Strengths and weaknesses of this new global tax regime

Introduction:

In this assignment an attempt is made to define ” international tax competition’ and examine the strengths and weaknesses of this new global tax regime. The various economies are being integrated into a single unit through globalization. The basic reasons behind these integration are increasing investment and trade flows, greater labor mobility, and enhanced technological transfers. A boost to this trend is given by free operation of financial markets, contraction of trade and investment barriers and decreased costs of interactions and travel.

Since the evolvement of states in 19th century, the progressive income taxation has been a major source of revenue for the modern state. The income tax is not alike its counterparts consumption and social security taxes. In a state the upper rich class saves higher than the lower income groups, a tax structure in which income from investment is included at the base is more progressive[1]than a tax which does not include investment from capital for e. g. a consumption tax or a payroll tax. In spite of this fact, the ability of a modern state to generate income tax is reduced to a great extent when the capital is transferred to tax free jurisdictions. The efficient use of withholding taxation by developed nations, and growth in number of production tax havens in developing nations are the two major developments that have boosted the opportunities for individuals and businesses to gain profits abroad without paying any tax.

The new environment is unable to inhibit high tax rates. Because of economic integration, corporations and individuals are free to avail of foreign economic opportunities. This leads to enhanced importance of taxation in decisions regarding investment and location. As a consequence, towering tax charge lead to big financial losses which force countries to decrease tax rates. Capital and labor mobility have further enhanced international tax competition. Several tax reforms have been introduced in most of the countries in order to be economically competitive for investment. Tax rates are reduced by several governments in order to deal with increased labor and capital mobility. The 30 major countries of the OECD have witnessed a sharp decline in the average top personal income tax rate from 67% in 1980 to 47% by 2000. The average corporate tax rate in the OECD also declined from 38% in 1996 to 31% by 2002[2].

A major role is being played by tax competition in changing the structure of corporate tax systems abroad-including the decreasing trend in corporate tax rates and the trend toward territorial tax systems. Because of enhanced capital mobility, the only source of attracting investment is through differences in corporate tax systems. This increasing international mobility of capital is being seen as an advantage by many countries.

Capital Mobility

The past few decades have witnessed a strong integration of world economies. Technological advancement and liberalization have led to a rapid increase in foreign investments which is a key aspect of integration. The years since 1970’s have seen decreased or absence of regulation of foreign currency exchanges, investment in foreign securities, as well as increased foreign investment in home countries. In order to decrease investment barriers, several bilateral investment treaties have been signed.

Deregulation of financial markets has taken place in several nations so as to attract foreign investment.

The economic framework of an economy needs to be worked out so as to attract foreign investment. It requires a stable currency free from frequent fluctuations, sound set of legal rules and transparent financial market with adequate liquidity. Capitalist nations have made several reforms and even socialist countries are on the same path. Thus, tax policy has now become a key factor which influences capital transfer worldwide. It means other factors being same in all nations, investors pay increased attention to varying tax rates while making decisions.

Tax factors have gained significant importance in deciding about the location of businesses. In the past, the major reason behind any foreign investment was to get control of fixed resources, such as oil deposits. But now almost all industries can be located anywhere. In addition, a major portion of product value is covered by intangibles like knowledge, trademarks and patents. The gains arising from intangibles are conveniently transferable to countries with low tax structure. Thus, it is now easier for businesses to transfer their funds to low-tax locations than previously.

Labor Mobility

Both mobile labor and mobile capital pave way for generation of international tax competition. It is clearly evident in case of highly skilled labor in technical and financial industries. International migration is primarily effected by family reunification but other causes are boost in navigation for service and economic factors. The basic reason behind migration is differences in personal taxation from one nation to other. It is a motivating factor primarily for high income earners since the majority of the nations have progressive income tax rate structures. The other things which have enhanced the significance of taxes in global movement are:

To start with, Internet has opened information gateways regarding global opportunities available as well as has widened the scope for job searches.

Second, the reduced costs of transportation and communication have provided workers with the ease to work abroad and stay in touch with their family.

Third, emigration barriers in several nations have been waved off.

Next, technical advancements have augmented the capacity to work from a remote location and even another country.

Fifth, regional trading pacts have led to enhanced labor migration.

Lastly immigration limits for highly skilled workers have been raised by many nations.

Advantages of International Tax Competition: Global tax reduction

The increase in labor and capital mobility is welcomed by many governments through tax rate cutting. In the main 30 nations of OECD, the average top personal income tax rate came down from 67% in 1980 to 47% by 2000[3]. The average corporate tax rate in the OECD declined from 38% in 1996 to 31% by 2002.

