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Tax co-ordination: crossing the Rubicon?

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1. Introduction

When Caesar crossed the Rubicon river, he created an irreversible political fact. Without Senate approval, he set out to subject Gaul. His choice was a digital one: either you cross the Rubicon, or you don't. International co-ordination of tax rates and bases is much like crossing the Rubicon: either you lose national fiscal sovereignty, or you don't. But choices are not necessarily digital. Caesar's account of his Gaulic War commences with a concise statement: Gallia omnia divisa est in partes tres (Gallia consists of three parts). Usually, this is taken to be a geographic insight. However, it can also reflect a more philosophical position. Besides 'yes' and 'no' there is always a third way: 'to some extent'. We may not note that we cross the Rubicon and yet, one day, be in Gaul.

In this contribution, we take a closer look at the process of international tax co-ordination which has gained momentum over the last few years. In this process, different areas have been discussed, such as corporate income taxation, taxation of savings, taxation of e-commerce, and measures against tax havens. Considerable progress has been made both in terms of subjects discussed and intensity of discussions. On the other hand, discussion results are rarely appealing to the general public. For those who were used to think of tax co-ordination in terms of minimum tax rates and tax bases, it may even be disappointing to get peer reviews and blacklists instead. For a sceptic observer, an EU Council or OECD meeting on tax issues must necessarily produce some result; and if significant results cannot be achieved, the best way out is to appoint some committees and working parties, and agree on a schedule of further discussions. Nevertheless, it is obvious that EU and OECD countries are trying to maintain an international tax order under growing pressures of globalisation.
A sceptical attitude may also be deceptive because an interesting re-orientation is indeed taking place. International discussions are moving away from minimum tax rates to administrative procedures. This affects countries' operational independence - their discretion in applying tax rules (McLure 1992, Cnossen 1996). The most notable examples are to be found in EU policies. This is only logical because the OECD was never a platform to discuss minimum rates (instead, the OECD Model Tax Treaty is based on the ideal of home state taxation, with limited withholding and source state taxes). But where tax havens are

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concerned, the OECD has made considerable progress, which includes increased attention for exchange of financial information and transparency of tax administration.
In our contribution, we offer some thoughts on this new approach of tax co-ordination. As we touch upon many related issues, we do not try to be conclusive.
We argue that operational independence is vital to national tax sovereignty but also a major source of jurisdictional distortion. We then proceed by discussing some recent developments in corporate taxation (the Primarolo list), taxation of savings (EU withholding tax) and taxation of e-commerce (EC proposal to tax digital services). We end by summing up some potential shortcomings of the 'new' approach.

2. Operational independence as the basis of national tax sovereignty

The practical meaning of national tax sovereignty is not that countries are fully free to choose their own tax bases and tax rates. In fact they are tied - both by market forces and by the tax treaty network - to a limited choice of tax bases, such as taxes on general income and on commodities. For the moment, a bit tax is outside the range of internationally acceptable tax instruments, and no single national state would probably be able to move from personal income taxation to an expenditure tax, nor to replace the corporate income tax by a comprehensive business income tax. Within this limited choice of tax instruments, international mobility of resources has lead to convergence of tax rates and bases (Haufler 1998, Messere 2000).
It is evident that national tax sovereignty leaves room for uncooperative tax policies. Formally, states cannot be forced to behave co-operatively. Large states with sufficient market power can pursue tax-exportation strategies (Wilson 1999), while small states with small domestic tax bases can opt for a tax-haven status (Kanbur and Keen 1993), either across the board, or with respect to certain *niches* of international financial markets. In practice, both the network of bilateral tax treaties and unilateral anti-abuse rules generate some sticks and carrots for co-operation. In the near future, open refusal to co-operate is to be countered by multilateral retaliation. The idea of a "List of Uncooperative Tax Havens" (OECD 2000) may echo Maoist rhetoric, but there is no reason to doubt that a joint effort of OECD countries would mark the end of national tax sovereignty in this respect.
National tax sovereignty, however, is still very much alive in a more narrow sense. The epitome of national tax sovereignty is not states' freedom to enter and leave co-operative arrangements, but their ability to administer their own taxes. Administration, control and collection of taxes is essentially a conflict of interests constrained by rules - a conflict with other states, and with international taxpayers. Operational independence allows countries to pursue their own policy objectives (e.g. banking secrecy) with respect to international tax bases. Moreover, operational independence implies the possibility that countries enter co-operative arrangements and subsequently opt for a low level of enforcement. States' freedom to operate their taxes is at the heart of the issue of international tax co-ordination. It may in fact be meaningless to achieve broad international agreement on e.g. a minimum withholding tax on savings income when participating states are free to choose their own level of enforcement.
Of course, states also have reasons to share information (Bacchetta and Espinosa 1995). To some extent, there is administrative co-operation between countries. Most bilateral tax

