Guy V.G. Stevens
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Tax Competition

Point 16 of the draft communique for the April G-7 meeting, dealing with international tax competition, is essentially identical to the February 8 statement on the same subject at the end of the Berlin meetings (press guidance, point 16); both of these statements are much better crafted than the paragraph proposed in the draft communique at the beginning of the Berlin meetings. The present proposal notes that tax "schemes" aimed at attracting financial capital have the potential to "distort international trade and investment, erode national tax bases, and undermine fairness and neutrality of tax systems." This is all true and expresses the concern of many countries, like the United States, that have always supported international tax neutrality. The present proposal goes on to throw the thorny issues, at least for now, into the lap of the OECD, noting and welcoming the work now underway to come up with a report on this subject in 1998.

The previous, Berlin draft took a very unsophisticated position, stating that "tax competition must be fair," and then went to maintain that fairness implied that tax policy "should not result in an erosion of the tax bases or encourage tax evasion." The first of these two, no erosion of the tax bases, seemed to suggest that *all* tax-induced capital flows should be prevented or discouraged -- a rather far departure from reality.

Germany, Belgium, and, more recently, France have been pushing for a concerted international effort to neutralize tax havens, particularly the major one within the EU: Luxembourg. Calls for action in both the EU and the OECD have increased as these three countries look for revenues to meet the EU budget criteria without raising tax rates. The proximity of Luxembourg (which has no withholding taxes and does not share information on the nationality of its non-resident investors) has had a strongly negative effect on all three countries' abilities to tax interest income. In a famous historical example, Germany in 1989 found that a withholding tax of only 10 percent caused such massive capital outflows to Luxembourg and other tax havens that the withholding tax had to be rescinded after only three months. Although Germany and some of the EU countries have learned from the 1989 debacle, and have carefully crafted withholding taxes on interest that have limited somewhat the resulting capital flows, the yield has been quite low. When combined with a widespread penchant for tax evasion on interest income in countries like Germany, the overall effective tax rate on capital in European countries also has been typically low.

The OECD work noted in the present draft communique is being undertaken by special study groups under the auspices of the Committee on Fiscal Affairs. Preliminary reports were presented at the OECD, January 23-24, on the following subjects: (1) determining criteria for identifying harmful tax competition; (2) measures to counteract harmful tax competition, once defined; (3) determining criteria for a related issue, tax regimes that are "non-transparent" -- i.e. emphasizing regimes where there exist a large number of special tax arrangements that are negotiated with foreigners on a case-by-case basis, often with little sharing of information with other concerned tax authorities. With regard to the discussion of the first two subjects, there was no sign of agreement at the January meeting on either the criteria for or measures against harmful tax competition. All parties allow that tax incentives are sometimes defensible -- for example, when countries like Ireland give tax incentives to MNCs to locate new facilities in depressed Irish areas. Once exceptions are admitted to total tax neutrality, all countries have found that it becomes difficult to draw a reasonable line.

The ongoing OECD work builds on earlier work at both the European Commission and the OECD, itself. In June 1995 an OECD task force (on which I was the Fed's representative) produced a report entitled: *The Globalization of Financial Markets and the Tax Treatment of Income and Capital.* No consensus on recommendations was reached in this report or in previous efforts. In 1995 there was, what I would call, strong pressure from Germany and Belgium to promote an OECD-wide withholding tax on interest income. There was also some interest in a hybrid system, which allowed the exchange of information between governments (taxpayer IDs, etc.) as an alternative to, or in conjunction with a withholding tax. Any agreement by the Europeans is made less likely by the unanimity rule within the European Union.