There has been a reduction in capital gains taxes in several countries. For example, Canada and Germany permitted individuals not to include 50% of their profits in taxation, thus decreasing the rate of capital gains tax by 50%[4]. The capital gains rate in the U. S. persists around 20% as compared to nil rate of individual capital gains tax in Austria, Belgium, the Czech Republic, Germany, Greece the Netherlands and Switzerland[5]. Lowering of capital gains rates is of prime concern as new firms depend on private equity from " angel" investors and others who fund risky companies. These investors gain their return from a huge capital gain on the initial projects.

Increasing tax competition has lead to tax cuts. But, few governments have followed less efficient policies making their tax codes weak. Basically, complex tax rules have been brought to force by some nations on global operations to limit them from restructuring abroad. One of the most difficult set of tax rules in the whole world is The U. S. tax rules on international businesses. The issue of American companies becoming less competitive because of Federal tax rules is gaining increased concern.

According to the rules, American firms are forced to give U. S. taxes on their global businesses vis-à-vis their counterparts who are not required to pay in same cases. More than 50% of OECD countries adopt " territorial" tax systems which do not compel firms to pay taxes on their international businesses. On the contrary, the U. S. firms are forced to pay taxes on their worldwide income which reduces their competitiveness in international markets. There is an increasing number of extinguishing figure and decreasing size of U. S. firms because the U. S. is not an appropriate tax location for MNC's.

The need for tax reforms is again necessitated by the latest threats by firms like Stanley Works to reincorporate abroad. The reason behind is higher corporate tax rate in U. S. as compared to other nations and complexity of the tax code. There is a need to reform the tax structure on the part of policymakers.

Tiebout's Theory

In 1956, economist Charles Tiebout observed the provision of services by local governments. He examined that there is an overall welfare of the country as a result of competition among local governments for mobile residents. The governments were required to adapt expenditure and tax rates to meet local requirements and reduce mobility of residents. The jurisdictions were chosen by individuals on the basis of pubic goods relative to local tax levels. For instance, residents that desire well-financed public schools may choose to reside in nations with higher property taxes. Other people may chose some other areas with lower taxes and more-limited government services.

The competition amongst governments is similar to market competition for goods and services. Product efficiency is enhanced by market competition. Similarly, government efficiency is increased by tax competition. And due to global integration, tax competition among governments of various countries is quite familiar with the competition among local governments.

There are many economic benefits arising from lowering of tax-rate which indicate that tax competition is not a win-win situation for a specific nation or the entire world. When an economy goes for a better tax system so as to enhance growth, it is followed by other countries which subsequently results in increase in global investment and production. For instance, the round of income tax reductions following American tax reforms in 1986. In the pursuit to achieve own goals, in the long run all economies end up better off.

The tax competition is supposed to provide “ global welfare” -the cost of which is based on the way tax variances change the share of countries in an hypothetical permanent sum of capital. But economies having income tax rates have to undergo more serious welfare costs.

“ Dead-weight losses” are a result of high marginal income tax rates. These losses are more than directly proportional to increase in tax rates, therefore, even a small decrease in tax rates lead to huge economic benefits. Capital taxes which are inefficient are curbed away by tax competition thus paving way for increased investment and global economic growth.

Drawbacks

The presence of so many advantages does not necessitate that international tax competition is free from side effects. Firstly, it destroys the tax neutrality and disrupts the movement of global resources. In case of world being considered as a global unit, tax competition reduces the harmful effects of taxes on global economic action. But from the point of view of an individual country, tax preferential areas are benefited by tax competition by flow of capital to lower tax burden nations thereby negatively affecting the geographically-mobile activities of global resources. Secondly, it affects the tax structure of other nations. The basic aim of tax competition is to benefit the industry of its own country whereby the investors’ decision of location for investment is affected by the preferential tax regimes. Thus, various industries and capital will switch from high tax burden country to a lower tax burden country. In this race of lowering tax burdens amongst countries, the global tax base will be hampered, thus weakening the global financial function, and will lead to production of less public goods causing non-satisfaction of public needs. In the end, it will lead to weakening of tax sovereign of all countries. Every state need funds to function and taxes are the primary source of such funding. Moreover the developing countries are in a greater need of such income generated by tax. In fact, the increase in dependency ratios[6]will be seen in all countries of the world, as there is decline in fertility rates and improvement in health care. This further strengthens the need to an efficient direct income taxation system to generate the desired revenue to meet the needs of this growing population. Therefore lesser public benefits are availed due to reduced tax revenue and it becomes difficult to reallocate goods and services and redistribute wealth. Third disadvantage is the increase in the cost of tax. In order to protect its tax system from poaching, every country will take actions. In addition, an international information network is required to be set up to ensure appropriate taxation and avoidance of duplicacy of taxation. But it will result in complicated tax system which will increase the cost of tax.