treaties contain provisions for exchange of information and mutual assistance between treaty partners. Traditionally, this used to be a weak spot in national administrative routines - there is ample anecdotal evidence that voluminous paper files received from foreign tax administrations were put to several non-tax uses.
But over the last decade, these provisions have been used with increasing frequency. This increase may be technology-driven, as the cost of collecting and exchanging information is probably decreasing. But when we consider states as agents on a market for information (convertible into tax liability), it seems that there is no effective mechanism to confront supply and demand. Reciprocity, combined with commitment to treaty obligations, will provide some incentive for states to supply information and assistance. Demand for information is rationed by bureaucratic hurdles, and as a consequence it may take years before a request for information is answered.
Globalisation seems to require that information and assistance are exchanged on a far more regular and systematic basis. Some countries are prepared to move in that direction while other countries show no keen interest in the subject. It seems that some form of price mechanism would be useful. This could serve to maintain and strengthen co-operative incentives to the tax administrators. Apart from finding the right incentives for co-operation, attention needs to be paid to legal and technical obstacles (Tanzi 1995).

3. Distortive effects of operational independence

Operational independence is a potential source of tax distortion to internationally mobile economic agents. Of course, any state's effective tax rates are determined by both its statutory rules (tax rates and tax base definitions) and the way it applies these rules (Cnossen 1990). Low enforcement and low participation in information exchange may attract foreign investment, and actually be instruments of harmful tax competition. This is why recent EU and OECD initiatives to combat harmful tax practices stress the relevance of transparency in tax administration. At the same time, unilateral adjustment of reported transfer prices, denial of deduction for business costs, expenses and foreign losses, and application of anti-abuse rules may all come down to aggressive income imputation. This can actually increase the effective tax rate on an international taxpayer's true economic income to a level well in excess of the statutory rates of the states concerned.
Moreover, dealing with separate national tax administrations can cause additional administrative burdens, e.g. when each state requires a taxpayer's worldwide income to be reported according to its own concept of income.
And in the end, the concurrence of tax loopholes and risks of double taxation can lead to arbitrary taxation - taxpayers cannot acquire reasonable certainty as to the tax consequences of alternative economic choices.
Investors can avoid the seductions and disappointments of international taxation by staying at home. And when they do engage in international activities, they may still find it worthwhile to invest in economically wasteful tax advice and eventually in offshore activity, up to the point where the marginal cost of tax planning equals the marginal tax savings.

It is imaginable that countries' discretion in applying their tax rules can also serve to reduce tax distortions. The opaqueness of alternative arm's length transfer pricing methods applied

on a multitude of intra-firm transactions may well allow for some horse-trading between national states and large taxpayers, especially multinational enterprises. Ignoring transaction costs, every MNE would then pay a 'tailored' Lindahl-like tax: the highest amount that he is willing to pay without leaving the country. Costs related to jurisdictional distortions caused by investment in that country would automatically be taken into account (Vording 1999).
However, it seems that arm's length allocation methods are not *that* flexible; and if they were, there would still be institutional restrictions on fully negotiable taxes. Without ethical values like equal taxpayer treatment and fixed rules, a tax administration would become unmanageable and, in the end, prone to corruption. Therefore, it is inevitable that the uncoordinated co-existence of national tax administrations creates distortions which cannot fully be negotiated 'away', opening opportunities for tax planning and risks of double taxation for real investment alike.
It should be noted that while national welfare maximisation is an important underlying cause of jurisdictional distortion, it may not be the only one.
Even with fully harmonised tax rates and income definitions, jurisdictional distortion could still exist because the application of tax base assignment rules is to some extent arbitrary. The allocation of an international taxpayer's income, losses, expenses etc. is a potential source of disagreement between the taxpayer and the states involved, and several parties may develop reasonable, but conflicting, solutions. This problem is known as regional arbitrariness, and to reduce tax planning opportunities, states respond to it by imposing additional administrative and reporting requirements on taxpayers.
A final cause of jurisdictional distortion is different quality of national tax administrations, both in terms of legal and technical skills and with respect to transparency, reliability, and (ab)use of powers.

