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"TAXATION IN AN INTEGRATING WORLD: CONCLUDING REMARKS"/

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"Taxation in an Integrating World"

By Vito Tanzi

Chapter 9

Concluding Remarks

THE previous chapters have dealt with several tax issues that arise, or are likely to arise, in a world in which national borders no longer represent the sharp dividing line that once separated the economic activities of enterprises and individuals residing in different countries. Economic activities are now often international in scope, and goods, people, financial capital, real investment, technologies, know-how, and so forth cross national frontiers with a facility and a speed that would have been unthinkable a few decades ago. The best assumption that can be made at this time is that, barring a major catastrophe, this trend, which is largely driven by technological and policy developments, will continue in the future. By the time the next millennium comes, the activities of an overwhelming proportion of economic agents will have an important international component.

This internationalization of economic activities brings with it major implications for the countries' tax systems. The earlier chapters of this study have shown that various pressures have been developing among countries as a result of particular aspects of taxation. In particular, the degrees of freedom, in the choice of the preferred tax system and the desired tax rates, that a country once enjoyed have been reduced and will be reduced further in the future. This reduction is likely to be more important for small than for large countries, but it will affect all countries. In a world in which many economic activities are conducted on a worldwide scale, or at least on a scale that transcends national borders, these trends, if they continue to coexist with differences among the tax systems of individual countries, will:

—Generate greater inefficiencies in the allocation of the world's capital because the allocation of capital will be significantly driven by tax considerations rather than by just rates of return before taxes and because the elasticity of the supply of capital for individual countries will be higher.

—Have implications for the effective progressivity of the tax systems if factors that are highly taxed in some countries, especially financial capital and highly skilled labor, can move to countries that impose lower taxes. Countries will pay a higher price than in the past if they impose effective marginal tax rates that are significantly higher than other countries. This is more likely to happen for factors residing in small countries than in large countries because the options available will be greater for the former.

—Affect the average tax level of some countries by forcing them to lower the tax rates for particular taxes unless they can increase taxes on inelastic bases; and more generally.

—Constrain the countries' policymakers in their choice of tax structures and tax levels.

Tax competition from other countries may force some countries into choosing tax structures (and, perhaps, tax levels) that their policymakers might consider less desirable than the ones they would have chosen if their economies had remained closed. In Europe, this effect has been given the not very complimentary name of tax (fiscal) degradation, although one should not infer from that name that the new systems are necessarily less efficient than the ones that would have been chosen in the absence of competition. Advocates of tax competition have argued that by forcing a reduction in marginal tax rates, competition will make the tax systems less distortionary and thus more efficient and will balance the policymakers' tendency to expand the size of the public sector and the level of tax rates beyond their economically justifiable limits. However, tax competition does not take place only through the lowering of the tax rates, even though this is the aspect of the issue that has attracted much attention in academic discussions. Tax competition may come mainly from changes or distortions in the tax bases that are less visible and more difficult to assess.

Tax competition will also provide incentives to some countries, and especially to some small countries, to become low-tax countries or even tax havens. If they can benefit by attracting large amounts of

financial capital and by taxing it at low rates, they can increase their tax revenue without imposing higher burdens on their own citizens. Some countries may even attempt to attract consumers from other and especially neighboring countries by maintaining low excise taxes on particular products. This is another form of tax exporting.

A potentially disturbing feature of recent tax developments is the conflict that they are creating between traditional tax principles, which, as it will be recalled, were developed largely at a time when economies were relatively closed and thus economic activities were predominantly domestic, and the tax systems that will be feasible in a world in which economic activities become more and more international. Before discussing this aspect, it is worthwhile to mention that unlike other areas of economic activities, say, trade where the principle of free trade is widely if not universally accepted, the principles that have guided taxation have had far less support.

There was a time when most individuals earned income from only *one domestic* source and most enterprises operated within only one jurisdiction. As economies developed, an increasing number of individuals came to earn income from more than one source, although these were still largely domestic sources. The concept of "global" income tax was developed at this time and became a guiding principle for personal income taxation especially in Anglo-Saxon countries. The global income tax requires the aggregation into a total, or global, income of all the component income sources that an individual receives (wages, interest, dividends, profits, capital gains, gains from gambling, pensions). This total is then taxed with a rate structure that, in theory at least, makes no distinction among its components. Global income taxation thus requires that the tax authorities must have the capacity to verify whether the income declared by an individual, in countries where self-declaration is the norm, is effectively the total of all the components. In countries where there is no self-declaration on the part of the taxpayers, the tax authorities must themselves be able to aggregate the total income of the taxpayers. In part, as a consequence of the inability on the part of the tax authorities to perform this task, many countries, and not just developing countries, continue to use schedular systems in which each category of income is taxed separately, or at least they continue to have schedular features with respect to particular incomes (such as interest income or dividend income on wages, which are taxed with final withholding rates).

