I Overview

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The Single European Act of 1987 represents perhaps the most significant step toward European economic integration since the creation of the EC three decades earlier. In accordance with and building upon the initial Treaty of Rome, the Act envisages the removal of remaining barriers to the free movement of commodities and factor inputs, with a view to enhancing competition and efficiency within the Community. Under the authority of the Act, the EC Council of Ministers was expected to approve nearly 300 provisions that would dismantle, by the end of 1992, physical barriers (customs and passport control), technical barriers (regulatory restrictions that affect trade, and financial and real factor flows), and fiscal barriers (border controls involving indirect taxation) among member countries. Of these, all except about 50 measures have been adopted a year before the deadline. In addition, by the end of 1991, agreement was reached in Maastricht on the Economic and Monetary Union (EMU) Amendments to the Treaty, mapping out the final stages toward economic integration and eventual adoption of a single currency, largely through fiscal convergence and monetary coordination.

Notwithstanding an early concern with tax harmonization, the explicit Community-wide mandate in this area has been limited to phasing in a common external tariff, eliminating internal tariffs, and achieving some uniformity in the type and base of commodity taxes. Although additional steps toward harmonizing the tax systems of EC member countries do not follow automatically from either the Treaty of Rome or the Single European Act, such measures must be consistent with them. Indeed, the intended removal of border controls and restrictions is intimately connected to tax harmonization: arguably, lack of sufficient harmonization may even inhibit completion of the single internal market. Progress toward formal unification or convergence of monetary, fiscal (including taxation), or social policy instruments, however, has been generally slower than the removal of regulatory restrictions for two reasons. First, these policies are by nature often politically contentious because they may reflect profound differences in social and economic philosophy and can be perceived to limit national sovereignty and discretionary policymaking. Second, unlike most Community-wide regulatory changes, which can be adopted by a qualified majority of member governments, enactment of provisions in monetary, fiscal, and certain social policy areas requires unanimous consent.

The first section of this chapter addresses the fundamental question of the extent of concerted tax harmonization that is necessary or desirable to support the completion of the single market. Harmonization of the bases of product and income taxes contributes to greater transparency for economic decision-making. In addition, tax rate harmonization is likely to enhance Community-wide efficiency and welfare. Concerted harmonization can be limited, however, to setting common minimum tax rates to protect the tax revenue of member governments, since, upon removal of border controls and restrictions on factor movements, competitive pressures would induce a spontaneous downward alignment of effective tax rates within certain margins. Further, consensus on minimum tax rates, accompanied by mutual assistance among tax authorities for enforcement purposes, is to be

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1 For a discussion of the major barriers, their economic effects, and survey results about attitudes toward such barriers, see EC Commission (1988e) and Emerson and others (1988).
2 In 1960 the Commission appointed the Fiscal and Financial Committee, under the chairmanship of Fritz Neumark, to study tax harmonization. The Committee's findings are contained in EEC Commission (1963).
3 Specifically, the EMU envisages eventual establishment of a supranational monetary authority, building on the European Monetary System (EMS), which already entails some loss of independent monetary control by participating member countries. Similarly, fiscal policy convergence implies some transfer of decision-making to a supranational level.
4 “Concerted” tax harmonization here denotes a formal agreement for convergence (not necessarily equalization) of tax structures; by contrast, “spontaneous” tax harmonization indicates convergence of tax structures in response to competitive pressures, without a formal agreement. Unless otherwise qualified, tax harmonization is used to denote concerted tax harmonization throughout this paper.
assigned priority as regards income from financial assets because these assets are the most mobile internationally. Similar action can follow in the areas of commodity taxation and, eventually, corporate income taxation. Harmonization seems least urgent in the taxation of less mobile labor and real assets.

An examination of various principles of international taxation in the second section suggests that, under a plausible set of assumptions in the EC context, retention of the destination principle for commodity taxation (through domestic taxation of imports and exemption of exports) and consistent application of the residence principle in capital income taxation (involving full offset for international tax rate differentials on foreign-source income) should ensure a more efficient allocation of resources than alternative principles. However, difficulties in enforcing the destination and residence principles without border controls and capital controls—given uneven administrative practices, including anonymity of financial holdings in certain countries—as well as relaxation of some of the assumptions underlying the efficiency implications of these principles, indicate that tax rate harmonization would lead to greater allocative efficiency, regardless of the principle adopted. Tax harmonization—much like other aspects of creating the single market—may have to be qualified by equity considerations. In particular, fairness in the distribution of tax revenue among countries engaged in tax harmonization and removal of nontax barriers argues for lump-sum transfers from high-income to low-income countries.

The third section outlines the main proposals considered or adopted in the EC for approximation of taxes on commodities and income from capital, supporting administrative steps, and other relevant measures. For commodities, agreement has been reached on a standard VAT rate, at not less than 15 percent on most products other than necessities: one or two reduced VAT rates not lower than 5 percent mainly on necessities, with a transitional arrangement for countries that have a lower reduced rate: and a set of minimum excise rates on tobacco products, alcoholic beverages, and mineral oils. The effective date of these rates coincides with the elimination of frontier controls, in January 1993. Among various administrative proposals, it was agreed that the destination principle would be maintained for four years and be replaced by a definitive system based on the origin principle in 1997. Meanwhile, border tax adjustments would be administered through a postponed accounting system (whereby transactions are reported to tax authorities in both importing and exporting countries, without border declarations) for the VAT and linked bonded warehouses for excises. As regards financial investment, an initially proposed 15 percent minimum withholding tax on interest income of EC residents has been virtually abandoned in favor of mutual assistance to combat tax evasion. For corporate income taxation, past proposals for harmonizing statutory rates and bases were either withdrawn or not formally submitted for consideration; formulation of future proposals awaits the input from a committee of experts. Nevertheless, several measures were adopted to eliminate the double taxation and other tax disadvantages on intra-EC investment income.

Although not formally part of tax harmonization, there are a number of measures that are anticipated to take effect either in tandem with tax harmonization or after its implementation. The removal of controls on commodity and factor movements within the Community will be largely completed by the beginning of 1993. The EMU Amendments envisage convergence of budget deficits and of government indebtedness to below certain limits, as a precondition for monetary unification. Moreover, to compensate for the probable exacerbation of regional disparities resulting from tax harmonization and further economic integration, an increase of disbursements from the EC Structural Funds to less developed regions within the Community is under way.

The fourth section of the chapter examines the likely economic effects of tax harmonization and of the associated financial liberalization and removal of border controls. On the basis of various quantitative simulations, it appears that the static effects will be modest for the largest member countries and for the Community as a whole. For certain countries and sectors, however, the effects, without compensatory fiscal action, can be substantial. Countries that rely on high standard VAT and excise rates are likely to experience a shift in consumption, especially toward goods with relatively high price elasticity of demand: a cut in consumption may take place in countries with low standard VAT or excise rates, obliged to converge to higher rates. The shift in consumption patterns would, over time, be accompanied by efficiency gains in production. From a distributional perspective, rate harmonization involves a moderate reduction in the progressivity of indirect taxation in countries that exhibit a relatively wide dispersion of VAT and excise rates.

A minimum withholding tax on interest income would result in shifts from newly taxed assets to exempt assets and to tax havens outside the EC. Pressures on capital outflows would be felt particularly in countries where certain exchange restrictions are yet to be dismantled or where interest income is in principle subject to ordinary income
tax but is not reported. Harmonization of effective company income tax rates would probably lead to a significant reallocation of capital to presently high-tax countries from low-tax countries over the long run. An increase in tax rates on income from capital, due to harmonization, could adversely affect labor and other immobile factors to the extent that in an open economy the tax burden tends to be shifted to them.

The static budgetary impact of harmonization is likely to be concentrated in the VAT and excises in a few high-tax and low-tax countries. Model-based simulations suggest that the overall macroeconomic effects tend to be negligible for most countries, especially for the largest ones. The simulations, however, understate significantly the consequences of these structural measures because of the exclusion of dynamic repercussions. Tax harmonization, together with financial liberalization and removal of border controls, is likely to have an adverse net static effect on non-EC economies.

Trade diversion, in combination with strengthened external competitiveness, would probably more than offset any increase in import demand vis-à-vis non-EC member countries. However, on balance, the dynamic effects of the enlarged market along with the resulting trade flows may outweigh the net negative static effects. In any event, the efficiency gains from completion of the internal market in general, and from tax harmonization in particular, should provide increased room for EC member countries to pursue trade liberalization and less restrictive macroeconomic policies, thus benefiting non-EC economies.

In the final section it is argued that harmonization of taxes on commodities and capital income and possible competitive pressures to align tax rates on labor income, within the single market, will reduce the scope for EC member governments to maintain an independent fiscal stance. Moreover, the combination of tax harmonization, financial integration, and the EMU should be conducive to convergence of both fiscal structure and performance in the EC. Within narrow limits, however, member governments might still rely on certain built-in stabilizers and tax incentives for domestic policy objectives. Overall, concerted as well as spontaneous tax harmonization—insofar as it involves convergence to relatively low minimum rates—coupled with the other steps toward economic integration, should contribute to greater efficiency in the public sector in most member countries, and, at the same time, may require a further substantial expansion and overhaul of the Structural Funds to support low-income regions in the Community.

