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Comments on Michael Keen: Some international issues on commodity taxation

Anders Kristoffersson*

Not being an academic expert on the international commodity tax issues Keen treats in his paper, I will primarily take the view of the tax policy bureaucrat. At any rate, Keen's paper illustrates the potential of economic modelling to produce insights that provide a valuable framework for considering tax policy issues.

Keen concentrates on problems with the so-called destination principle, i.e. the taxation of commodities in the country where they are consumed. Given the broad support for this principle among tax policy makers, there are good motives for concentrating on the *consumption* aspects of international taxation of commodities, and their implications for broader welfare issues.

On the other hand, if there is an interest in the allocation of productive resources among countries, the alternative principle, the principle of origin, where taxation takes place in the country where commodities are produced, and *its* problems should also be brought into the discussion. Although the subject for another paper, I would like to give two examples of international tax policy issues related to the principle of origin:

A further harmonization of the VAT has been an issue for a long time in the EU tax policy discussion. For an economic union, the motives for moving to an origin-based system is, on the surface, rather self evident: For a "borderless" Europe, the cross-border corrections inherent in the destination principle could be seen as an anomaly. But in the present Commission program, the transitional system, mainly building on the destination principle, will be indefinitely prolonged. In my view, this reflects well-motivated concerns within most countries about what will happen, not only to the distribution of tax revenues among member countries (and the need for more or less complicated clearing mechanisms), but also to production and employment in single countries when the VAT burden could no longer be shifted for-

* *Anders Kristoffersson is Deputy Director-General at the Tax and Customs Department at the Ministry of Finance, Sweden.*

ward to the consumer. Normally, the destination principle is considered to facilitate a forward shifting, in comparison with what happens under the principle of origin, although the differences in a general-equilibrium framework, if any, should be limited. At least in a medium term perspective, and especially for countries with high tax rates at the outset and where labour markets primarily react through quantity, and not through price adjustments, problems will arise. Consequently, after the introduction of an origin-based system, some countries will face two not very attractive policy options, either to reduce the VAT rate with its revenue implications, or to accept negative adjustment effects in real economic terms.

A second example of an international tax issue related to the application of the principle of origin is given by the taxation of commodities used as inputs in production. An application of the destination principle is, at least for administrative reasons, not a practical option. Although it could be argued that input taxation as such is not good for allocative reasons, and should be abolished, we have those taxes. Here, we face the same problems as with an introduction of origin-based VAT, i.e. at least medium-term problems for production and employment in high-tax countries. This is illustrated by the present evolution within the EU regarding energy taxes.

With reference to the rules for State Aid and in order to safeguard these rules, the Commission puts pressure for a uniform tax in Member states applying a differentiated tax structure for different kinds of business, using lower rates for those parts exposed to international competition in the market for final goods. Although the lower rates may be higher than those in other countries with no negative effects on competition *between* countries (the latter is a necessary condition for the existence of a State Aid in economic, although not necessarily in legal, terms, judging from recent rulings by the European Court), the Commission considers this as State Aid. This illustrates the need for further economic analysis, and a more efficient communication of already existing results of the effects of origin-based taxes on inputs (e.g. capital and energy) in production in economies with internationally open markets for final goods.

After this diversion into issues not covered by the Keen paper for natural reasons, let me return to the problems of the destination principle. As pointed out by Keen, there are problems both when the principle is applied and when it is not. When applied, there is the risk of an implicit protectionism where domestically produced commodities are taxed lower than those produced abroad. As observed by Keen, the relative tax on beer and wine in Sweden is one example, although the problems have been handled through tax measures in the last few years.

However, the major problem with the destination principle arises when it is not applied (primarily due to enforcement problems regarding the proper cross-border corrections). For those problems, Keen introduces an analytical and valuable distinction between two types of transactions, legal arbitrage transactions (LA-transactions) where consumers legally exploit tax-rate differentials, and those transactions caused by the existence of a domestic tax that the consumer wants to avoid entirely, so-called tax-not paid transactions (TNP-transactions).

According to Keen, the theoretical models of tax-setting games have been used to analyse LA-transactions, but Keen expands the analysis to deal with TNP-transactions. A general result of this exercise is that tax revenues will be lower when TNP-induced behaviour is assumed.

One common feature of the models used is that they assume identical preferences for public goods in a two-country model (with one large and one small country). Given that and other assumptions, this results in a lower tax rate in the small country (with a smaller tax base and more to gain from tax revenues from consumers in the larger country), which applies in the LA transaction case. As pointed out by Keen, this deviates from at least some observations showing higher rates in small countries (e.g. the Nordic ones) which could reflect different preferences for public goods but also economies-of-scale in the production of public goods.

In relation to the analytical distinction between LA- and TNP-transactions, Keen asks which of these is most important in reality. This is certainly an important tax policy issue. As he observes, data are difficult to obtain. From a Swedish perspective, it may be noted that up until now, TNP transactions seem to have been the most important ones. Including VAT-frauds and the effects of smuggling of cigarettes and alcohol in the TNP-class, available, although most uncertain, data, indicate the TNP class to be the most important from a revenue-loss perspective. This might change in the future, however, due to lower transaction costs in different areas and changes in the legal conditions. Concerning the latter, the large changes in the volume of alcoholic beverages allowed to be privately imported to Sweden until the final adjustment to the EU rules in January 1, 2004, expand the room for LA transactions.

On the empirical side, Keen covers several issues. In general, the data showing the extent of cross-border trade and its revenue effects are scarce and difficult to interpret for different reasons. As pointed out in the paper, international comparisons between countries are subject to a self-selection bias, where countries showing a high interest in measuring cross- border effects also report high numbers. Another fruitful observation by Keen is that one must distinguish between actual and potential cross-border trade; a lack of observable cross-border activities might well reflect the fact that in the past, the country involved adjusted its tax rates to mitigate cross-border trade. For Sweden, the evolution of the tax rates on cigarettes between 1996 and 1998 provides an illustration. At the beginning of the period, rates were increased for fiscal reasons on three separate occasions. After observing the effects on smuggling, the rates were reduced in 1998 and after that, there have been indications of less smuggling and recovered tax revenues.

From Keen's paper, it is clear that there are only few empirical studies of actual tax competition among countries in the commodity tax area, using tax reaction functions. More studies of actual behaviour are needed as one cannot rely on declarations by governments.

One important section of Keen's paper deals with how to move from, in themselves not easily measured static effects on tax revenues, to the impact of cross-border trade on welfare. The potential magnitudes of the welfare losses are illustrated by a tax competition model containing parameters like the marginal cost of public funds in the countries and the elasticity of cross-border trade with respect to tax differentials. The numerical results indicate that the welfare losses due to tax competition and the gains to be made through tax cooperation are not negligible. I have only one general remark on these welfare issues. It is fairly hard to communicate efficiency results to tax politicians, whose preferences are directed towards revenue and equity effects, especially when the figures are not dramatically high. There is certainly a need, that could only be met by the economists themselves, to "translate" efficiency concepts like the marginal cost of public funds and excess burdens, so that they can get their proper place in the political decision-making process.

Keen concludes by discussing the tax policy options, for example the use of minimum tax rates as an element in an enhanced coordination of tax policies among countries. Up until now, attempts in this direction have not been very successful. But the mirror image is the trend, observed by Keen, towards relying on administrative cooperation, e.g. exchange of information. There are good causes for this development, although one might be not that optimistic as concerns the outcome of this option either. In that respect, Keen's final reflection on whether administrative cooperation can substitute for deeper policy reform is well worth considering.