4. Some recent developments in tax co-ordination

a. Corporate income taxation

Twenty years ago, a draft Directive on corporate taxation proposed a EU-wide minimum tax rate of 45%. Less than ten years ago, the Ruding Committee proposed a 30% minimum. Had the first proposal ever been accepted, it would have taken a unanimous vote in the European Council to accept the second proposal. In fact, no minimum rate was ever agreed upon. In the meantime, a considerable spontaneous convergence of tax rates and tax bases has taken place in Europe without degrading into anything like a tax race to the bottom. Countries have responded to increasing international tax planning by reducing statutory tax rates. But at the same time, they reduced investment tax incentives, and as a result, it seems that effective tax rates nor tax revenues have changed much over the last decades (Haufler 1998).
Instead, attention has been shifted towards the fringes of corporate tax systems like tax expenditures and administrative routines that benefit specific domestic sectors or specific groups of mobile foreign investors. These have recently been reviewed by the Primarolo working party, following the Code of Conduct on Business Taxation accepted by the European Council in 1997. In this procedure, EU Member States have made no attempt to achieve an overall definition of minimum tax base. Instead, they have set out to identify and

eliminate only the most evidently harmful tax practices while at the same time respecting each Member State's tax sovereignty.
The resulting list of potentially harmful tax practices shows both the possibilities and the risks of this approach. The Primarolo list contains 66 'measures with harmful features'. A large part is attributed to dependent or associated territories of the UK and the Netherlands. The 40 remaining tax rules are distributed very unevenly over Member States. The Netherlands rank first with 10 measures and only four countries - including also Belgium, Ireland and Luxembourg - account for the broad majority of cases. The four largest Member States together account for 6 measures (leaving the 19 measures of UK-related small jurisdictions aside).

Tax measures with harmful features: distribution over EU Member States

	number of measures	share (%)
Primarolo Top Four	25	63
Four Largest Member States	6	15
Remaining Member States	9	23
EU-15	40	100

Explanation:
Primarolo Top Four: The Netherlands (10), Belgium (5), Luxembourg (5), and Ireland (5)
Four Largest Member States: France (4), Germany (1), Italy (1), and the United Kingdom (0)
Remaining Member States: Spain (3), Austria (2), Denmark (1), Finland (1), Greece (1), Portugal (1), Sweden (0)
in all cases excluding the dependent or associated territories

source: Primarolo Report Annex C, following the Code of Conduct on Business Taxation

This pattern can be explained in several ways. It is theoretically plausible that smaller countries have stronger incentives to engage in tax haven behaviour but it should be noted that both Denmark and Finland have just one measure listed while Sweden is not even on the list. An alternative explanation is that the largest Member States have exerted a disproportional influence in the making of the list (but then, it would seem that the UK has sacrificed its associated and dependent territories). For the moment, the Primarolo list remains in a political void. The ECOFIN Council has not reached any conclusion as to the status of the list - which in fact allows countries to adjust the relevant tax rules and administrative practices.
The practical effect of the Code of Conduct procedure may be beneficial in making tax competition more transparent. Visible general rate reductions are to be preferred over opaque administrative routines. This implies that tax administration has to become more transparent as well. On the other hand, there is a risk that procedures based on peer review and pressure will lose their credibility when the outcomes are not acceptable to all participants.

b. Taxation of savings income

More than ten years ago, an EC draft Directive on taxation of savings income proposed a 15% withholding tax. Two years ago, a new draft Directive proposed an optional system: a

20% withholding tax or exchange of information from source state to home state. In June 2000, the European Council reached a compromise, not on a Directive, but on a path possibly leading to a Directive. Again, it marks a shift from a minimum tax rate approach to improvement of administrative co-operation.

The Council stressed that the EU should negotiate with Switzerland and the US on exchange of information on interest payments to EU private investors. By the end of 2002, and in the light of progress made in those negotiations, the EU is to decide on further steps. The fact that the Code of Conduct procedure is to be finalised at the same time may allow for a package deal.

Further steps are to be aimed at increasing the exchange of information between Member States. Some Member States have indicated that they prefer to levy a withholding tax, which will be allowed for a limited period. The choice for full home state taxation raises questions as to the incentives for source states (like Luxembourg) to supply the necessary information. For those states, submitting information creates administrative and economic costs. The right to levy a withholding tax may offer too much compensation (or not enough, depending on what costs are taken into account). But without any form of compensation, source states will be reluctant to co-operate.

c. E-commerce

The Internet allows consumers to engage in international trade at low cost. Several problems emerge with respect to VAT. When consumers order commodities over the Internet within the EU, the normal rules for mail-order services apply. Whenever a mail-order business exceeds a (low) threshold value of sales in a Member State, it has to apply that Member State's VAT rate. If the retailer lives outside the EU, VAT can be levied at the border. When consumers use the Internet to purchase digital services, current VAT rules are unsatisfactory. The mail-order rules do not apply, and imports from outside the EU are difficult to observe by the consumer's tax administration.

Different problems arise in the corporate tax area. The Internet allows firms to be active in foreign markets without having physical presence in the traditional sense. The accepted nexus criterion for source state taxation is the permanent establishment concept, which has always been thought of as being a bricks-and-mortar phenomenon. Local presence through the Internet would then allow a US-based firm to make profits in Europe without being liable to corporate tax in Europe.