A harmonized EC tax system may pave the way to greater tax coordination between EC and non-EC member countries. In particular, ongoing financial liberalization and efforts to harmonize taxation of interest income argue for agreement on a minimum withholding tax rate or increased administrative cooperation in a broad international forum. Such an approach would be comparable to existing international agreements on minimum interest rates on export credits and a minimum capital adequacy ratio on international bank lending.

The Case for Tax Harmonization

Tax harmonization is generally understood as a process of adjusting tax systems of different jurisdictions in the pursuit of a common policy objective. In the context of the Single European Act (EC Commission (1986a)), tax harmonization involves the removal of tax distortions affecting commodity and factor movements in order to bring about a more efficient allocation of resources within an integrated market. Narrowly defined, tax harmonization guided by this policy goal implies—under simplifying assumptions about other policy instruments and economic structure—convergence toward a more uniform effective tax burden on commodities or on factors of production across EC member countries. Convergence may be attained through the alignment of one or several elements that enter the determination of effective tax rates: the statutory tax rate and tax base, and enforcement practices.

Perhaps the most widely accepted argument for harmonization involves convergence in the definition of product value or income for tax purposes. Such tax base harmonization would contribute to transparency for economic decision-making and, thus, to improved efficiency in resource allocation. In particular, a common income tax base for multinational companies operating in different jurisdictions would be instrumental not only in enhancing efficiency, but also in preventing overlaps or gaps in tax claims by different countries.

Under various assumptions examined in the next section, some of the efficiency effects of rate harmonization can be accomplished with tax coordination—that is, through offsetting commodity or income tax rate differentials among

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member countries. As defined here, tax coordination—distinguished from tax rate harmonization proper—consists of specific tax adjustments on trade or income flows between jurisdictions that aim to neutralize the effect of tax rate differentials on the location of production or investment. In this regard, the consequences of such tax coordination on commodity or factor movements may be close to those of effective tax rate equalization. Nevertheless, the two approaches may have different effects on the pattern of consumption and production, on the choice between consumption and leisure, or on the choice between consumption and saving.

The basic rationale for tax harmonization or for tax coordination lies in the general proposition that either approach should lead to a more efficient allocation of resources. That is, the decision to consume imports or domestic products would depend on relative before-tax prices: likewise, the decision to invest at home or abroad would depend on before-tax rates of return—assuming uniform public service benefits at home and abroad. The relevance of this rationale diminishes, however, in the presence of direct or indirect regulatory barriers to international trade, investment flows, or labor migration. In the extreme case of autarky, intercountry tax rate differentials play no role in resource allocation. By contrast, phaseout of physical and regulatory barriers, as envisaged by the Single European Act, exposes the distortionary impact of taxation on trade and factor flows and enhances the elasticity of economic decisions to tax rate differentials. To the extent that economic agents do respond to such differentials, the latter will be reflected in relative commodity prices, interest rates, and wages at home and abroad.

Furthermore, the abolition of nontax barriers may result in increased allocative distortions under prevailing tax rate differentials because possible second-best efficiency arguments—predicated on the combination of tax and nontax distortions—for such differentials would no longer apply. Given the difficulty of enforcing satisfactory tax coordination to offset tax rate differentials in the absence of border controls and capital controls, it may become increasingly necessary to harmonize tax structures to correct the new distortions. Apart from these considerations, whereas tax coordination is expected to contribute to improved efficiency in production, tax rate harmonization should also enhance efficiency in exchange. Thus, tax harmonization would be conducive to higher overall welfare in the EC, albeit without necessarily raising welfare in every member country. An examination of these implications of tax harmonization, as opposed to those of only tax coordination, is deferred until the next section.

The view that concerted tax harmonization is a necessary ingredient in unifying the European market has been challenged by those who advocate the preservation of the fiscal sovereignty of member countries on philosophical or technical grounds—including the need for a wider range of policy instruments to pursue domestic stabilization, growth, equity, or regional development. Some argue that tax coordination, through a consistent multilateral network of tax adjustments, would be sufficient to attain the objectives of the Single European Act. Others simply favor spontaneous tax harmonization or tax competition. As member governments compete to attract production or investment, they will adapt the tax structure to market conditions—compensating with preferential tax treatment for differences in risk factors or insufficient infrastructure. Under tax competition, effective tax rates (net of benefits) are expected to converge to the lowest common denominator and, thus, to help contain government spending and promote efficiency in the provision of public services. From this perspective, it is argued that concerted (rather than spontaneous) tax harmonization is tantamount to tax “cartelization,” whereby governments act as oligopolists to protect market tax shares and, by implication, perpetuate a large and wasteful public sector (Cnossen (1988)).

There is ample historical evidence to support the view that increased economic openness, in combination with an international demonstration effect, leads to some degree of spontaneous harmonization of tax structures both inside and outside the European Community. As defined in the present analysis, tax coordination is ordinarily used to indicate discretionary policy action undertaken to achieve an objective shared by a group of countries: see, for example, Tanzi (1989). Such a broad definition of policy coordination is adopted in the final section of this chapter.

9These and other references to the allocative efficiency gains to be derived from tax rate harmonization are predicated on the assumed absence of other policy-induced distortions that would nevertheless continue to prevail—notably, as regards personal income taxation.

10See, in particular, the arguments against harmonization of VAT rates in United Kingdom (1988) and Salin (1989).

11For a review of the arguments for and against tax competition, see McLure (1986).
the Community. Nevertheless, the ability of a country to engage successfully in tax competition depends above all on its revenue needs, which are determined by its social welfare function, resource endowment, and public sector debt. A country with a relatively small public sector (reflecting, for example, modest defense outlays or social programs) or a large tax base (especially in terms of natural resources) is in a relatively advantageous position to lower effective rates of taxation—net of benefits—and to be lukewarm to proposals for concerted tax harmonization. In addition, a country that seeks to operate as an international financial center or to develop a free trade zone would want to minimize the tax burden on nonresidents through low statutory rates or lax enforcement practices. Tax harmonization or tax coordination is necessary to counteract the incentive for economic activity to move from high-tax countries to low-tax countries; yet tax coordination, in the absence of border controls and capital restrictions, may not be sufficient to prevent a shift of the declared tax base to low-tax jurisdictions. Along these lines, the case for concerted rate harmonization in an integrated market has been argued on equity grounds—that is, to alleviate an otherwise excessive tax burden, particularly on the owners of the least mobile factors.13

In sum, the argument for tax rate harmonization rests on Community-wide allocative efficiency and welfare enhancement, with the least loss in tax revenue for individual member countries. Given that, under tax competition, realized tax rates tend to fall in an integrated multicountry market, any concerted harmonization scheme should set minimum tax rates over the broadest possible base to avert revenue leakage.14 In the event that agreement on minimum tax rates is not viable, it would be necessary as a fallback to resort to coordination for offsetting tax rate differentials, supported by mutual administrative assistance to combat tax evasion.

12The introduction of the VAT, broadening of the income tax base, and reduction of marginal income tax rates are examples of innovations that have spread from country to country without concerted harmonization. For a discussion of more or less parallel trends in tax reforms in industrial countries, see Tanzi (1988) and Hagemann, Jones, and Montador (1988).
13As observed in Sinn (1990), under tax competition, mobile goods and factors would ultimately tend to be subject only to benefit taxation, whereas the tax burden would be borne chiefly by the owners of immobile factors—unskilled workers and landlords. Concerted tax rate harmonization, however, would ensure that the tax is borne by the owners of capital, either if such harmonization is accomplished worldwide or if the harmonized region is cut off from the rest of the world. See the discussion of equity considerations in the next section.
14To follow up with the analogy of a cartel, the success of tax harmonization in an integrated market hinges on the size of the membership of the cartel and on the coverage of the tax base.

Failure to reach a sufficiently comprehensive agreement on either tax harmonization or tax coordination supported by administrative cooperation could jeopardize financial deregulation and removal of border controls, as envisaged in the Single European Act, since high-tax countries would be reluctant to phase out such barriers and thus risk a loss of revenue.

The urgency to agree on some form of tax harmonization, or tax coordination supported by administrative cooperation, differs greatly according to the market being deregulated. Because arbitrage is speediest and most efficient in financial markets—and given the concomitant risk of capital outflow and revenue loss in relatively high-tax countries—taxes on income from financial assets should be harmonized or cooperation should be secured with the least delay, before or shortly after the removal of capital controls.15 Compared with international portfolio investment flows, the responsiveness of direct investment to differences in after-tax rates of return is slower. The scope for arbitrage is also relatively limited as regards merchandise trade. Upon removal of border controls, however, tax-induced trade could become significant mainly in high-value durable goods and in all goods between contiguous jurisdictions separated by significant tax rate differentials. Tax harmonization or tax coordination, coupled with administrative cooperation, seems least urgent as regards relatively immobile (especially unskilled) labor services and certain real assets.

Principles of International Taxation

For a better understanding of the rationale for tax harmonization, it may be useful to review certain basic principles of international taxation and their application to commodity taxes (destination versus origin principle) and to capital income taxes (residence versus source principle), the main areas for harmonization in the E.C. Any effort at tax coordination or tax harmonization to achieve an efficient allocation of resources must be based on principles that ensure neutrality of economic decisions with respect to relative effective tax burdens at home and abroad, tempered by equity considerations. This section focuses first on efficiency criteria, and then on interpersonal and intercountry equity criteria. To conclude, certain critical administrative issues are examined.