This tax competition resembles a race toward the bottom in which one country provides preferential tax terms in order to attract foreign investment and is ousted by some other country which provides better tax terms for the same investment. In order to compete, the first country offers a even more generous tax treatment and so on. This continues till the incentive to attract the investment becomes nil. There might develop a situation where such country could suffer a loss by permitting the foreign investor to avail benefits without any cost from the country's infrastructure. If this happens the competitive tax rates would exploit the host country rather than promoting growth.

The states offering tax competition often lack transparency. The inexistence of transparency in the administration of a jurisdiction makes it difficult for the home nation to adhere to preventive actions. The following conditions need to be satisfied in order to make administrative policies' operation transparent:

First, clear cut conditions regarding applicability to tax payers must be set forth so that these conditions may be invoked against the authorities;

Second, tax authorities of concerned nations must be provided with details of the jurisdiction, including any applications thereof in the case of a specific taxpayer. The areas not satisfying this condition increase harmful tax competition as they offer their beneficiaries freedom to negotiate with the tax officials thus resulting in differential treatment of taxpayers in similar cases.

The inexistence of exchange of information between the host country and the tax heaven country of ten leads to negative impacts. The potential of a regime to cause harmful effects is judged by the capability or readiness of a nation to transmit data to other countries. A country might be reserve in exchanging information due to secrecy laws which restrains tax officials to receive data from other countries regarding tax payers operating and benefiting from a preferential tax regime. Also, in cases where secrecy laws do not exist, administrative policies or practices restrain information exchange.

Conclusion

This tax competition trouble is basically a matter of cooperation and faith. Foreign tax investors will be a temptation for each jurisdiction but it will be afraid of losing investors to other regimes that are tax free for them. The existence of coordination of actions amongst several jurisdictions will facilitate mutual gain for all without any risk of investment loss.

The solution to this problem lies in establishment of an organization such as OECD which attacks it on a broad multilateral basis. The present situations necessitate the creation of OECD to coordinate actions against tax competition basically for 3 reasons. To start with, individual investors are required to invest in an OECD member country in order to earn adequate returns on their capital with lesser risks. Ample investment opportunities are not provided by Tax havens, and portfolio investment is not suitable for developing countries as they are quite risky. Therefore, enforcement of taxation of portfolio investment by all OECD members will eliminate the need of cooperation from tax havens.

Second, OECD member countries witness a concentration of about 85% of the world's MNCs. This trend is likely to continue because of presence of established commercial and securities law protection to investors in OECD member nations which is not seen in other countries. Thus, the major part of tax competition problem might be solved by a resolution and agreement amongst OECD members to tax their MNC’s presently on their revenues from foreign operations.

Third, the required expertise is inherited by OECD (its model tax treaty is the global standard) and it is on its way of decreasing tax competition. In 1998, it adopted a report entitled Harmful Tax Competition: An Emerging Global Issue (OECD, 1998). The scope of this report is restricted to tax competition for financial activities and services (as opposed to, e. g., Intel’s manufacturing plants). The taxation of investment income is not under its scope. But it is an very constructive step, and an evidence that an agreement can be sought on the tax competition issue (Luxembourg and Switzerland abstained, but did not dare veto the adoption of the report by the other 27 members of OECD).

OECD has drawn a clear line of difference amid tax competition in the shape of normally applicable lower tax rates, and tax regimes specially established to attract global investors. Curbing tax competition does not signify the loss of rights of electorates in self-governing nations to find out the size of the public sector through general tax increases or reductions. Instead it indicates that economies should not offer facilities at the cost of other economies to foreign investors which their countries can provide. These limitations become appropriate because the investors residing in nations which provide several services which accrue because of taxes and yet they refuse to pay these taxes.

A major drawback of dependence on OECD for tax competition problem solution is that developing nations are ignored and they may feel that their interests are curbed for the interests of rich nations. In fact, as citied above, it is not likely that tax competition reimburses developing nations, which can also use the tax income they sacrifice to draw global investors. There can be a mutual gain for all developing nations if they are restricted from competing against each other. But a long run measure to this problem is to handle over it to WTO where developing countries have adequate representation. It will also give a solution to the problem of rest 15% of multinationals which are not concentrated in OECD member countries (this number is likely to increase if OECD restricts tax competition for its MNCs).