Both these problems have been addressed in the OECD context. Achieving co-ordination is difficult. For indirect taxes, the technical problem is evident. The EU has a fairly broad-based VAT while the US have a multitude of sales taxes at the sub-national level, primarily in the retail stage and usually excluding services from the tax base. Moreover, national welfare maximisation could bring the US to lean back and wait how its Internet sector flourishes, while the Europeans would risk to increase their competitive disadvantage by trying to tax Internet commerce. But in fact, discussions are proceeding and all parties seem to aim at broadly acceptable solutions. Again, we see a pragmatic process where states try to keep talking. There are no grand designs or ambitious goals, other than making existing taxes work in an Internet context. This, again, requires more exchange of information and more mutual assistance in tax collection. Both for VAT and for corporate taxation, European

countries may well need large-scale support by US tax authorities - after all, most of the information that EU tax administrations need is present in the US.
Apart from VAT and corporate tax issues, attention is also being paid at improving administrative co-operation and taxpayer service. As a sign of states' uncertainty *vis-a-vis* the taxation of E-commerce, taxpayers' representatives are fully included in the process.

5. The 'new' approach: problems and prospects

It cannot be denied that the prospects of the 'new' approach to tax co-ordination are yet unclear. However, they will probably not be meaningless. Market forces demand simpler international taxation and states are forced to explore the narrow path between fiscal degradation and loss of fiscal sovereignty. Peer review methods, eventually combined with sanctions against offenders, may well prove a satisfactory way of reducing jurisdictional distortions. It can be argued that pragmatic "muddling through" is the only feasible approach to the problems of international tax co-ordination (Bird and Wilkie, 2000). But some problems of the 'new' approach to tax co-ordination are emerging.

First, it may be desirable to have a co-operative climate but it is the result that counts. Some parties may be interested in delaying the result while others want more progress. The recent European Commission proposal to apply VAT on digitally provided services is a clear illustration.
In 1998, the OECD Member States agreed in principle that the consumption state is entitled to tax consumption. However, the US was (and still is) involved in a debate concerning the sales tax treatment of Internet commerce. In that context, the US government has not been very eager to confront its Internet business sector with European VAT obligations. In an apparent attempt to speed things up, the European Commission in June 2000 proposed to make US-based suppliers of digital services (exceeding a threshold value that would exclude only the very small firms) taxable in Europe. American firms should register in a single Member State and apply that state's VAT rate when delivering electronic services to consumers in the EU.
Effectiveness is doubtful. Probably the largest US-based firms will comply, but without some form of assistance from the US tax administration, large loopholes seem inevitable. For the moment, however, the problem is still very small or non-existent. In 1999, US retail e-commerce valued around $25 bln; US e-commerce export to European consumers was less than $ 1 bln. The share of digital services may well be under $ 0,1 bln. This implies that the EU's current VAT interest in this area is close to zero. However, things may change rapidly, and the Commission's proposal can even be interpreted as an attempt to speed up the internal US decision-making. The idea that US Internet retailers would have to apply EU VAT anyhow might help the US to introduce something like a country-wide sales tax on Internet sales. However, the trade figures mentioned suggest that for the moment the EU cannot play a significant role in US decision-making. Perhaps the idea of exclusive tax assignment is no longer useful in the field of e-commerce - instead, to achieve a stable tax environment for Internet business it may be required that states develop joint interests in taxation.

Secondly, the 'new' approach may not satisfy taxpayers. European business representatives keep pressing for results rather than procedures. They are in favour of simple solutions in international corporate taxation, which would reduce corporations' problems with jurisdictional distortions while creating problems of revenue sharing for governments (Lodin and Gammie 1999). Instead, tax loopholes are being reduced while the risks of double taxation are not. For the moment, this asymmetry seems inherent to the 'new' approach. In the longer run a more comprehensive approach of jurisdictional distortions seems to be required. Market forces may well demand that states co-operate in tax assessment and collection or improve the legal protection of international taxpayers.

And finally, it is not yet obvious how increased administrative co-operation will work out. One can imagine a World Tax Administration (Owens 1998, Tanzi 1998) as a kind of database containing information on individual taxpayers as well as best administrative practices. But national support for such an institution may be insufficient, as it is an obvious threat to countries' operational independence. The most fruitful approach might be to reconsider existing co-operative provisions from an economic perspective. A form of 'price mechanism' can serve both to ration demand and to make supply accountable. Meaningful international tax co-operation may well require that in the near future, a substantial part of national tax administrations' efforts is to provide services to other national tax administrations. In that way, we may indeed cross the Rubicon without noticing it.

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