15The announcement effect of the withholding tax on interest income in Germany—more than one year before its introduction in January 1989—on capital outflows and before-tax interest rates illustrates the potential speed and magnitude of the response to international tax rate differentials.
Efficiency Considerations

In general, global allocative efficiency hinges on international tax neutrality. Tax neutrality can be defined from several vantage points, among them consumption, production, factor use, or factor ownership. A neutral tax system leaves the international pattern of economic decisions unaffected, as if there were no intercountry tax rate differentials. It follows that tax neutrality is a condition for efficiency—in line with comparative advantage and consumer preferences—assuming no other policy-induced distortions, market imperfections, or externalities. For a more precise assessment of neutrality, it is necessary to consider first-round or short-run tax shifting and to identify who engages in arbitrage across country boundaries. Other key assumptions involve the flexibility of exchange rates and prices and the degree of commodity and factor mobility.

Neutrality in the taxation of internationally traded commodities is ordinarily appraised from the standpoint of an individual who consumes an identical product supplied at constant costs at home and abroad. For neutrality to obtain under these circumstances, commodities should be taxed according to the destination principle, whereby the same tax rate is levied on imports and domestically produced substitutes. Assuming that consumers respond to gross-of-tax price differentials on substitute commodities, the destination principle ensures that production takes place in the least-cost location. In this view, international tax rate differentials are normally offset through border tax adjustments by imposing domestic indirect taxes on imports and by rebating them on exports. In the absence of such offsets, the burden of adjustment lies with the exchange rate, which in practice cannot compensate exactly for international tax rate differentials as long as some commodities and services are taxed at different rates or remain tax-exempt (Krauss (1967)). Yet even with border tax adjustments, the destination principle cannot generate complete neutrality—with attendant pressures on the exchange rate—to the extent that consumers cross borders to purchase goods.

In the event that the tax is borne by the producer, neutrality is achieved through application of the origin principle. Under this principle, a uniform domestic tax rate is levied on commodities produced in a given country, whether they are sold domestically or exported, and no border tax adjustment is necessary to leave the producer indifferent between local and foreign markets. Given capital mobility and fixed exchange rates, however, the origin principle and the underlying arbitrage assumption have limited applicability in international trade. Furthermore, the destination principle is preferable to the origin principle in the event that cross-border purchases are insignificant relative to the mobility of production facilities.

Signatories of the General Agreement on Tariffs and Trade (GATT) subscribe to the destination principle of indirect taxation and grant border tax adjustments, adopting implicitly the view that such taxes are shifted forward. Tax coordination according to the destination principle should help to correct allocative distortions—albeit imperfectly for cascade-type taxes on semifinished products—caused by rate differentials in VAT and in sales taxes or excises levied at the retail stage. But application of this principle without border controls becomes rather ineffective for achieving full tax neutrality, given the incentive for direct cross-border sales from low-tax to high-tax jurisdictions. Besides correcting for such leakage, tax rate harmonization is superior to tax coordination in that it not only contributes to a more efficient allocation of resources on the production side but also should do so on the consumption side. Whereas coordination of differential tax rates under the destination principle restores the relative before-tax prices for a given commodity across countries (efficiency in production), tax rate harmonization across commodities and countries sets, in addition, before-tax marginal rates of substitution equal across countries (efficiency in exchange or consumption).

Neutral taxation of income from capital—net of benefits received by the taxpayer—can be defined from the standpoint of either the investor (or saver) or the location of the investment. If the tax is not shifted and the investor arbitrages after-tax rates of return on capital at home and abroad, neutrality obtains under the residence (or worldwide) principle of taxation. According to this principle, the investor should face the effective income tax rate set by the home country no matter where the capital is located (capital-export neutrality). If, instead, the tax is shifted forward to the source of income, then, neutrality is achieved through the

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16 To be distinguished from long-run tax incidence, which is concerned with who ultimately bears the tax burden.

17 The background of the approach adopted by the GATT is discussed in Floyd (1973). In contrast, turnover taxes levied as presumptive income- or factor-based taxes are in general treated according to the origin principle, consistent with the assumption of no tax shifting.

18 See Keen (1987) for a theoretical demonstration of the welfare-enhancing effect, in a Pareto-optimal sense, of a convergence in member countries' commodity tax rates to a weighted average of initial tax rates. Tax harmonization would also equalize the marginal rate of substitution between consumption and leisure across countries.
source (or territorial) principle, under which income from capital is to be taxed only at the effective rate of the host country, regardless of the owner’s residence (capital-import neutrality). It can be further argued that as investors arbitrage between borrowing (or raising equity funds) locally and abroad, they will resort to the least-cost source of financing if foreign and domestic lenders are subject to a uniform effective tax rate. From an international welfare standpoint, the source principle is deemed superior to the residence principle only if capital is not sufficiently mobile and saving is highly interest-elastic (Giovannini (1989)). The first condition is unlikely in an integrated market, however, and the second is not unambiguously corroborated by empirical evidence.

Application of the residence and source principles of capital income taxation is analogous to that of the destination and origin principles of commodity taxation. Under the source principle, investment income of residents and nonresidents is taxed alike in the host country at a nondiscriminatory effective rate and is exempt from further taxation in the home country. Like the origin principle of indirect taxation, the source principle does not require offsetting tax rate differentials. In contrast, the residence principle requires that international tax rate differentials be offset through current (as against deferred) taxation of before-tax foreign investment income at the home tax rate, while granting a refundable tax credit for taxes paid abroad (that is, including a refund to the investor for any excess host tax over the home tax liability).

Application of the residence principle to portfolio investment income (savings in the form of equity and fixed-income securities without controlling ownership) is relatively straightforward. Interest and dividends received from abroad should be grossed up for any host withholding taxes, and such taxes should be credited against the investor’s income tax liability in the home country. Furthermore, any relief from double taxation (commonly through the imputation method) made available on the shareholder’s dividend receipts for the underlying domestic corporate income tax should be provided equally for the foreign corporate income tax. Parallel treatment should be accorded to income from savings intermediated by taxable and tax-exempt financial institutions.

As regards direct investment, it is not always unambiguous where the arbitrage takes place. For closely held corporations, the residence principle should be defined at the individual shareholder’s level. For large, widely held multinational corporations, which account for the bulk of multinational investment, the investment decision rests usually with the parent company rather than the individual shareholder. Tax coordination through current domestic taxation coupled with the foreign tax credit—without distinction between foreign branches and subsidiaries—should therefore apply at the corporate level, with no further adjustment at the shareholder level. However, the form of implementation of the residence principle, applied traditionally in reference to a well-defined home country, is an open question with respect to multinational corporations, including joint ventures, that are controlled equally by multiple parents established in a number of home countries.

The analysis of international tax neutrality and of its efficiency and revenue implications is further complicated by the explicit distinction between the allocation of financial savings and the allocation of real investment. In globally integrated financial markets, savings and capital formation may take place in different countries, as determined by risk-adjusted after-tax yields and the after-tax marginal product of capital, respectively. The saving and investment locations are linked either directly by financial flows between such locations or by intermediation through low-tax offshore financial centers (tax havens).

Moreover, tax enforcement of the residence principle in a given country may encourage round-tripping of financial flows between savers and investors of that country through tax-haven jurisdictions abroad. Although much of this intermediation is in the form of portfolio investment flows between unrelated lenders and borrowers, a significant portion represents direct investment flows within multinational corporations. In either case the social costs of tax-induced third-country financial intermediation entail above all a revenue loss, a misallocation of risk, and, to a relatively minor extent, a misallocation of real resources (consisting of the displacement of value added in financial services to the tax haven).

Unlike the case of commodity taxation, where the destination principle is widely accepted by

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21In the past, the Netherlands Antilles provided such financial intermediation between non-U.S. lenders and U.S. corporate borrowers to escape the U.S. withholding tax on nonresident investment income, exempt under the U.S.-Netherlands Antilles treaty. In 1984, with the abolition of the U.S. withholding tax, the Netherlands Antilles lost this advantage because U.S. corporations could borrow tax-free directly in the Eurobond market.
international convention, no consensus exists as regards the principle that should govern capital income taxation. A major attempt at codifying a multilateral agreement on capital income taxation—under the Organization for Economic Cooperation and Development draft convention on double taxation (OECD (1977))—has been less than successful. Most industrial countries follow a mixed approach with regard to direct investment: the source principle for incoming investment (corporate income tax, as well as withholding tax on interest and dividend remittances, levied at reduced rates under bilateral treaties); the residence principle for outgoing investment through branches (with limitations on excess foreign tax credit); and a partial residence principle for most outgoing subsidiary investment (partial exemption or deferral due to separate entity status, with limitations on excess foreign tax credit). The residence principle is usually applied, although not always enforced, for portfolio investment.

