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GOOD TAXES MAKE GOOD FRIENDS

Various countries in the European Union are in the process of reducing taxes and above all improving supply-side conditions. The aim is to reduce costs and make countries more attractive for investors. That said, trade interdependence, a unified monetary policy in the Eurozone and capital mobility permit greater tax competition and strengthen the need for coordination. But this is hard to achieve, given that interests differ across countries in terms of economic structures, size, EMU membership and location. This explains why it has been so difficult for harmonisation to move forward, and why the trend in policy is merely to remove the most evident distortions, though this risks pushing the costs of competition onto the least mobile tax bases.

Most countries of the European Union have entered a process of extensive tax reform, since the end of the 1980s. France has cut corporation taxes and has scheduled significant income tax reductions, together with tax credits for low-income households. Germany has been even more ambitious, by reducing corporation tax from 40% to 25% (compared to a cut from 36.6% to 33.3% in France, though SMEs benefit from a 15% rate), by exempting the sale of company shares from capital gains tax and by planning a cut of about 8 percentage points in marginal income tax rates over the next five years (compared to a 2 percentage point cut in France, over three years). Other European countries have not stood aside from such trends. Tax cuts for companies and individuals are a general trend in Europe, which is certainly far from over. The "Charzat Report", presented by this Socialist Deputy to France's Prime Minister, suggests cutting company taxes even more and creating a more favourable tax regime for "impatriated" workers, i.e. foreign managers and researchers who are resident in France for a fixed period of time[1]. The same proposals were made simultaneously by the Ferrand Report, examined by the French Senate the 14 June last[2].

Both of these proposals underline clearly the motives for cutting taxes in Europe. In contrast to the spirit of tax cutting found in the United States, this is not so much a question of supporting demand in a Keynesian fashion, but rather a means of improving supply conditions. These reforms and projects share the objective of reducing marginal tax rates in order to encourage private agents to work, produce and invest in the country in question.

Yet reform in one country may have consequences for its partners. Such "externalities" are particularly important in a highly integrated zone like the European Union. A lower tax rate in one country reduces costs and so makes it more attractive to investors, to the detriment of other countries. If high taxation is a gift given to neighbours, then low taxation will conversely penalise them. The risk in this case is that each country will try to improve its position by lowering taxes. Tax competition may also lead to sub-optimal public spending or to an unequal distribution of its financing costs. Tax coordination is therefore desirable, but also difficult to implement as the advantages it holds out are far from identical across countries[3].

Variable Geometry Competition

Macroeconomic models are a traditional tool for analysing the effects of tax policy. Only multinational

1. See: ***Les Echos***, 13 July 2001.
2. D. Badré and A. Ferrand, "Mondialisation : réagir ou subir. La France face à l'expatriation des compétences, des capitaux et des entreprises", ***Rapport d'information***, n°386; <http://senate.fr>.
3. See: CEPII, ***The Reform of Taxation in EU Member States***, Report for the European Parliament, April 2001. Responsibility for the opinions expressed in this report lies solely with the authors : <http://www.cepii.fr/francgraph/domainesrecherche/peee/Taxreforms.pdf>.

models can be used to analyse the externalities to be examined here. The simulations presented below have been developed using the multinational MARMOTTE model, developed by the CEPII in cooperation with the CEPREMAP[4]. Two technical aspects that are specific to such models condition the results provided. On the one hand, the rule for long-run fiscal sustainability (the state cannot rely on the expansionary effect to finance its tax cuts) necessitates that other, non-distortionary taxes are increased: normally this means a lump-sum tax. Agents' expectations thus incorporate such compensatory increases, which limits the expansionary impact of the original measure taken. Overall, this amounts to a redistribution of taxation, rather than a cut. On the other hand, such models generally contain a rule for the endogenous setting of monetary policy.

Simulations show that a cut in taxes in a country will raise output permanently, as it cuts production costs in the country, whatever the tax cut may be on (corporation tax, income tax or social security contributions). Such cuts constitute a supply-side effect. For example, a cut in income taxes in Germany increases households' disposable income, which in turn leads to wage moderation. Over time, this reduces the real cost of labour, raising both output and employment. A real depreciation of the exchange rate is needed to absorb excess supply, and German prices fall (see Table). The ECB reacts to such a cut by relaxing monetary policy.

Germany's partners are affected differently by this reform.

For those countries which are in the eurozone, the permissive policy of the ECB is no longer appropriate, in as far as their own supply-side conditions have not improved, thus favouring inflationary pressure. These countries therefore suffer from a loss of competitiveness ***vis-à-vis*** Germany, especially as they are small and open to trade with this country. Hence, Belgium is more affected than France (Table). Furthermore, it is clear that the trade and monetary impact of tax reform in an EMU member will depend on the size of the country: were the same reform to be undertaken in Belgium and not in Germany, then it would have practically no effect on the other countries.

