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The international mobility of tax bases: An introduction

John Hassler and Mats Persson*

The existence of the welfare state is arguably one of the most pervasive features of the modern economy. In several European countries, including the Scandinavian ones, citizens pay around half their income in taxes, and welfare state institutions affect the daily life of most individuals. For its survival, the welfare state must tax its citizens, either directly or indirectly. However, recent trends appear to make this increasingly difficult. Increased mobility of highly educated individuals may hamper progressive individual income taxation. Reductions in transportation costs and financial innovations have the same effect on taxation of firms and financial assets. These trends could cause increased international tax competition; countries not offering "competitive" tax levels on physical, financial and human capital simply lose these essential factors of production, which might entail the dismantling or downsizing of the welfare state. In cooperation with the Swedish government's Committee on Tax Base Mobility, the Economic Council of Sweden therefore organized a conference on international tax-competition on November 1, 2001, where some of the world's leading researchers in the field presented the papers in this volume.

The first article is written by *Michael Keen* and focuses on commodity taxation. Keen shows a fairly general theoretical result to be that tax competition has a larger effect on commodity taxes in smaller countries and countries with several borders. This is consistent with the observation that tax havens typically are small and that many low-tax US states are sparsely populated, but closely located to more heavily populated states (e.g. New Hampshire). The solution to problems arising from tax competition is international cooperation, but this is easier said than done and reforms like a uniform increase in tax rates

* *John Hassler is research fellow at the Institute for International Economic Studies, Stockholm University. Mats Persson is Professor of Economics at the Institute for International Economic Studies, Stockholm University.*

may not necessarily lead to higher welfare in high-tax countries. Keen also discusses international evidence on tax-driven cross-border trade, but notes that the volume of such trade is a bad indicator of the strength in tax competition, since sub-optimally low but similar tax rates have a limited impact on trade. A more promising way of measuring the extent of tax competition is to analyse how responsive tax rates in a particular country are to changes in foreign tax rates.

Wolfram Richter considers labour mobility and taxation of labour income. Richter's starting point is that Europe should be a place of free mobility for everybody, including non-working individuals. However, this principle may be in conflict with the main tasks of the welfare state—in particular, to redistribute income and provide insurance against income uncertainty. If individuals who are fortunate and do not require assistance from the welfare state can move to other countries, tax competition may make the national welfare state unviable. One extreme solution would be to allow individuals to choose between competing redistribution systems, provided by different countries, early in life but without the possibility to switch later. They would then be free to move within the EU, but would always face the same redistribution system. Certainly, this would create administrative difficulties and Richer instead argues for an intermediate system, where individuals moving to another country retain their old home-country benefits and tax obligations for a limited transition period. The length of this period may differ depending on the type of social insurance, but should be coordinated between the member states.

Michael P. Devereux and *Rachel Griffith* survey the empirical literature on how corporate income taxes affect firm decisions on the location of capital. They note that tax policy can affect both the allocation of physical capital between countries and the ownership structure of this capital. Data on foreign direct investment and portfolio investment are both quite imperfect measures of how the aggregate stock of capital and its ownership are changing.

It is obvious that the aggregate stock of physical capital affects national welfare—but the ownership structure is also something a government may want to influence. Devereux and Griffith argue that it may be beneficial to have multinationals own a large share of domestic capital.

In the empirical survey, the authors distinguish effects on decisions at three levels; whether to produce abroad or at home, where to produce abroad and finally, how much to invest at each foreign location.

Even if the evidence is far from overwhelming, most studies find tax rates to have an effect on firm decisions at each of the three levels. However, due to the great variety of measures used for investment and taxation, it has yet not been possible to arrive at consensus estimates on how large these effects are.

Guttorm Schjelderup cites empirical evidence indicating that although financial capital is less than perfectly mobile, tax differentials between countries and types of assets do affect investment flows. A striking example is the German attempt to introduce a source tax on interest income, which led to a massive flow of funds to Luxemburg. Schjelderup also discusses the taxation of derivative financial instruments. Such instruments can be used to convert income and payments, shift them over time and country borders and create synthetic transactions. Since it is difficult to create a tax system taxing all income from portfolio investments at the same rate, derivatives may be used to escape taxes by using such arbitrage opportunities.

The residence principle, i.e., the home country taxing all interest income accruing to its citizens, regardless of in which country they have their funds, would theoretically lead to an efficient allocation of real capital. However, without a world-wide agreement on information exchange, it is difficult to enforce this principle in practice. Even within the European Union, information exchange may be difficult to achieve. It would require an EU-wide identification number and, possibly, an international tax agency counteracting the incentive to compete for capital by withholding information. The alternative of implementing a minimum withholding tax on the capital income of non-residents is also problematic for various reasons, e.g., that different member states are likely to have different views on how large such a tax should be. Furthermore, tax havens outside of EU would still remain, reducing or possibly eliminating the gains from coordination within EU On the whole, Schjelderup is therefore fairly pessimistic regarding the possibility to internationally coordinate capital income taxation.