Lack of agreement in this area probably reflects not so much the unsettled controversy over the incidence of capital income taxation and the locus of arbitrage but—perhaps more important—the absence of full reciprocity of interests between net importers and exporters of capital as they attempt to balance tax revenue needs and incentive effects. (By contrast, in commodity taxation the implementation of either basic principle is seen as having roughly equivalent revenue consequences for countries in their double capacity as exporters and importers.) The host country exercises the right to tax investment income in the first place, and the home country is left with the decision to compound, mitigate, or leave unchanged the initial tax liability under the chosen neutrality criterion or national welfare objective. In addition, the two countries have the option of negotiating a bilateral tax treaty to coordinate the basic tax treatment within certain limits.

In these circumstances, as regards direct investment, there are good reasons for moving toward tax coordination, following the residence principle, on the basis of a uniformly defined and administered company income tax base (especially through standardized capital cost recovery allowances). For portfolio investment in particular, tax coordination depends on enforcement—as indicated below—especially upon removal of capital restrictions. In the absence of adequate enforcement, concerted harmonization—preferably in a worldwide context—of source tax rates on income from all substitute financial assets is required for protecting revenue. An added practical argument for harmonization is that it imposes a common effective tax burden on footloose companies, including those established under a multiclass tax statute.

More generally, compared with tax coordination, tax harmonization should enhance welfare because convergence of income tax rates tends to equalize marginal rates of substitution between consumption and saving across countries and to lead to neutrality under various degrees of tax shifting or plausible rate-of-return elasticities of supply of and demand for capital. Furthermore, agreement on minimum effective tax rates is consistent with efficiency under different principles of international taxation of capital income and commodities, while at the same time protecting government revenue.

**Equity Considerations**

International tax policy in general, and tax harmonization in particular, cannot be predicated on criteria of allocative efficiency alone. Equity, both at the interpersonal level (fairness in the distribution of the tax burden among taxpayers) and at the intercountry level (fairness in the distribution of tax revenue among countries), must also be taken into account. There are alternative definitions of interpersonal equity: equity among residents of a given country or equity among residents of different countries. In the former sense, equity can be handled through international tax coordination, but in the latter sense, it would require concerted harmonization of the structure of personal income taxes and benefits—an approach that lies beyond the scope of the proposals under consideration by the EC. Interpersonal equity according to factor ownership should also be considered. In a closed economy a tax imposed on capital assets uniformly across all sectors is borne in the long run by the owners of capital. By contrast, in an open economy the tax is shifted in part to nontaxed assets, but mainly to labor and other immobile factors (Harberger (1982)). Thus, to ensure that the tax is borne by the owners of capital, it is necessary to enforce the residence principle or to extend concerted harmonization to practically all countries endowed with a comparable investment environment.

Although not an explicitly declared objective of any of the EC proposals for tax harmonization, criteria of intercountry equity can be important in shaping government attitudes to various harmonization schemes. According to the benefit criterion, tax revenue from international commodity and fac-

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22 For a discussion of inconsistencies in the tax treatment of international investment income, see Mutén (1983).

23 This point can be inferred from Horst (1980).
tor flows should accrue to the country where public services (infrastructure, legal services, public safety, national defense, and the like) are rendered, free of charge, in connection with the economic activity that underlies the tax base. To implement the benefit approach, it is necessary to identify and measure the benefit provided. If the benefit is measured broadly by the value added generated under each jurisdiction, then commodity tax revenue should be apportioned accordingly, whether tax rates are identical or not. Under the destination principle, tax revenue from imports should be transferred from the importing country to the exporting country in an amount equivalent to the rebated tax on exports; under the origin principle, no such transfer would be necessary (Cnossen and Shoup (1987)). Largely because of administrative convention, actual practice departs from this approach and allocates the revenue to the importing country—with the implicit understanding that, since all countries are both exporters and importers, the adoption of either principle has equivalent long-run revenue implications.

Application of the benefit approach to the taxation of foreign investment income would also entail allocation of tax revenue in proportion to the value added under each jurisdiction. Thus, the bulk of the revenue would go to the capital-importing country, while the capital-exporting country would claim the share attributable to the capital cost component of value added.24 Under the residence principle, most of the tax collected in the capital-exporting country would have to be refunded to the capital-importing country. More precisely, the tax would have to be apportioned, whether the rates are fully harmonized or not, on the basis of a formula linked to value added or some other base that reflects benefits provided free of charge. Therefore, in practice, the benefit criterion could be approximated by income taxation at source and by commodity taxation at origin.

Apart from the benefit approach, various criteria of vertical intercountry equity are conceivable to promote a desired distribution of fiscal resources among member countries, consistent with an international social welfare objective. To this end, tax harmonization may be accompanied by lump-sum budgetary transfers from high-income countries to low-income countries—regardless of each country’s tax structure. The case for such transfers is strengthened by the accentuation of regional imbalances that is likely to emerge from market integration and tax harmonization.

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**Administrative Aspects**

Most of the above principles and qualifications must be buttressed by appropriate administrative instruments. Full application of the destination principle and the residence principle offsets international effective tax rate differentials on commodities and on capital income, from the perspective of the resident consumer and investor, respectively, requiring no more administrative tools—including minimum reporting standards—than the enforcement of any other tax. By contrast, the source and origin principles, as well as a qualified residence principle (allowing for domestic tax deferral on foreign subsidiary income), are likely to give rise to manipulation of transfer prices and of cost allocation by multinational corporations aimed at minimizing income and commodity tax liabilities in home and host countries.25 Under the origin principle, even unrelated entities may collude to underinvoice exports and overinvoice imports for purposes of evading commodity taxation. The revenue losses from such manipulations can be significant with regard to highly differentiated products and intangibles, and to prevent them, tax authorities normally resort to arm’s-length pricing rules. For corporate income taxation, alternatively, crude unitary apportionment formulas can be used to determine the tax base in each country where affiliated entities operate. However, this method—practiced, for example, in several state jurisdictions in the United States—tends to give rise to frequent disputes between tax authorities and taxpayers.

Removal of border controls among countries that follow the destination principle would exacerbate allocative distortions and revenue leakages associated with direct cross-border purchases by residents of high-tax countries from producers in low-tax countries. Likewise, under either the residence or the source principle, removal of capital controls would entail a revenue loss for countries where the anonymity of the taxpayer is protected through bank secrecy and bearer instruments, as a result of portfolio investment flows to tax havens. Such capital flight would need to be discouraged through uniform disclosure rules and exchange of information among tax authorities of member countries. In any event, and particularly without agreement on minimum tax rates, successful market integration requires mutual administrative assistance among tax authorities, preferably in a multilateral

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24 An even more restrictive underlying assumption than that applied to commodity transactions is a uniform profit margin on all cost components. See Musgrave (1969).

25 The theoretical analysis by Horst (1971) of the relative importance of company income taxation and import tariffs in influencing transfer prices is applicable to multinational companies in the EC. For an analysis of transfer-pricing manipulations as regards intangibles, see Kopits (1976).
context—as provided in the Council of Europe-OECD draft convention on mutual assistance in tax administration.26

Proposals for Tax Harmonization27

Commodity Taxation

After elimination of all internal duties on imports and exports and establishment of a common external tariff in 1968, the EC launched the process of harmonizing domestic commodity taxes by requiring all member states to substitute a VAT for turnover taxes. The sixth VAT directive, adopted in 1979, was a major step toward a uniform basis of assessment. However, frontier controls were retained for implementing border tax adjustments for VAT rate differentials among member countries. It was recognized that the removal of border controls, a major element of the completion of the single market, would have potentially important administrative and policy implications.

In 1987, the EC Commission proposed a VAT clearinghouse system (CHS) to facilitate removal of border controls. Under the proposed system, sales among member countries would be treated in the same way as those within each country. Exporters would no longer qualify for tax rebate, and importers would be allowed to credit the VAT paid in the exporting country. The exporting country would be required to transfer tax credited on exports to importing countries, through a central clearinghouse to ensure continued accrual of VAT revenue to the country of destination. Although several important technical details of the CHS remained to be worked out, the Commission suggested that each country should calculate its own net position vis-à-vis the rest of the EC instead of requiring member states to reconcile net revenue flows bilaterally.

The Commission later reconsidered the CHS proposal and explored alternative options to maintain the present division of tax revenue among member countries, such as the suspension of VAT liability on intra-EC transactions among associated companies and taxation of mail order sales only in the country of destination, while the calculation of net VAT liabilities on other transactions among unrelated taxable persons would take place through a clearing account on the basis of each country’s trade statistics. With regard to transactions among unrelated entities, EC member gov-

26Council of Europe and OECD (1989); for a discussion, see Daniels (1988).
27For detailed description and documentation of proposals, see the relevant sections in Chapters II and III.

ernments have been leaning in favor of the so-called postponed accounting system (PAS)—used in the Benelux countries—whereby transactions are reported to tax authorities of both exporting and importing countries, without need for border declarations. In 1989, the Commission recommended maintenance of the present destination principle over a four-year transition period, following the elimination of frontier controls in January 1993; meanwhile, all border tax adjustments would be administered through the PAS approach. In 1991, the Council confirmed this arrangement with the understanding that it would be replaced with a definitive system consistent with the origin principle effective 1997. Also in 1991, the Council issued a new directive on the implementation of VAT within the Community—amending the sixth directive—to be applied after the abolition of fiscal frontiers.