The countries either unilaterally or by bilateral tax treaties are no longer eligible to set tax rules and the consequence of liberalization and tax competition. In a global economy, where capital is fully mobile and investors and multinationals are offered with various investment opportunities and locations, the monopoly of any nation (or any two countries together) to tax is no longer appropriate. Other countries will react aggressively in the same fashion to curb any such unilateral attempt. Such action might not be even carried out for the sake of preserving national competitiveness. Thus, in order to protect the basic objectives of taxation or other regulation, multilateral solution is a prerequisite. Private market actions that cover the world can only be controlled or taxed by institutions with a related international reach.

Restrictions on Tax Competition: A Threat to Economic Freedom Layering Tax Rules on Foreign Business Investment

Various approaches have been followed by different countries for the International tax competition. A general trend that is observed depicts that most of the countries have cut the tax rates, when it comes to personal as well as corporate income. But still there remains a lot of exceptions as a lot of countries have implemented complex tax rates on majority of the multinational firms. The major reason behind these complex tax rates is to prevent corporations from leveraging on the minimal tax rates that are offered by various other countries. Due to this defensive policy, the international tax competition is clamped down. This results in the delaying of the much needed transformations in the not so efficient corporate tax system.

There is a very complicated set of the tax incentives as well as disincentives on every international investment that is being made by the multinational corporations. This may result in differences in the tax climate in a number of ways, which includes, moving from one location to other, changing the debt to equity structure of subsidiaries, varying the policies related to subsidiary dividend, or using “ transfer pricing”. This is mainly done so as to enjoy the shifting profit which they get from shifting from a country with higher tax rates to a country with lower taxes.

Around 50% of OECD members, including the United States, tax businesses for their foreign operations. For instance, a permanent citizen of the United States who has some stocks in a UK oriented firm or an American firm that has some of its production plants in Germany, is liable to report his income from global operations on a US tax return. Many other nations which are the part of OECD have “ territorial” corporations-tax systems. In these systems the income of an individual from foreign sources is not taxable.

Non-taxation of commercial profits earned through foreign operations in majority-owned subsidiaries by home governments until repatriated poses an important limiting factor.

But, rules are being framed by the governments regarding limiting the skill of businesses to suspend tax on subsidiary earnings. For instance, the United States’ “ subpart F” anti-deferral rules taxes the income when earned by a subsidiary, like dividends and interest. For instance, if an American manufacturing subsidiary in Ireland earned profits which were invested in British equities, those investment revenues would be taxed in the United States’ “ Subpart F” rules also immediately tax foreign income from “ base-company” sales and services, that is, sales into third countries from certain American foreign subsidiaries. For instance, gains from export sales to Germany from an American-owed Swiss subsidiary may be immediately taxable in the United States. In total there is a set of six overlapping anti-deferral regimes which form a complicated trap of rules for foreign investors.

The United States is being followed by other countries. For example, the tax base became vulnerable after abolishment of exchange controls in 1979 by Britain. This situation was tackled by introduction of decrease in business and personal tax rates but anti-deferral legislation was enacted by Britain in 1984. In a similar fashion, tax rates have been cut and new tax rules on foreign income being incorporated as Germany opened its borders. There persists a high rate of corporate tax in Germany and German establishments are very clever in decreasing their income to be taxed. The corporate tax rate was brought down from 60% in the early 1990s to 38% by 2002 by the German government. The title of a 1994 tax cut law denotes the burden from tax competition Germany experienced: “ Law to Secure the Competitiveness of Germany as a Location for Enterprises in a Common Market”. In order to reduce the outgoing of investment to low-tax structured nations, anti-deferral rules were introduced by the government.

There is an urge by the OECD for the adoption of anti-deferral rules. Increase in number of these rules has resulted in decreasing global tax competition by restraining firms the advantages of investing in nations having low-tax structures. Moreover, this protective approach to globalization leads to huge cost in tax complication and ineffectiveness: one research concluded that, for the 500 largest American companies, rules pertaining to foreign income costs around 46% of the costs of complying with federal tax law.

In contrast, there are some countries which have kept themselves apart from this aggressive intensifying taxation strategy of international revenues. The Netherlands, as discussed, is very suitable for corporate location. The government of the Netherlands considers absence of anti-deferral (or “ CFC”) rules as a significant benefit.

Among the few nations in Europe not having Controlled Foreign Company (CFC) rules is Netherlands. The prohibition of the utilization of low tax locations and other tax planning ideas is the basic aim of CFC rules. The very nature of CFC rules contains over-killing elements and restriction of establishment of a tax efficient group structure. This necessitates the existence of a holding location free from CFC rules.

