two distortions. We compare three possible tax harmonization scenarios: no tax harmonization (all countries set taxes unilaterally), global tax harmonization (all countries coordinate their capital taxes), and partial tax harmonization (only a subset of all countries coordinate capital taxes). We show that, if capital is sufficiently mobile, partial tax harmonization benefits all countries compared to both global and no harmonization.

JEL classification: H21; F21; C73
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1. Introduction

This paper addresses the question of whether a group of countries as a whole can gain from harmonizing capital taxes if the rest of the world does not follow suit. This question is motivated by the recent debate about corporate tax harmonization in the European Union (EU). There have been various attempts to coordinate some aspects of business taxation within the EU. In particular, in 2003 the EU Council adopted a voluntary Code of Conduct against harmful tax competition and more ambitious proposals for corporate tax harmonization have been put forward, including the introduction of a single EU corporate tax (see Bond et al., 2000). However, EU member states are divided about whether or not to pursue further corporate tax harmonization.[1] For this reason, the idea of an Enhanced Cooperation Agreement (ECA) – whereby only a *subset* of European countries would coordinate their corporate tax policies – has recently gained ground. The question of the implications of partial tax harmonization is not only relevant within the EU, due to the possible creation of an ECA, but also between the EU and the rest of the world, due to fears that tax coordination among European countries may shift capital income to third countries.[2]

We examine the implications of partial tax harmonization, in a setting in which capital taxation suffers from two distortions working in opposite directions: on one hand, governments compete with each other for mobile capital and are thus tempted to offer corporate taxes that are too low; on the other hand, they are unable to commit to future policies and have incentives, once capital has been installed, to levy corporate taxes that are too high.

It is often argued that increasing integration of economic activities generates a “race to the bottom” in capital income taxation, a view that is supported in the literature on tax competition (see Wilson, 2004 for a review of this literature). The general concern is that tax competition will result in a shift away from taxes on mobile capital toward taxes on labor.[3]

At the same time, it is well known that potential time consistency problems can generate an upward bias in capital taxation (see Fischer, 1980; Rogers, 1987; Chari et al., 1989; Bernhabib and Rustichini, 1997): when investment decisions have yet to be made, optimizing governments recognize that capital taxes discourage investment; if they could commit to policy plans, they would thus wish to minimize the taxation of capital in the long run; however, once investment has taken place, they have incentives to raise capital taxes, since the taxation of capital is weakly distortionary in the short run. Hence, in the absence of credible commitment mechanisms, a policy of low capital taxation is time inconsistent.[4] Indeed, though much of the optimal tax

[1] Only “20 of the EU’s 25 members are supportive of the idea: Britain, Ireland, the Czech Republic, Slovakia and Estonia are opposed” (Financial Times, November 24, 2005).

[2] The concern is that investors may be “increasingly considering using business structures outside the EU because of the threat of removal of tax incentives” (press release by Deloitte & Touche, June 6, 2003).

[3] In the EU, the fear is that tax competition could undermine the foundations of Europe’s welfare state (see, for example, EU Commission, 1998, 2001). Fears of harmful tax competition have been increasing since the accession of new member states, as old member states struggle to come to terms with lower corporate taxes in Eastern Europe. For example, “The competitive threat from the new EU members, almost all with significantly lower corporate taxes, last year forced Austria to act. From January 2005, company tax was slashed to 25% from 34% in response”(Financial Times, November 24, 2005).

[4] In some European countries, commitment problems in capital taxation may be linked to political considerations. Governments may announce low capital taxes to encourage investment; however, once factories have been built, they may find it politically tempting, on distributional grounds, to meet their budget requirements by increasing capital taxation and lowering labor taxation. Politicians find it harder to lower capital taxes, since it is “impossible to get popular support for a tax-cutting policy that gives the impression it was designed to ease the burden for a small group of high earners and would be funded by cutting welfare programmes for low earners” (Financial Times, November 24, 2005).