In principle, the CHS or the PAS could operate with prevailing intercountry differences in VAT rates and without border controls. However, largely to avoid leakage through direct cross-border transactions, the Commission proposed an approximation of tax rates. According to the initial proposal, announced in 1987, member countries would adopt a dual rate structure with a standard rate set anywhere between 14 percent and 20 percent and a reduced rate set between 4 percent and 9 percent (on goods and services deemed to be necessities, accounting for approximately one third of the common tax base). In 1989 the Commission adopted a more flexible approach with a suggestion to replace the recommended standard VAT rate band with a minimum standard rate, to be set at not less than 14 percent, while retaining the originally proposed reduced rate band—a lower or zero rate being permitted on a limited number of commodities in countries that currently provide such a reduced rate for social or cultural reasons.

In 1991, the Council agreed on a 15 percent minimum standard rate and one or two minimum reduced rates set at 5 percent or more—while allowing a lower reduced rate under a transitional arrangement—effective January 1993.

Progress in approximating excises has been slow because of differences in attitudes and taste patterns (for example, as regards drinking and smoking) and because of diverging policy objectives for health, environmental protection, and energy conservation. Interests of domestic producers also constitute an obstacle to harmonization. In 1987, the Commission proposed the retention of excises on manufactured tobacco, alcoholic beverages, and mineral oils; other excises affecting traded products were to be eliminated. As regards the three identified commodity groups, it argued for the equalization of excise rates across member countries, in
part because the remaining differences in VAT rates, imposed on the duty-inclusive price, would compound differences in excises.

In 1989, however, the Commission acknowledged that the earlier proposal would have limited the flexibility of member countries in setting excise rates in the pursuit of the above domestic objectives. Thus, it suggested to amend the original proposal by setting only minimum rates for alcoholic beverages, tobacco products, and perhaps petrol. For mineral oils (with the possible exception of petrol), excise rates might still have to be equalized so as to prevent competitive distortions insofar as they are inputs in the production process. Minor rates were supplemented with a set of target rates to be approximated in the medium term. In 1991, the Council agreed on a set of minimum excise rates on the principal alcoholic, tobacco, and petroleum products, effective January 1993 and subject to review at two-year intervals.

The Commission has proposed linking the bonded warehouse systems operating in member countries to enforce excises on traded dutiable goods after abolition of frontier controls. Dutiable goods would cross intra-EC borders under seal while the excise payment would be suspended. The commodities would be taxed in the country of destination as they leave warehouses for delivery to domestic retailers. As an alternative, the Commission has also suggested the use of tax stamps to prevent fraud due to intercountry differences in excise rates.

**Capital Income Taxation**

With the process of financial liberalization well under way, the risk of increased tax evasion faced by some member countries had put interest income taxation at the forefront of the Commission's agenda for tax harmonization. Because interest income is usually not taxed at source or an exemption is granted to nonresidents (unilaterally or under treaty), foreign bank deposits and interest-bearing securities would provide, in the absence of EC-wide reporting requirements, a conduit for tax evasion after removal of remaining capital controls.

Therefore, the Commission considered three possible approaches to the problem: increased cooperation and exchange of information among national tax authorities; stepped-up reporting requirements; and a common minimum withholding tax on interest from deposits and securities imposed at source on all EC residents. Largely because the first and second solutions were seen as running counter to a long-standing tradition of taxpayer anonymity in some member countries, the Commission initially opted for the third approach.

A 1989 proposal called for a minimum withholding tax on interest income of EC residents, set at 15 percent. The proposal would only apply to debt instruments issued by EC residents and defer to national authorities the tax treatment of interest income on Eurobonds and small-size savings deposits, interest paid to or received by non-EC residents, intra-enterprise interest income, and interest received or capital gain distributed by investment unit trusts. The proposal would not preclude multiple rates, higher rates on own residents than on nonresidents, or exemption when full taxpayer identification exists. The tax could be treated as final or as an advance payment creditable against ordinary income tax. In the latter case, the country of source would bear the budgetary cost of crediting or refunding the tax, unless agreed differently under bilateral treaty. Faced with mounting opposition from some member countries, however, the Commission shifted the emphasis from the minimum withholding tax toward possible agreement on the implementation of minimum reporting requirements and exchange of information on EC resident interest income to assist member countries that seek to enforce the residence principle.

Harmonization of corporate income taxation was the object of a proposed directive in 1975. Its main features were application of a single statutory rate of corporate income tax between 45 percent and 55 percent; adoption of a partial imputation system along the lines of the French avoir fiscal, with a single rate of tax credit on the distributed dividends; adoption of the source principle with respect to the imputation system applied to dividends crossing frontiers, with the budgetary cost of the tax credit borne by the host country; and imposition of a 25 percent withholding tax on dividends distributed to noncorporate shareholders, except where their identity is known to the tax authority. The proposed directive was never adopted because the European Parliament announced the prior need to harmonize the computation of the corporate income tax base. Although the Commission still supports the basic goals of the 1975 proposals, it probably would modify the recommended rate band in line with the lower rates now in effect in most member countries and would favor full imputation.

In response to the concern expressed by the European Parliament, in 1988 the Commission began to draft a proposal to harmonize the determination of taxable corporate profits. The initial draft contains guidelines about depreciation allowances, capital gains, inventory valuation, reserve provisions, valuation adjustments, and overhead costs.

The basic purpose was to establish a more uniform and transparent tax treatment of corporate income, which would pave the way to a harmonization
elimination of such controls depends, however, on the degree of tax convergence and administrative cooperation. In addition, removal of border controls would be accompanied by either the replacement of quantitative restrictions currently imposed by EC member countries on imports from non-EC countries with Community-wide restrictions or their complete repeal, and by the removal of restrictions on cross-border provision of financial services. By implication, implementation of these measures also would be partially contingent on tax harmonization.

In 1989, the Commission unveiled a proposal for the EC company statute, available to any company whether effectively owned by residents of member or nonmember countries. Companies incorporated under the statute would be permitted, for tax purposes, to consolidate losses incurred in one member country and profits generated in another country. Widespread adoption of the statute throughout the Community could speed up the competitive downward convergence of effective corporate income tax rates.

The EMU Amendments envisage a set of measures that, albeit not narrowly connected to tax harmonization, are of relevance. As part of the process toward unified monetary control, the EMU allows for harmonization of minimum reserve requirements on credit institutions in member countries. Equalization of reserve requirement ratios (along with elimination of formal or informal obligation of financial institutions to hold government securities), which still differ throughout the EC, would constitute an added form of harmonization of taxes on financial intermediation. Also relevant for its possible interaction with tax harmonization is the eventual convergence of summary fiscal indicators. Specifically, under the EMU, each member country will be required to maintain (or reduce) the general government budget deficit at (to) not more than 3 percent of GDP and gross debt at (to) not more than 60 percent of GDP. Financing of the budget deficit by the central bank will be forbidden.

Pursuant to the Treaty of Rome and the Single European Act, the Community is committed to strengthen economic and social cohesion by expanding substantially disbursements from the EC Structural Funds. The Funds have been established to assist less developed regions, declining industrial and rural areas, and areas with high structural unemployment in member countries—increasingly through private sector involvement. Between 1988
and 1993, the Structural Funds were expected to double outlays to a level equivalent to about one fourth of the EC budget. The expansion of social expenditures thus incorporates a criterion of vertical intercountry equity in the tax harmonization process.

Economic Effects

The economic consequences of various proposals for EC tax harmonization must be studied not in isolation but within the broader context of the completion of the internal market. As suggested above, it is difficult to envisage removal of controls over commodity and capital movements without a minimum concerted approximation of effective tax rates. Alternatively, removal of physical border controls and capital restrictions should lead to some degree of spontaneous tax harmonization among member countries. Thus, the effects under scrutiny can originate from three interrelated sources: the effects of concerted tax harmonization and cooperation, absent other steps toward market unification; the effects from removal of border controls and capital restrictions; and the effects of the ensuing spontaneous harmonization. Whereas the first and second set of effects can be traced to well-defined proposals, the third set of effects must be based on conjectures about each country’s reaction function following the removal of fiscal and regulatory barriers. This section focuses on the direction of microeconomic and macroeconomic effects from these three sources providing, wherever possible, broad orders of magnitude.

Allocative Effects

Indirect tax harmonization, including administrative measures, by itself (that is, while retaining border controls) would probably have negligible allocative consequences in most member countries, for two reasons. First, the substantial tax rate changes required to meet the prescribed minimum standard VAT rate and excise rates on alcohol, tobacco, and mineral oils, as well as abolition of the higher VAT rate and various excises on other commodities, is concentrated in relatively few member countries. Second, notwithstanding the proposed mechanics of tax revenue distribution among member countries, the destination principle will be broadly adhered to in the medium term.

Relative price changes, owing to tax rate approximation within each country, shift consumption patterns away from commodities that are subject to tax rate increments to reach the minimum standard VAT rate and minimum tobacco, alcohol, and petrol excise rates, toward commodities that will no longer be subject to the higher VAT rates or to excises. The extent of the shifts in consumption depends on the own-price and cross-price elasticities of demand. Meanwhile, changes in the volume of production are determined by price elasticities of supply and, in the case of tradable goods, also by tax changes adopted by other member countries. Before equilibrium is restored, mobile factors would move from the sectors facing a decline in demand, because of increased commodity tax rates, to sectors where demand is on the rise.