The placement of complicated tax rules on global investment can backfire as firms have the option of restructuring abroad. The US Treasury of late earmarked that there has been a phenomenal growth in the figure and size of American companies that are moving to other nations because the United States provides an unpleasant system for taxing MNCs. This was highlighted by the 1998 Daimler-Chrysler merger, which established the merged firm's headquarters in Germany, in part for tax reasons. In the past, cross-border mergers were rare but the last decade has witnessed a phenomenal increase in this number and value. This has lead to increase in tax competition through foreign reincorporations. Consequently, low-rate, consumption based tax systems are required to be implemented by the governments so as to motivate companies not to evade taxes in the more and more integrated economy.

Curbing Tax Competition through an International Tax Cartel

The release of the OECD's 1998 report on " harmful tax competition" has become a controversial issue because of the report's wide sweep and aggressive stance. The follow up of reports by OECD in 2000 and 2001 led to identification of " harmful" tax practices by OECD member nations and listing of 41 jurisdictions as tax havens.

The ambitious plans of the OECD regarding construction of an international cartel to wave off tax competition has been curtailed by The Bush administration. In the US House of Representatives, majority leader Dick Armey has argued that the United States should not support " a global network of tax police" and that it is biased on the part of large wealthy nations to frighten small countries, to alter successful economic policies.

The main concentration is being laid on indirect measures to wave off tax competition. The OECD is attempting to gain agreement between offshore financial centers, or tax havens regarding transfer of data about taxpayers. The basic features of offshore financial centers are low-tax climates and elevated levels of financial privacy. These factors put at the helm of the commercial victory of these regimes. Transparency in tax systems and negotiated extraordinary rates of taxation are some other demands.

However, Countries having limited natural resources can opt for the strategy of attracting financial services in order to build a growing economy. Moreover, endangered approvals are considered as breaches of global law and violations of their sovereignty by targeted nations. They oppose the biasness of the whole process, throwing light on the fact that many nations of the OECD also have " harmful" tax rules that are not yet changed or reformed. In spite of this fact, deals have been conducted leading to some changes in their laws by some targeted jurisdictions so as to save themselves from attacks of OECD members.

Now, The UNO has also joined the mission of curbing international tax competition. A high-level UN panel last year recommended the establishment of an International Tax Organization (ITO) that would frame norms for tax policy, involve in look out of tax systems, and insist nations to discontinue harmful tax competition. This organisation would likely have a strong bias toward tax increases. An international source of funds is recommended to be formed by The UN report through high yielding tax source. It also recommends study of a " Tobin tax" on foreign-exchange transactions to finance " global public goods". And, it says that an ITO " could take a lead role in restraining the tax competition designed to attract multinationals".

The common thinking is that ITO will be more like the World Trade Organization, which settles business disputes. There is a unanimous consensus amongst economists regarding free trade; on the contrary, the tax world has no such unanimity. There are wide differences in conclusions being arrived regarding the working of ITO made by followers of broad-based income taxes and followers of consumption-based taxes.

In fact, high-rate broad-based income tax systems are being supported by tax competition critics. The OECD says that nations should remain free to frame their own tax systems as long as they abide by globally accepted standards. The consumption-based tax system favorers need to be on the look out that the OECD or other international bodies do not create such global " standards" that provide high-rate income taxes and prevent pro-growth, consumption-based tax reforms.

Responding to Tax Competition with Consumption-Based Tax Reforms

The past few years have seen a shift in the interest from individual and corporate income taxes to consumption-based tax systems. There have been proposals which include retail sales tax systems and a consumption-based " flat tax" based on the design of Robert Hall and Alvin Rabushka of the Hoover Institution. The benefits of consumption based tax reform are a fine domestic tax policy and an optimistic approach for nations to fight increasing global tax competition.

These consumption-based tax reforms are expected to lead to increased investment and economic growth and subsequently make easier tax systems. Consumption-based taxes would be regional and would not include taxation of international economic activity, thus curbing many global tax rules. This type of tax would prompt corporations to compete in international markets without thinking of tax burdens being imposed by governments in the home country.

A much lower rate is required than the existing top marginal income tax rates by the consumption based tax in order to substitute the presently generated incomes by corporate and individual income taxes. The requirement of complex defensive tax measures, such as anti-deferral rules, that governments are taking will be greatly reduced by this single factor. Also, tax evasion and avoidance behavior by individuals and corporations will be reduced because of lower marginal tax rates and an easier consumption tax base.

The adoption of consumption-based systems would make economies more lucrative places for capital investment. The pursuance of these reforms by major nations will make these reforms lucrative for other nations as well. The worldwide reduction of tax rates on capital income would lead to reduction in economic distortions. Lower marginal tax rates wi