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Comments on David E. Wildasin: Tax coordination: The importance of institutions

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After a short discussion on the role of governmental institutions and a general discussion on the mechanisms of different kinds of "coordination" of tax systems, David Wildasin concentrates on the coordination of corporate tax systems through explicit agreements between states. This generally leaves aside other forms of coordination, such as coordination by delegation, that is through the establishment of new governmental structures with taxing powers. The EU-development is far from reaching that stage. Another type of coordination that is mentioned, but not discussed, is coordination or harmonization by voluntary implicit agreements between states, that is, that a state chooses the same policy as one or several other states. The paper concentrates on the development of state taxation in the US and the use of formula apportionment in order to allocate the tax base among states. The experiences of state cooperation in the US are of interest because there are many similarities between state relations in the US and the relations between the Member States of the European Union. Being a federal state with many member states, the US generally functions as one market, while a true single internal market does not yet exist in the European Union. Therefore, a comparison with the US situation is of great interest also in the tax field.

There are, however, many differences to be kept in mind. In the US, the corporate tax base is, in general, almost the same in most states with the federal tax legislation as the model. In EU, the 15 different corporate tax systems are not coordinated in that way. On the contrary, they contain many differences which often lead to double taxation effects and administrative problems. Another difference is that the tax rates are in general approximately three times as high, around 30 percent, as on the state level in the US where the state tax rates do not reach 10 percent. These lower tax rates make differences between the systems less important, while the higher tax rates in the

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EU will have more serious effects, e.g. the difficulties in both systems to set off losses on cross border activities against profits in another state. This means that the need for cooperation is more urgent in the EU than in the US.

Although cooperation between the states in the US is rather limited in many ways, 45 states cooperate on the issue of allocating the income of multistate activities among the states through a formula apportionment established by the Multistate Tax Commission, i.e. a Multistate Tax Compact.

This is the so-called "three-factor formula" which, for corporate tax purposes, attributes to a state a certain proportion of a company's income based on a weighted average of the state's share of the corporation's payroll, capital assets, and sales. In the absence of a common tax base, some kind of formula apportionment is necessary to make it possible to allocate an income tax base between several jurisdictions in a rational way. Therefore, the US experiences are of great interest to the EU, since an allocation key for the division of income between the Member States on cross-border activities in the EU is a necessary part in removing the income tax obstacles to a proper functioning of the internal market.

Although the three-factor formula has existed for many years, today it is only applied in its original form in a minority of the states. Several states lean more heavily on sales, despite the fact that modern technology makes it possible to sell to customers in a state with less physical presence in that state than ever before. The payroll factor has been abolished by several states. The capital factor has proved to have severe weaknesses as physical capital has become less important in the modern economy. While intellectual property has become more important, the value of intangibles, such as patents, know-how, trademarks, human capital etc. is seldom reflected in the balance sheets. Therefore, the capital factor does not seem to properly reflect the economic realities of today. Moreover, there are clear signs that changes in the formulas are used by states as a means of tax competition in order to attract activities and increase their tax bases.

For a formula apportionment system to function properly, some conditions must be fulfilled. The first condition is that all income included in the formula ought to be calculated according to uniform rules for calculating the tax base, which is not the case in the US. However, in a EU context this is mandatory as the tax rates are considerably higher than in US state taxation. Otherwise, the result will be over- or undertaxation with severe effects.

One way of achieving uniform rules is of course to introduce a harmonized system in all states involved, e.g. a EU corporate tax. Such a federal solution does not seem politically possible within a foreseeable future. It is totally outside the EU agenda.

Another way is that the Member States agree upon a special common tax base applicable to the consolidated income of companies or groups of affiliated companies with interstate activities, so-called "Common Consolidated Base Taxation" (CCBT). This model is put forward by the EU Commission as a possible alternative for the future, applicable parallel to the national systems (see European Commission, 2001 and 2002). The national tax rates will be applied to the share of consolidated income which is allocated to a specific Member State according to a formula. The question is, however, whether the Member States will be able to agree on a special and detailed system for calculating the income on cross-border activities in the EU. Looking back at the Member State's unwillingness to compromise on tax issues, it is doubtful whether such a decision is within the political capability of the Council of Ministers.

However, it is not necessary for the states to harmonize their tax bases or agree upon one harmonized tax base according to a formula. The only necessary thing is that the entire income of a group of affiliated companies is calculated on a consolidated basis according to the same set of rules. This can be achieved by an agreement between states to mutually recognize each other's income calculation rules and allow the entire income of the group to be calculated according to the rules of the home state of the parent company, so called "Home State Taxation" (Lodin and Gammie, 2001). Alongside CCBT, this method is put forward by the EU Commission as a possible alternative for the future (see European Commission, 2001 and 2002), as it can be expected to be politically more acceptable for Member States with similar income calculation rules to join such a system, based on mutual recognition only. For the states, as for the companies, it will be voluntary to join the system.

A second condition for a formula apportionment to function properly is that only income in states applying the system should be subject to the allocation. This has been a problem in the US, as several states have wanted to include the entire income of a company or group of companies, even foreign income subject to taxation in foreign countries according to different rules. A so-called "water's edge rule" has been introduced in most states later on, implying that no income outside the states applying the formula apportionment should be included in the allocation. In the EU context, this means that only income in Member States that have joined the allocation system should be included. All other income will be taxed according to normal national rules.

A third condition is that the formula reflects economic realities, is stable and cannot be manipulated, neither by states nor by companies. This is an area which has to be studied closely. Although much can be learned from the US experiences, the three-factor formula does not seem to properly reflect economic realities. The experience is also that it can be manipulated.

Therefore, one should look for other solutions. In a European context, a formula based on the share of the total value added of the activities produced by each company seems near at hand. Value added is a familiar concept in the EU, as the general consumption tax within the EU is based on that principle, which also means that the information needed for such a system is easily available. The VAT base must, however, be slightly adjusted to arrive at the value added appropriate for the allocation of consolidated income. However, more research is needed before the most appropriate base for a formula apportionment can be established.

According to David Wildasin, the US experience suggests that a coordination of the tax systems in such a way as has been discussed here is difficult to achieve, at least through voluntary adherence to a system of tax principles such as those embodied in the Multistate Tax Compact. In the US case, effective coordination of income taxation has been achieved through "delegation", that is, through the growth of the federal tax system.

With regard to the prospects for corporate tax coordination in the EU, "delegation" to the federal institutions is obviously closed for the foreseeable future. The only way forward seems to be by voluntary agreement. The EU-history in the income tax field is not encouraging. On the other hand, the only way to live up to the proud statements of the Lisbon summit in April 2000, according to which the European Union should be developed into the economically most successful region in the world by 2010, is to get the internal market to function as one single market. This will never be achieved unless the tax obstacles to cross-border activities are removed. Therefore, voluntary tax coordination of the corporate taxation in EU is mandatory, if EU shall ever be able to reach the main goals set up for the union's economic policy by its Member States.

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