Combination of tax harmonization and abolition of border controls would augment the above effects, through an expanded volume of intra-EC trade. The bulk of the enlarged trade is attributable to trade creation—that is, a shift in demand from domestic suppliers to lower-cost suppliers in EC partner countries whose products are no longer subject to border controls. Another component is the increase in direct cross-border purchases from low-tax countries by households and some institutions in relatively high-tax countries.

The potential for cross-border transactions places pressure on high-tax member countries—particularly those that are contiguous to low-tax member countries—to reduce the standard VAT rate on tradable products toward the recommended minimum rate, in addition to abolishing the higher rate. At the same time, substantial cross-border transactions could result in exchange rate pressures. On the basis of the experience of tax jurisdictions operating in a single market (notably, state jurisdictions in the United States), it is plausible to assume that member countries would be able to sustain a differential in tax rates for most product categories, roughly equivalent to the standard VAT rate band proposed initially by the Commission, and even larger differentials for certain services and perishable consumer goods. Spontaneous harmonization narrows the scope for tax-induced retail price differentials and cross-border

31 Transfers from the Structural Funds are usually matched at least in part by counterpart expenditures from the recipient country’s budget. In any event, it cannot be assumed that the tax revenue loss incurred by a member country because of tax harmonization would be compensated with transfers from the Funds.

32 A systematic and comprehensive quantitative analysis of these effects would have to be undertaken in the context of a multicountry general-equilibrium model that can accommodate a number of commodities and factors of production—similar, for example, to the model used in Jones and Whalley (1988) to simulate the effects of various tax changes in Canadian provinces.

33 Simulation of the effects of the tax harmonization proposals on consumption patterns in Belgium, Germany, France, Italy, and the United Kingdom are reviewed in Chapter II.
intra-EC trade. As a result of both concerted and spontaneous commodity tax harmonization, consumption will shift at the margin from commodities with price-elastic demand that currently are taxed below the prescribed minimum VAT and excise rates toward price-elastic commodities that are subject to standard VAT rates around 20 percent or more and to the higher VAT and excise rates (other than tobacco, alcoholic beverages, and mineral oils) to be abolished or reduced.34 In a few instances, consumption would also shift toward commodities that at present are taxed at the standard VAT rate but that would qualify for a reduced rate.

Although most allocative effects are transmitted through changes in consumption, these in turn would engender factor movements away from sectors where the marginal revenue product of the factor would decline and toward those where it would rise. Comparative advantage would increasingly determine the location of production, since segmentation of EC commodity markets would disappear. The largest allocative efficiency gains will be realized in countries with the largest excess of commodity tax rates over the recommended minimum rates. An increase in consumption can be expected in countries that at present either impose relatively high VAT standard rates (Denmark, Ireland) or rely on the higher VAT rate schedule or excises for a relatively large number of commodities (Denmark, France, Italy, Ireland). By contrast, countries with comparatively low standard VAT or excise rates should experience a decline in consumption of price-elastic commodities (Greece, Luxembourg, Portugal, Spain).

The allocative effects of the proposed minimum withholding tax on interest income would be reflected in changes in asset yields, which in turn would trigger considerable portfolio shifts from newly taxable assets, whose yields were previously not subject to a withholding tax, toward tax-exempt assets (small deposits, Eurobonds, shares in investment unit trusts) and toward tax-haven jurisdictions outside the EC. The extent of induced portfolio shifts would be contingent on relevant elasticities of substitution, which tend to be rather high even in the short run.35

Abolition of capital controls would extend these effects to member countries (Greece, Ireland, Portugal, Spain) where certain restrictions are yet to be dismantled. Furthermore, if the minimum withholding tax were accompanied by enforcement of disclosure and provisions for the exchange of information in all member countries, asset substitution could increase, particularly out of taxable assets in member countries that, lacking administrative tools, de facto follow the source principle. Pressures on gross capital outflows and revenues would mount in the mentioned countries where financial investment is still subject to exchange controls and from countries (Germany, Luxembourg) where in principle interest income is subject to ordinary income tax but without withholding at source or reporting requirements. Countries that have lifted all capital controls and impose a withholding tax should see their position improve (Belgium, United Kingdom). The remaining countries (Denmark, Netherlands) that also have some form of reporting requirements should not be affected by the introduction of a minimum withholding tax.

The allocative effects of corporate income tax harmonization are complicated by the fact that statutory rates contain incomplete information for ascertaining tax-induced distortions. Effective tax rates, normalized to a common base, depend, among others, on arbitrage conditions, financial structure, economic rates of asset depreciation, interest rates, and the expected rate of inflation. The dispersion of effective tax rates across countries confirms that there is room for harmonization, or for closer approximation of the residence principle with consistent application of arm's-length pricing rules. Illustrative simulations of various possible proposals for harmonizing statutory rates, or capital cost recovery allowances, or both, indicate that these tax modifications could entail substantial changes in the equilibrium capital stock for certain countries. High-tax countries (in particular Germany) could experience a significant buildup in capital stock, whereas low-tax countries (Ireland, Luxembourg) could suffer some capital depletion relative to the long-run steady-state stock that would prevail under current tax treatment.36

The likely magnitude and path of these allocative effects depend on several determinants—including the relevant price-of-capital elasticities, adjustment parameters, and various institutional constraints prevalent in member countries—some of which cannot be taken readily into account even in a complex modeling framework. Besides influ-

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34 The elimination of these excises involves a larger than proportionate reduction in commodity prices subject to VAT because the VAT base is gross of excise duty.

35 There is a paucity of quantitative estimates of the impact of the proposed tax changes on interest yields and financial flows among asset categories and countries. However, the experience of Germany with the imposition of a 10 percent withholding tax (without compulsory reporting) in 1989 and of Belgium with the reduction in the withholding tax rate from 25 percent to 10 percent in 1990 suggests large and rapid portfolio shifts, including in asset holdings abroad. These cases are consistent with the effect in Canada of the removal of the 15-25 percent withholding tax on nonresidents in 1975, documented in Brean (1984).

36 For a discussion of the methodology underlying the calculation of effective tax rates and the simulation results, see Chapter IV.
Encancing the sectoral and regional allocation of fixed capital, harmonization of the corporate income tax structure and enforcement practices would tend to alter the derived demand for and prices of other inputs, as well as the financial structure and internal commodity and factor prices of multinational corporations. These effects might be speeded up by the proposed establishment of EC companies, which would have a greater potential to engage in tax-minimizing transactions across intra-EC borders. In all, the pressures for spontaneous harmonization of taxation at source would mount, assuming retention of the residence principle on income derived from outside the EC.

The above static effects underestimate the efficiency gains in production and consumption from tax harmonization and from the associated abolition of controls over trade and capital movements among EC member countries. Removal of controls, convergence of effective tax rates, and emergence of EC-incorporated companies would widen the scope for exploitation of economies of scale in decreasing-cost industries and promote dynamic efficiency gains—through intensified competition, productivity spillovers, technological innovation—and external economies. The alignment of VAT and excise rates is likely to contribute significantly to such gains. Moreover, specific steps toward standardized computation of taxable profits, elimination of remaining international double taxation (in the form of conflicting arm’s-length pricing rules applied by different national authorities and possible double taxation of intracompany dividends) and unification of the tax treatment of domestic and international mergers would encourage the realization of economies of scale and dynamic effects by multinational firms in the internal market.

Distributional Effects

National tax authorities are concerned about the possible implications of tax harmonization on domestic income distribution. Short of a comprehensive study of tax incidence for each member country, these implications lend themselves only to a partial assessment. In most member countries, indirect tax rate approximation will involve a reduction in the progressivity of taxing products with highly income-elastic demand, through the aboli-

 Tribune of the higher VAT rates and selective excises on luxury goods. At the same time, convergence of excise rates on alcoholic beverages and tobacco products, for which demand is usually both income- and price-inelastic, tends to have a favorable (adverse) effect on income distribution, as rates are reduced (increased) to the proposed minimum rates.

The distributional consequences of capital income tax harmonization are less clear than the effects of commodity tax harmonization. In view of both the partial coverage of taxes on capital income and the openness of member countries’ economies, the incidence of such taxes cannot be interpreted unambiguously. In general, an increase in tax rates on income from capital, as a result of harmonization of such taxes across EC member countries, might be borne largely by labor and other immobile factors, given the openness of the Community toward countries where capital income is tax exempt or taxed at a low rate. A critical element involves the administrative steps to prevent tax evasion that would accompany the harmonization effort.