In recent years, the total or global income of an increasing number of individuals has been made up of not only various domestic sources but also of incomes derived from foreign sources. This raises the question of whether the tax administration of the country in which the taxpayer resides has the capacity and the means to verify the declaration of the taxpayers who have naturally a strong incentive not to report or to underreport especially the incomes earned abroad. The existence of tax havens with banking secrecy laws and an interest in attracting foreign capital on the part of many countries not technically classified as tax havens point to the possibility that many foreign incomes may end up escaping taxes in the country of residence of the recipients of the incomes. For example, much of the flight capital of the 1970s and early 1980s never paid income taxes to the countries in which its owners resided.

If the residence principle were strictly followed for all income and *if* information on taxpayers' incomes could be obtained by all tax authorities and exchanged efficiently and without restrictions, then global income taxation, with rates independently set by each country, would have a sure future. In this case, capital export neutrality would prevail because investors would be concerned only about the tax rates in the country in which they reside and, at most, they would engage in the drastic act of emigrating to lower-tax countries. However, this is not the case. The existence of tax haven countries that do not have an interest in sharing information with the countries from which they attract capital, and of banking secrecy laws in other countries, makes other countries unwilling to abide by this principle so that the latter impose taxes at source. Furthermore, the substantial legal, political, and technical limitations that exist on the exchange of information, even among non–tax haven countries, imply that it would be unrealistic to assume that the exchange of information can be the simple and only solution to the problems created by the developments described previously.

In recent years, there has been a growing intolerance on the part of some countries, and especially of the United States, toward tax evasion. Therefore, one can expect that political pressures will stimulate at least some countries to make greater efforts than in the past at limiting tax evasion by those who operate in their countries (both residents and nonresidents) and by their citizens when they operate outside their countries. They will urge or occasionally push other

countries to cooperate in this effort. As with the fight against money laundering, the close cooperation by the G-7 countries and by other industrial countries can help promote this objective. In particular cases, some countries will expand their collaboration through the joint auditing of particular taxpayers. In some other cases, countries may even agree on the presence of foreign tax officials in their territory.

Still, all these actions, although worthwhile, are not likely to be very successful as long as there are sovereign countries or areas that benefit greatly from setting themselves up as low-tax jurisdictions at least for some forms of income. These countries will thus continue to attract (especially) financial capital that will be rechanneled to countries with large productive capacities and from which it can get a high rate of return. The income earned on these investments will then be channeled back to the tax haven countries. A tax address in one of these tax havens would thus allow some individuals to evade paying taxes in the countries in which they effectively reside. There is evidence of intensified competition among tax haven countries in providing tax advantages to those who invest in them. This competition may largely neutralize the effects of the intensified campaign against tax evasion.

It may be worthwhile to restate here a point made in an earlier chapter. The tax haven countries are often too small as real economies to significantly affect the world allocation of, and thus the return to, real investment. Often, they attract financial capital from some countries to invest it in other countries, or they provide a convenient address for receiving income earned from foreign sources. As long as the capital attracted by the tax havens and by the low-tax jurisdictions is not actually invested in them, the world allocation of real investments does not change and the world rate of return (before tax) to that capital does not fall. Of course, the allocation of taxable income does change so that some countries lose while others gain. However, the existence of tax havens tends to lower the world level of taxation. It is a different story when countries with large real economies lower their tax rates. In this case, the move of *financial* capital toward those countries is often followed by a move of *real resources,* thus leading to a potential misallocation of resources and a fall in the (before-tax) rate of return to capital if the additional investment in the low-tax country is strictly tax-induced.

No sim[illegible] solution exists for this problem. However, if the attempts to reduce tax evasion through cooperative actions fails, it will

progressively lead to a de facto second-best solution if countries abandon the concept of the global income tax and the residence principle and introduce schedular elements for at least some income (such as dividends and interests). These incomes would end up being taxed at source with final withholding flat rates, which would not discriminate between domestic and foreign taxpayers.

If this happens, the link between the taxpayers' global income and the tax that they pay would be broken. Some may see the breaking of this link as leading to a tax system that, in principle at least, would be less equitable or fair than the taxation of global income with progressive rates. However, in reality such a system would reduce the tax advantage enjoyed by those who channel their financial investments through low-tax or tax haven countries. In this case, the incomes paid to the tax haven countries would have taxes withheld on them, and the advantage of channeling investments through these countries would be reduced or even eliminated.