As for countries which are not in the eurozone, exchange rate flexibility and monetary policy autonomy isolate them from the effects of a cut in German costs. As a result, small countries like Denmark can protect themselves against tax competition from their larger neighbours.

If tax cuts are implemented in all the countries of the eurozone at the same time, then production conditions will improve throughout the zone. The relaxation of monetary policy by the ECB will be all the greater. Such a cut in interest rates will lead to a depreciation of the European currency, and hence to a rise in prices (imported inflation). For Germany, the effectiveness of the measures is reduced, as it does not achieve increases in competitiveness with respect to its European partners.

Three main lessons may be drawn from these simulations:

- Tax reform may not lead to the expected changes if it is defined without taking into account externalities affecting neighbouring countries.
- In terms of the desired supply-side effects, the European countries are not all equal in the face of tax competition. Tax cuts in the "large" countries such as Germany or France are clearly damaging to "small" countries such as Belgium and Austria, though the opposite does not hold. Thus, large countries are structurally less interested in tax coordination than small countries.
- The macroeconomic externalities are limited to the eurozone. Countries in the EU that do not participate in the EMU, have no reason to push for tax cooperation[5] (in contrast, the negative effects of tax reform in these countries should not be feared).

Still, the impact of capital movements has to be taken into account, before any conclusions can be drawn from these observations on European tax matters. This question does indeed alter the distribution of the potential advantages and disadvantages of tax competition.

Table - The effect of a 10% cut in income tax rates

The % change relative to the reference level, in the 10th year	A cut in Germany alone			A simultaneous cut throughout the eurozone		
	Output	Real Wages	Prices	Output	Real Wages	Prices
Germany	0.39	-0.43	-0.12	0.31	-0.36	0.96
France	-0.02	0.03	0.55	0.11	-0.14	1.27
Belgium	-0.09	0.04	0.59	0.67	-0.62	0.65
United Kingdom	0.00	0.01	0.00	0.00	0.02	0.02
Denmark	0.00	0.01	0.01	0.02	0.01	0.03

Note: the measure corresponds to a cut in the effective rate of taxation from 20.59% to 18.53% in Germany, and from 21.75% to 19.58% on average in the eurozone. It is financed by a rise in flat-rate taxes, starting five years after the shock.
Source: Marmotte, calculations by the CEPII.

4. MARMOTTE is a medium-term macro-econometric model. See <http://www.cepii.fr/francgraph/domainesrecherche/mfc/marmotte.ppt>.
5. The British Chancellor of the Exchequer, Gordon Brown, has recently confirmed that tax coordination is not among his priorities, see ***The Financial Times***, 13 July 2001.

Competition under variable geography

The tax externalities described so far stress the importance of a unified monetary policy and mobility in goods and services as two sources of interdependence. However, the mobility of factors of production, and above all capital, is central to the question of tax competition: trade in goods and services is today dominated by sales of foreign affiliates by multinational firms.

Obviously, when a company invests in a foreign industrialised country, it does not do so primarily for tax reasons. Setting up foreign operations takes place within strategies to acquire new technology, to bring together pools of qualified labour and to access foreign markets. The case of the European Union, however, is particular. The relative easy access to a fully-integrated market from any location makes it relatively simple to set up plant anywhere. Tax policy may therefore influence the choice of production location across the different countries of the Union.

In this case, the smaller countries gain an advantage, as foreign companies make up an important part of their tax base: by cutting taxes, small countries can enhance their tax bases proportionally more than large countries (due to the inflow of foreign capital). The extension of tax bases thus partly sets off the impact which tax cuts have on earnings. From this point of view, small countries have a strong incentive to cut corporation taxes. Indeed, cutting taxes on foreign companies alone is even more tempting, for obvious reasons. This would then constitute tax dumping.

Studies carried out by the CEPII[6] show that a cut in corporation tax attracts foreign direct investment (FDI) from those countries to which repatriated profits to the parent company are taxed under a tax exemption regime (in other words they are not taxed a second time). They attract far less FDI from countries with credit regimes (whereby repatriated profits are taxed at the rate of the investor country, with deductions being made for taxes already paid in the country where the subsidiary is located).

Two conclusions emerge. First, greater geographic distance from the "centre" of the EU justifies lower tax rates: whereas "central" countries such as France and Germany may carry higher rates without firms fleeing abroad, a peripheral country like Ireland must apply low rates. This is not necessarily a matter of unfair competition. Coordination of policies in tax areas cannot be summed up simply by the uniformisation of rates and tax bases, or the setting out of minimum rates, which is more or less the same thing, in the long-run.