The distribution of government revenue from trade and investment among member countries would be altered, in part because of tax harmonization and in part because of stepped-up transfers from the EC Structural Funds. To the extent that tax revenue from commodity flows continues to accrue to the country of destination—channeled through various administrative methods under consideration—each country’s share would remain broadly unchanged. The shares would be altered only as a result of realignment in VAT and excise rates, depending on the difference between the present rates and the harmonized rates. As regards capital income taxes (notwithstanding the application of either principle of taxation), effective rate harmonization would be tantamount to a switch to taxation at source. At the limit, uniform effective income tax rates would obviate any offsetting home tax liability on foreign investment income under the residence principle. Although harmonization of capital income taxes should confer revenue gains to member countries that are primarily the source of EC investment income, these gains would not be fully captured by source countries if alternative tax-exempt investment opportunities are available. Member countries that currently impose tax rates on interest income derived by their

\[37\] For a survey of the empirical literature on the responsiveness of multinational firms’ decisions to tax changes, see Al-\[38\] worth (1988).

\[39\] For a fuller evaluation of distributional consequences it would be necessary to know the nature of measures (on the revenue or expenditure side of the budget) undertaken in any given member country to compensate for the net revenue gain or loss associated with a specific harmonization proposal.

\[39\] Under the originally proposed directive, the elimination of zero rating of necessities would have compounded the regressive character of the VAT rate harmonization. For a survey of estimates of the equity effects of the proposals for product tax harmonization for a few member countries, see Chapter II.
own residents or EC residents below the recommended minimum withholding rate could also benefit, assuming that adoption of this rate would be supported by adequate enforcement. Member countries that at present levy relatively low effective corporate income tax rates could likewise gain revenue from harmonization. However, the hypothesized revenue gains are likely to be eroded in part by adverse incentive effects.

The envisaged expansion of the Structural Funds is expected to contribute to a more equitable distribution of fiscal resources between high- and low-income regions within the Community. The bulk of the transfers are directed to member countries with large economically depressed regions where living standards are significantly below the EC average (Greece, Ireland, Portugal, and parts of Italy and Spain). Accordingly, such transfers could in part compensate for the likely welfare loss incurred in these regions, particularly in the short run, as a result of the completion of the internal market and tax harmonization. However, investigation into past practices casts suspicion on whether the expenditure financed from the Funds is in fact additional to—rather than a substitute for—national assistance to depressed regions. Moreover, there is evidence to confirm the view that, in their present form and scale, the Funds are inadequate as a social safety net for compensating adversely affected regions.

Macroeconomic Effects

The macroeconomic effects of tax harmonization and of the accompanying financial liberalization and removal of border controls are reflected largely in changes in aggregate supply and demand. On the supply side, the allocative effects are translated into fuller capacity utilization (represented by a movement to the production boundary), or capacity expansion (involving an outward shift in the boundary), or both. On the demand side, the impact of effective tax rate changes on the government budget, as well as on household and enterprise incomes, is further transmitted through several rounds of repercussions on domestic absorption. For analytical convenience, it can be assumed that during this process EC member country authorities do not adopt compensatory fiscal action, and nominal exchange rates remain fixed.

Convergence of VAT rates and excise rates should initially involve corresponding changes in the tax-inclusive retail price level of member countries; the removal of border formalities tends to lower the price level throughout the Community. The initial net price changes would be followed by cost-push price pressures whose strength depends on labor market conditions and capacity utilization in each country. Changes in effective corporate income tax rates and interest income tax rates would alter before- and after-tax rates of return. The initial changes in asset yields are likely to be diffused, however, because of substitution between taxed and exempt assets within and across countries. Liberalization of financial services, including removal of capital controls, should contribute to an overall decline in the price of capital in all member countries. Ultimately, interest rates in each country would be influenced by changes in the public sector financing requirement and by the need to maintain exchange rate parity.

The supply-side response to commodity and factor price changes engenders, through the reallocation of resources, a likely increase in capital formation, employment (with labor productivity as well as real wages rising near full employment), and output growth. These effects would tend to be relatively strong in member countries with tax rates that exhibit great internal dispersion and are distant from the proposed band or minimum rates and in countries that are about to remove remaining obstacles to factor movements. All member countries would, in addition, benefit from secondary dynamic repercussions stemming from the enlarged commodity market and the wider pooling of factor resources, technology, and risk across member countries.

Whereas supply-side effects can be expected to materialize over a medium-term horizon, demand-side effects should take place mostly in the short run. The effects on absorption can be predicted broadly on the basis of the magnitude and direction of the government revenue impact, net of ensuing changes in interest payments on government obligations. The initial decrease in revenue from a tax rate cut, reflected in a tax-induced fall in retail prices, enhances the purchasing power of households; the rise in net capital bolsters the cash-flow position of enterprises. As a result, private consumption expands and, reinforcing the improved profitability of enterprises, spurs fixed investment and employment. Depending on the degree of unused capacity, the increase in absorption may lead...
to added output growth, inflation, a wider external imbalance, or a combination of these. An initial boost in revenue stemming from a tax rate increment would, of course, result in an opposite causal chain. In either case, this process is followed by secondary effects on tax revenue through induced changes in the tax base. The consequence of tax harmonization on national saving rates is a composite of the budgetary effect and tax-induced changes in private consumption in each country. On the whole, saving rates would not necessarily converge within the Community.

The net effect on each country's external sector cannot be ascertained a priori. For a given EC member country, the expansion (contraction) in domestic demand involves a rise (fall) in import volume, which may be offset by a rise (fall) in export volume to a partner member country. On the supply side, the EC would collectively experience an improvement in external competitiveness, with a positive contribution to the current account balance. On the capital account, gross long-term investment flows are likely to take place in response to changes in after-tax yield differentials. Significant net direct investment inflows should be experienced by all EC member countries because of dynamic effects over the medium term. The emergence of net imbalances in the current and long-term capital accounts among member countries would be met primarily with net short-term financing—absent changes in monetary stance or nominal exchange rates.

The static budgetary impact (that is, excluding secondary repercussions) of tax harmonization can be expected to be concentrated in countries with relatively high VAT and excise rates. For most countries, commodity tax harmonization could result in an immediate revenue change equivalent to less than 1 percent of GDP; revenue losses of 3 percent of GDP or more have been estimated for Denmark and Ireland, Greece, Portugal, and Spain are likely to benefit from a revenue gain of around 2 percent of GDP, chiefly because of increments in excise rates. The budgetary impact of capital income tax harmonization—broadly in the direction of intercountry distributional effects, as discussed above—is likely to be much smaller. The harmonization of interest income taxation in particular would have a limited impact on most countries, given the remaining scope for avoidance within and outside the Community.

A quantitative assessment of macroeconomic effects requires a medium-term, multicountry computational framework with sufficiently disaggregated commodity and factor markets. Consistent with the budgetary estimates, the simulated effects of VAT harmonization are negligible for most member countries, especially the largest ones. Notable exceptions are Denmark and France. In the former, after five years VAT rate cuts are expected to result in a 4 percent increase in real GDP, a cut in the unemployment rate of more than 1 percentage point, and a fall of some 7 percent in the GDP deflator, relative to baseline levels. In France, liberalized VAT deductibility would induce a 1 percent rise in real GDP and a 4/2 percentage point decline in the unemployment rate. In a simulation of the EC-wide effects of completing the internal market, abolition of border controls and liberalization of financial services were estimated to yield a 2 percent increase in real GDP and a 2/2 percent fall in the price level and to create 0.7 million jobs over the medium term (EC Commission (1988a)). In the short run, however, unemployment may worsen, especially in the Community's less developed areas, tempting some member governments to protect or subsidize the affected industries and regions (Bean and others (1990))—hence the rationale for a sizable increase in Structural Fund transfers to such regions.

These simulation results underestimate the potential contribution—to economic growth, employment, and price stability—of the convergence of commodity and capital income taxation, as well as the removal of border controls and liberalization of capital movements and services, in the EC. One source of underestimation is partial coverage, with few (if any) estimates available for the macroeconomic effects of the harmonization of excises and capital income taxes, which on balance can be expected to create additional economic activity and to further dampen price increases. Second, the simulations are limited in capturing the static allocative efficiency gains from commodity and asset substitution and increased competition, given the lack of sufficient sectoral detail. The third and perhaps most important source of underestimation involves the dynamic supply-side effects (such as improvements in factor productivity from economies of scale, technological progress, and expectations), which are particularly difficult to model. Besides

Over time, this gain would be partially eroded by the negative demand response to the tax rate increase. In the case of Luxembourg, a much larger revenue gain is likely to evaporate rather quickly because of a large volume of cross-border shopping.

Selected simulations of commodity tax harmonization have been performed with the Community's HERMES model, the OECD's INTERLINK model, and several national macroeconomic models that approximate more or less such a framework. For a survey of these results, including estimates of budgetary effects, see Chapter II.

In interpreting the simulation of the single market, the Commission (1988a, p. 159) acknowledged that "even though its
I OVERVIEW

Effects on Non-EC Countries

The implications of tax harmonization and of the associated liberalization of internal commodity and factor movements for non-EC economies can be inferred largely from the above microeconomic and macroeconomic effects. As regards static allocative effects, the abolition of border controls and capital controls—much like the elimination of discriminatory government procurement practices, removal of barriers to entry, and unification of regulatory standards—are tantamount to the dismantling of intra-EC trade barriers. Along with trade creation among EC member countries, in general these measures divert trade from relatively low-cost non-EC producers in favor of high-cost EC producers.46 In addition, each EC member country stands to benefit from improved terms of trade because of the fall in import prices. All told, the removal of border controls has been simulated to improve the EC external current account balance by 0.2 percent of GDP over the medium term. The liberalization of financial services would, primarily through the reduction in the price of capital services, both induce some increase in import demand and strengthen external competitiveness. The latter effect apparently would dominate, with a net positive contribution to the EC current account balance equivalent to 0.3 percent of GDP (EC Commission (1988e)).