A shift from the residence to the source principle would, of course, have large allocative costs if the tax rates at which the taxes on incomes were withheld varied substantially from country to country. In this case, the international playing field could become quite bumpy, and capital export neutrality would be violated. If the taxes withheld at source became final taxes, then capital would tend to flow to the areas with the lowest tax rates, which might not necessarily have the highest before-tax rates of return. Some would argue that competition would tend to equalize the rates so that the efficiency costs associated with rate differences would be reduced or even eliminated. However, competition might tend to equalize the rates at too low a level, implying significant revenue losses for particular countries and the inability of these countries to sustain their level of public spending. Competition might also distort the tax bases, as explained in the previous chapter.

Economists have often argued that in a world with mobile capital, labor, particularly unskilled labor, will have to bear a greater tax burden because it is a less mobile factor of production than capital. Although the economics of this conclusion may be right, the politics of it is surely worrisome. It is difficult to conceive of a democratic society in which workers agree to be highly taxed while those who receive capital incomes are, even statutorily, taxed at low rates. The world just does not operate this way. In reality, the real incidence of the capital taxes might fall on labor if the statutory taxes on capital

lead to the exodus of capital and thus to a fall in real wages. But this conclusion is not likely to impress politicians and to determine political decisions.

For enterprises, similar concerns arise. Many enterprises now operate on an international scale, with branches and subsidiaries in different countries. Some of these branches and subsidiaries may have been established keeping in mind the tax factors. Decisions by companies on where to locate and even on where to establish their headquarters or to raise their capital are now heavily influenced by tax factors and are likely to be even more influenced in the future.

For an enterprise with multinational activities, a big problem arises from the need to allocate its world, or global, income among the countries in which the enterprise operates. This problem has been increasing in importance, and given current and future likely developments, it is realistic to assume that its importance will continue to grow. This problem is particularly significant because, for enterprise income, countries have often relied on the source principle. The transfer prices used to do the allocation have often been challenged by the tax authorities of particular countries. And the concept of transfer prices to do the allocation has been challenged by various American states. Multinationals have been forced to hire an army of tax lawyers, accountants, and economists to defend the particular transfer prices they use. In some cases, advance pricing agreements have been negotiated to forestall future litigation. This has been the case between the United States and Australia with respect to Apple Computers.

The arm's length criterion for establishing acceptable transfer prices has often proved ambiguous or not very helpful. It may not be too far-fetched to predict that in a technologically evolving world, the allocation of income by the use of transfer prices may be subject to increasing challenges and may thus become progressively more controversial. Other allocation principles based on formulas may acquire more legitimacy than now. In the meantime, the conflict between the currently used principle of using transfer prices (based on arm's length) and the practical difficulty of determining objective transfer prices is likely to create the kind of frictions that came to a head in California and that led to the use of unitary taxation that is a formula-based allocation of profits. It should be recalled that the allocation of income of U.S. enterprises that operate in many states within the United States is done by formula and not by the use of transfer prices.

This discussion highlights the possibility that the world playing field may become less even and the need to promote more evenness. This, in turn, raises the issue of whether harmonization of rates might be brought about politically, either by agreement among the countries or by moral suasion on the part of some influential political institution.

Tax harmonization has proved very difficult for capital incomes even within the European Community. Various proposals for harmonizing the treatment of withholding taxes on saving, for example, have so far not been successful, but work is continuing within the Commission. For the Community, the lack of success so far has come despite the driving force provided by the work of the Commission.

For the world at large, there is so far no international institution that provides a kind of "surveillance" function over the developments in tax systems. There is thus no institution comparable to, say, the General Agreement on Tariffs and Trade or the new World Trade Organization for trade issues, or comparable to the International Monetary Fund for general macroeconomic issues, despite the fact that tax matters may become as important in relations among countries as trade matters. In fact, in some areas taxes may replace tariffs as instruments for manipulating trade for promoting the movements of factors of production.

For Organization for Economic Cooperation and Development (OECD) countries, the Committee for Fiscal Affairs provides a useful informative role, but that role falls short of what it needs to be on a worldwide scale (because only OECD countries are members) and on a political scale (because the role of the Committee is largely the diffusion of tax information and the discussion of technical issues). For European Union countries, the Commission provides more of the kind of political role that a world institution would need to play in taxation. There is no world institution with the responsibility to establish desirable rules for taxation and with enough clout to induce countries to follow those rules. Perhaps the time has come to establish one.