Second, the tax regime on repatriated profits is more important than the rates themselves: regime exemptions exacerbate tax competition, whereas credit regimes dampen it.

Based on these two observations, it follows that the central countries, which on the whole do not need tax incentives to attract companies, would have an interest in generalising the system of tax credits in order to limit tax competition between them[7]. But the interests of peripheral countries are precisely the opposite, as their lighter domestic taxation would lose its capacity to attract FDI.

Solving the Issue or Burying It

The single market and the single currency have opened the way to tax competition, by removing the ability of Member States to improve their competitiveness through devaluation, while at the same time strengthening competition within a unified market. To be sure, the Stability and Growth Pact restrains such temptations, by preventing Member States from cutting taxes inordinately without reducing government spending at the same time. But the Pact in no way hinders cuts in public investment or social security, nor in the redeployment of tax revenues across various types of tax. The quality of public services and infrastructure, as that of social security risks being adversely affected by cuts in spending. As for revenues, tax competition is likely to affect the most mobile tax bases first — capital and qualified labour. If competition is given free reign, the cost of sustaining public finances it is therefore likely to bear down on the least mobile tax bases, which would not be equitable.

Despite such risks, the idea of harmonisation must be handled with caution: as it has been indicated here, European countries are not equally positioned to deal with tax competition. The European Union is divided structurally on this issue, essentially along three lines: country size, membership or not of the eurozone, and the whether a country is located at the centre or on the periphery of the Union. Given such diversity, it is easy to see why negotiations on this issue are so difficult.

What would be the best strategy to adopt? Should the "federal" powers and responsibilities for tax policies be raised, albeit leaving competition to occur at the margins? The manner in which the Council of Finance Ministers[8]

6. See: A. Bénassy-Quéré, L. Fontagné, A. Lahrèche-Révil, "Tax Competition and Foreign Direct Investment", mimeo, March 2001; <http://team.univ-paris1.fr/trombi/fontagne/papers/taxcompet.pdf>.

7. Thus, the recent cut in company taxation in Germany is exaggerated if the country's favourable geographic position within the EU is taken into account. It risks drawing investment away from France, where the effective rate of corporate taxation is the highest in the EU, according to the consultancy Baker & MacKenzie. France therefore finds itself more or less obliged to cut tax rates to German levels, even though relatively high company taxation could be justified for both countries.

received the proposals of the Belgian Finance Minister, Didier Reynders, to levy a eurotax in order to contribute to the European budget raises some doubts. Gordon Brown's reminder of the tragic fate of the British Chancellor of the Exchequer who introduced a Poll Tax in 14th century England will undoubtedly have restrained even the most ardent reformers.

Would it be more appropriate to conduct the negotiations among smaller groups of countries which are relatively homogenous (for example, the major countries of the eurozone on the one hand, and the smaller countries of the zone on the other hand, with countries outside the zone remaining on the sidelines of the negotiations)? Such a solution would appear to be run up against the fact that the large countries do not share the same neighbours. It could be very difficult for the larger states to negotiate without the smaller ones.

A further dimension also needs to be added to the structural divisions of Europe, namely the varying priority that governments place on public spending and which could bury the case for harmonisation more than anything else. Tax federalism would clearly be postponed until better days, even if some of the worst distortions are addressed, for which a list already exists.

Unexpectedly, the EU could be helped by the approach taken by... the US administration. Irritated by US positions on hormone-treated beef and bananas, the Europeans have asked the WTO to arbitrate on America's ***Foreign Sales Corporations***[9] , which are accused of being a means for removing taxes from US exporting companies. After a preliminary analysis, the WTO came down on the side of the Europeans. Once all the appeal procedures have been completed, the latter will then be able to impose trade sanctions in the order of $4 billion on the US (a higher figure than any other) if this tax regime is not altered. For their part, the Americans too have announced that they are already looking at retaliatory measures against European tax policies which have a similar effect. According to Gary Haufbauer[10] of the Institute of International Economics (Washington), France and the Netherlands would be targeted. But, once again it cannot be ruled out that the Europeans will not go back on their position to find a compromise with the Americans, as part of the launching of a new trade round. Policy will most likely thus move towards relatively minor adjustments, aiming to reduce the most important tax distortions. For the rest, a turnaround in the business cycle is likely to herald a pause in the reduction of global tax pressures. But, as has already been pointed out, competition could indeed take the form of a redeployment of taxes, in favour of capital and highly qualified labour.

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8. Ecofin, Brussels, July 2001.
9. These are foreign subsidies which benefit from corporation tax exemptions on income earned from exports.
10. See: ***Financial Times***, 26 June 2001.

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