Broadly speaking, tax harmonization is likely to lead, on the supply side, to an improvement in external competitiveness and possible terms of trade gains for the EC. On the demand side, the net external effects of tax harmonization tend to be insignificant, as illustrated by the simulated VAT harmonization.47 However, specific instances of increased imports, through trade creation, could be expected regarding commodities currently subject to higher VAT or excise rates, which may provide hidden protection to high-cost EC producers against more competitive non-EC producers. In an analogous manner, even partially effective interest income taxation in EC member countries that currently exempt such income could drive out portfolio investment to non-EC tax havens.

On the whole, the adverse static effects on the current account position of non-EC countries, reflecting mainly trade diversion and improved competitiveness of the EC, are likely to dominate, as suggested by model-based simulation results. However, these effects would be offset, at least in part, by medium-term dynamic repercussions that transcend the simulations. Direct investment would be attracted from major capital exporting non-EC countries by trade diversion and, especially, by the enlarged market. Multinational companies based both within and outside the Community would be lured to expand operations in EC member countries by several factors: lower transactions costs and capital costs on account of abolition of border controls and financial restrictions, economies of scale, increased labor productivity, EC-wide incorporation, and increased transparency upon harmonization of the corporate income tax base.

Expanded multinational enterprise activities in the EC confer benefits to non-EC home countries through added capital income and, depending on the nature of the activity, might generate favorable net trade flows and stimulate employment and growth in these countries. Meanwhile, increased investment in the EC may displace investment that would have taken place in non-EC home countries (mainly in Japan and the United States) or non-EC host countries (possibly in Northern Europe, Eastern Europe, and North Africa), with the attendant loss in local employment and growth. To a small extent, neighboring regions with excess labor supply may recoup a portion of these losses through migration to the EC in response to new employment opportunities.

46The abolition of national import quotas, in connection with the removal of border controls, should have no effect on imports assuming that the remaining EC-wide quantitative restrictions would be equivalent to the sum of fully utilized national restrictions; see Balassa (1989). This is the case of restrictions on textile and clothing imports which are negotiated on an EC-wide basis. However, an EC-wide restriction set at less than the sum of national restrictions would divert trade. Alternatively, if the present national restrictions were less than fully utilized, then an EC-wide restriction equivalent to the sum of these restrictions could lead to some trade creation.

47The explanation concerning VAT harmonization lies mainly in the neutral tax treatment of consumption under the destination principle.
The EC Commission has stressed that, although creation of the single market can be shown by itself to impart static adverse effects on non-EC countries, the attendant allocative efficiency gains, reduction in the nonaccelerating-inflation rate of unemployment (NAIRU), and capacity expansion should permit EC member countries to adopt a less restrictive macroeconomic policy stance, which would contribute to non-EC economic expansion (EC Commission (1988e)). Similarly, the improvement in efficiency should provide an opportunity for the Community to further liberalize trade vis-à-vis non-EC countries. This argument can be extended to the improved resource allocation attributable specifically to tax harmonization.

**Systemic Implications**

Apart from microeconomic and macroeconomic effects within and outside the EC, tax harmonization may have implications for the conduct and effectiveness of fiscal policy in member countries. These implications cannot be ignored in view of the importance that certain member governments assign to national fiscal autonomy. Simply put, a major issue in the debate on tax harmonization involves each government’s ability to make independent use of fiscal policy in the pursuit of domestic stabilization, distributional or structural objectives, especially in the context of the EMU.

In broad terms, more than one third of EC general government tax revenue (roughly one fourth from commodity taxes and one tenth from capital income taxes) is likely to be tied down by convergence toward minimum tax rates (Chart 1). Although subject to certain exceptions to mandated harmonization (such as retention of existing zero VAT rates for interpersonal equity reasons and allowance of investment tax credits if warranted by structural or regional development considerations), the scope for modifying unilaterally the base and rate structure of VAT, excises, corporation income tax, and interest income tax will narrow substantially. The remaining major sources of revenue, not to be covered by concerted harmonization, consist of personal income taxation (other than on interest income) and social security contributions, which together account for well over one half of tax revenue. Since the 1970s, however, industrial countries have attempted to contain, and then to reverse, the earlier rise in social security contribution rates. Furthermore, with a predictable increase in labor mobility, some spontaneous reduction of tax rates on labor income in the future seems inevitable.

Besides the limitations imposed by tax harmonization, EC member countries’ conduct of fiscal policy will be subject to two mutually reinforcing constraints under the stage-by-stage implementation of the EMU. The first is that member countries that have traditionally relied on the inflation tax as an added revenue source will no longer be able to monetize their budget deficits through central bank financing; downward harmonization of reserve requirement ratios would anyway reduce the scope for financing deficits through reserve money creation. And, as exchange rates are increasingly fixed—preparing for the introduction of a single currency—in principle, the only major avenue for independent macroeconomic policy action would be in the form of discretionary noninterest government expenditure. Thus, discipline on each member’s fiscal stance would be left mainly to market forces, reflected in risk-adjusted interest yields on government securities. However, a second potentially powerful constraint consists of the fiscal rules limiting the budget deficit and public debt in terms of GDP. If binding, these rules would enhance the Community’s collective responsibility for macroeconomic stability in member countries and possibly obviate its role as lender of last resort.

An upshot of the foregoing discussion is that, against a background of significant differences in budgetary stance (Chart 2) in the past—despite the convergence of monetary policies among countries participating in the EMS (Tanzi and Ter-Minassian (1987))—the fiscal performance of EC member countries is bound to converge in the period ahead, on the strength of both tax harmonization and financial integration, assisted by the enforcement of fiscal rules. At the same time, the case for national

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48It is conceivable, however, that, within a more integrated Community, wages in the low-income regions may rise faster than warranted by productivity gains—to catch up with wage levels in high-income regions—and structural unemployment may worsen. In the event, a less open and expansionary policy stance might be anticipated.

49For evidence of possible adverse consequences of rising social security contributions for external competitiveness—absent border tax adjustments and given fixed nominal exchange rates—and for employment, see Koebs (1982).

50For an analysis of the interaction between the exchange rate and fiscal policy under the EMS, see Vehrenberg (1990).

51For a discussion of the rules applied to state budgets in the United States and their possible relevance to the EC, see Isard (1989). Rules to limit the size and financing of budget deficits in EC member countries had been advocated for example by the Delors Committee for the Study of Economic and Monetary Union (EC Council of Ministers (1989)). See also the analysis in EC Commission (1990e).

52The role of lender of last resort was assumed by the Community in providing financial assistance to Italy in 1977 and to Greece in 1983.
fiscal independence for domestic stabilization purposes would be weakened by the ensuing convergence of inflation rates across member countries. However, the loss in fiscal autonomy by member countries need not be complete. In particular, member governments would retain the automatic stabilizer feature of progressive personal income taxation—unless subject to bracket indexation for inflation, as in Denmark—and of unemployment compensation benefits. In addition, within the limits imposed by common minimum tax rates, financial markets, or fiscal rules, a discretionary countercyclical stance might still be adopted through noninterest government outlays or certain tax changes.

Overall, tax harmonization will also narrow the scope for member governments to pursue independent structural or social policy goals. Again, within limits, they could alter the composition of noninterest budget expenditures or grant tax incentives for investment or employment. Increased factor mobility and some competitive downward pressure on tax rates (toward the prescribed minima) are likely to have a twofold effect on public finances in the Community. On the one hand, member governments will rely increasingly on benefit taxation, and, except for a few low-tax countries (that is, where tax rates would need to be raised to the prescribed minima), there will be a tendency for the public sector to become more efficient. On the other, such conditions strengthen the earlier argument for a substantial expansion and overhaul of Structural Fund transfers to low-income regions in the Community.

Since the 1980s a number of EC member governments and non-EC governments have launched medium-term fiscal consolidation programs so as to meet an increasingly tighter intertemporal budget constraint imposed by a rapidly mounting public debt stock and interest payments. Thus, the latitude for an independent fiscal stance has already been reduced, quite apart from the recent impetus
An additional systemic issue involves the coordination or harmonization of the tax structures of EC members and non-EC countries. In this regard, a harmonized EC tax system can facilitate closer income tax coordination and administrative cooperation—as envisaged in part under the Council of Europe-OECD draft convention (Council of Europe and OECD (1989))—between EC members and non-EC countries. More immediately, policymakers in these countries have to address this issue as it relates to financial liberalization and taxation of capital income. In particular, to prevent loss of revenue from interest income taxation—through financial reallocation to low-tax jurisdictions or to exempt instruments—EC and non-EC governments may consider agreeing on a common minimum withholding tax rate on such income at source, along with uniform reporting requirements and other forms of administrative cooperation to support residence taxation. There are precedents for such an approach in at least two other areas. One is the arrangement among OECD member countries, effective since 1978, on the application of minimum interest rates on officially supported medium- and long-term export credits. The other is the 1988 Basle Accord among industrial countries on a minimum capital adequacy ratio with regard to international commercial bank lending; nearly all major banks are expected to comply with this requirement by 1993.