Søren Bo Nielsen, Poul Schou and *Jacob Krog Søbygaard* analyse Danish evidence on income tax evasion and avoidance, in particular whether consumption taxes or income taxes are more vulnerable to evasion. The authors use the fact that in the national accounts, total net income minus domestic investments must equal private and public consumption, plus the change in foreign asset holdings. The income and consumption tax bases can be estimated independently, using data from the tax authorities. If these estimates are inconsistent, this should be due to differences in the degree of misreporting of income and consumption. For the examined years 1995-97, the calculations imply that the reported income is too low to be consistent with consumption—an amount in the order of 2-4,000 million euros is missing every year. A possible conclusion is that consumption taxes should be used more heavily, since the "leakage" is smaller from this tax base than from income.

By analysing the determinants of migration, the authors also study whether migration causes a problem for Danish tax collection. They find that high education tends to increase the probability of emigration from Denmark. Age is also important—individuals between 25 and 39 are the most likely to emigrate, as are singles without children. Regarding income, the relationship is U-shaped with a higher probability of emigration for high- and low-income earners. Most individuals who emigrate eventually migrate back to Denmark and, on average, they have higher incomes than individuals with the same characteristics who remained in Denmark. Temporary migration may therefore be beneficial for the size of the domestic tax base in steady state. Although the results of the paper indicate that migration is affected by economic factors and therefore, could potentially be of some concern from a tax collection perspective, the authors conclude that current migration patterns pose no threat to Danish tax collection.

David Wildasin focuses on the coordination of corporate income taxation, arguing that important lessons can be drawn from the US experience. US states can levy corporate income taxes on firms with some physical presence in the state. Although a formal coordination of these taxes would be possible, most states have chosen to set their tax rates unilaterally, calculating the tax based on the firms' sales, payroll and capital assets in the state. Over time, sales have been given a higher relative weight in the tax formula, while the payroll and capital assets components have been de-emphasized. This can be understood as an attempt to compete more aggressively for labour and capital while, at the same time, capturing some of the profits accruing to shareholders located outside the state.

Federal corporate income taxes are imposed at substantially higher rates than state taxes, which seems to illustrate the feature that using corporate income taxes for redistributive purposes may require some coordination. Wildasin's conclusion is that the US experience suggests that coordination of taxes through implicit or explicit agreements is difficult. Instead, coordination by delegation to a higher level (like the federal government or, in the case of European states, the EU) might be necessary.

Jonas Edlund and *Rune Åberg* use international surveys to analyse individual attitudes to tax evasion. They find that it tends to be more socially accepted to evade taxes in high-tax countries, but the correlation is fairly weak. Sweden is somewhat of an outlier, with relatively negative attitudes towards tax evasion, despite the high tax level. The authors also find that higher taxation tends to be associated with larger differences in attitudes between different groups. Once more, Sweden is an outlier with relatively small differences in attitudes. Differences between the sexes are small and not significantly correlated with the national tax level. On the other hand, individuals working in the private sector tend to have less negative attitudes towards tax evasion, a difference which becomes more pronounced in high-tax countries. In high-tax countries, attitudes are more negative among left-party voters but, somewhat surprisingly, the opposite is true in low-tax countries.

Edlund and Åberg also attempt to see whether the attitudes towards tax evasion can predict actual evasion. The result is surprising once more; controlling for the tax level, the authors find no support for the hypothesis that the reported attitudes have an effect on actual evasion.

Finally, we want to draw a few conclusions of our own. We believe tax competition due to factor mobility to pose no immediate threat to the welfare state. Neither border trade nor labour mobility appears to be sufficiently elastic for this to be the case. Some other tax bases may be more elastic—and increasingly so; for example tobacco and alcohol, sports super stars, corporate and capital income and international experts and businessmen. Typically, these tax-bases are not sufficiently large to be of crucial importance from a purely fiscal perspective. However, this does not mean that it is unimportant to set these taxes right. On the contrary, high elasticities mean that the welfare consequences of suboptimal taxes are large and that more is at stake in the construction of the tax system. At the same time, the political system cannot only take into account tax-base elasticities and efficiency. For example, we have previously argued that property taxes should be raised in Sweden, at least to U.S. levels, since there should be no fear that houses in Sweden leave the country. However, we are also aware of the political difficulties in getting acceptance for such a proposal.

If more is at stake in the construction of the tax system, the need for more quantitative knowledge on how taxes affect individual and corporate behaviour becomes more pressing, warranting more academic research on these issues. It also seems very likely that financial innovation and globalisation as well as increased competition for the elastic tax bases all increase the demands on the tax authorities. It is therefore very important that the latter are given sufficient budgets to be able to attract competent personnel in sufficient numbers, something we are worried not to be the case at present.