Intervention by:
Jeffrey Owens[1], Director, Centre for Tax Policy & Administration, OECD
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What's new?

Today tax competition is a reality around the world. Some politicians may not like this, and it may make life more difficult for governments, but it's not going to go away, so we must learn to adapt to this more competitive environment, not just in the tax area but in all areas of economic life. And, after all, competition is what the Lisbon agenda is all about.

We must recognize that if we are to get the full benefits of tax competition, we need a set of rules to distinguish between fair and unfair competition, just as we needed WTO rules to get the full benefits of free trade.

What influence does tax have on location decisions?

The short answer is: tax is increasingly important. The removal of non-tax barriers to cross-border activities, new communication technologies, the development of regional economic blocks have all made capital (including intangible capital), skilled professionals and even consumption increasingly geographically mobile and increasingly sensitive to tax differentials.

The American banker who moves from New York to London, the German pharmaceutical company that shifts its headquarter from Munich to Zurich, the IT company that centralises its intangibles in Luxembourg, the Austrian consumer who buys software from a Singapore based outlet, all are examples of the increased mobility of the tax base.

I do not believe that any of these decisions are driven just by tax considerations. If tax were the only determinant of these location decisions, we would see a massive outflow of activities from high tax to low tax countries, which clearly has not been the case.

[1] The views expressed in this document are those of the author and do not in any way commit the OECD not its Member countries.

Companies look at long-term profitability in making decisions as to where to locate. And this, in turn, depends on access to markets, availability of qualified labour, political stability and unit costs. Tax is one of these costs and business will, other things being equal, prefer a low tax to a high tax jurisdiction. But as we know, other things aren't equal. A relatively high tax country which uses its revenues to provide a first class infrastructure, a well-educated and flexible labour force, a well-functioning health and pension system[2] will be more attractive than a low tax country which has none of these productivity enhancing features.

Ireland's success proves this point. Its success has less to do with its tax regime than with the fact that it has a well qualified English speaking, flexible and relatively cheap (at least until recently) labour force in a geographically convenient location. Clearly tax helps, primarily by promoting Ireland as a business-friendly environment, but Ireland first got the fundamentals right.

Individuals do not normally decide where to establish their residence just for tax reason. Individuals look at the "quality of life" in different locations. Nevertheless, for very wealthy professional, tax can be a very important driver, as can be seen from the attraction of Monaco for successful sport personalities and the way the UK has used its non-domicile rules to increase the attraction of working in the City of London.

Within integrated economic areas like the EU, we can expect – and this is confirmed by recent economic studies[3] – that tax is set to become a more important factor determining where companies and individuals locate their activities. And, of course, tax will remain one of the major factors that determine how a company structures and finances its investments.

What taxes are relevant to these decisions?

Most of the debate on tax competition and growth focuses on the corporate income tax, particularly the headline rate of tax. This is understandable since this has an immediate impact on after-tax profits. But other taxes may be equally important in influencing location decisions:

- Non-profit related business taxes (the Gewerbesteuer in Germany; the "taxe professionnelle" in France). These are taxes that hit firms even when they do not make a profit.

[2] To give an example, each car produced by GM in the US incorporates approximately $1,500 of medical costs; Toyota's equivalent figure is $200. Why: because the social security system is more extensive in Japan than the US.
[3] See Taxation and Foreign Direct Investment OECD 2008.

- Social security contributions: When these contributions can account for a third or more of the cost of hiring labour, as in France, Germany or Belgium, this will surely discourage companies to enter these markets and take on new employees.
- VAT can also be a competitive factor. Look at how Luxemburg has used its low VAT rate – the lowest in the EU - to attract service activities to locate there.

Corporations will also look at how headline rates of tax translate into effective tax rates, after account is taken of the impact of tax reliefs and tax minimization strategies. Corporations will take all of these tax factors into account. Yet there is no ambiguous index – a sort of total tax contribution for business index – which can measure the overall attractiveness of a country's tax system (the World Bank "Doing Business" series has attempted constructing a series of indicators, but these are very crude).

At the level of individuals, personal income taxes, capital gain taxes and tax on wealth and inheritances will all influence where highly skilled professionals will migrate to.

Tax Administration also counts

But it is not just the tax system that counts: it's also the way in which the system is administered.
Is the tax administration perceived as being aggressive or business-friendly? In today's rapidly changing environment, corporations increasingly expect tax administrations to provide predictability, certainty, consistency and to engage business in the formulation of new rules. Again there is no reliable index but if you asked business across Europe, I think you could pretty quickly get a consensus on which countries are seen as being tax business-friendly and which are not.

How have governments responded to this more competitive environment?

They have cut corporate and personal income tax rates. Since the mid 1980s, we have seen corporate and top personal income tax slashed, with Europe taking the lead. Today very few countries have CIT rates near the 45% plus rates found in the early 1980s; and even fewer countries have top marginal PIT rates about 50%. It's also been a long time since I heard a Finance Minister say he or she was going to increase these rates. And I expect that this trend will continue, although I do not see a "race to the bottom" amongst the larger European countries (although this may occur amongst the small newer EU countries and in the Balkans which are more exposed to tax competition).

Governments have also reviewed taxes on capital. Some countries have abolished or reduced capital gain taxes; the number of countries with net wealth taxes has fallen significantly (to less than eight); death taxes have either been eliminated (Sweden) or thresholds raised (UK), property tax burden on business lightened.

Some countries have shifted from income to consumption taxes in the belief this makes them more competitive (New Zealand, TVA sociale debate in France). Interestingly, very few countries have, despite the political rhetoric, succeeded in reducing the overall tax burden.
Taking together these structural changes in our tax system are probably leading to a less progressive system – not necessarily less fair, but less progressive. And this may raise some difficult political issues since taxes are one of the main ways in which government can achieve a fairer sharing of the costs and benefits of globalization (a point recently acknowledged by the Chairman of the US Federal Reserve). In this context, it is interesting that some of the richest people in the US are lobbying hard against abolishing what President Bush refers to as death taxes. Perhaps the challenge for governments is: can we maintain competitive tax systems but at the same time ensure that they fulfill their re-distribution function. I believe we can, partly by the way we define the tax base and by looking afresh at the way we use taxes on wealth, inheritances and property, but that is an issue for another conference.

Another response of governments to this more competitive environment has been to review the international tax arrangements. An increasing number of countries are examining whether to move from tax systems which tax active income on a worldwide basis to taxing on a territorial basis. Many countries have put in special tax regimes for highly mobile service activities (headquarter regimes, holdings, consolidation regimes).

Yet another response has been to try to create a more business-friendly tax environment. Companies want an administration which provides certainty (no surprises), predictability (a tax vice-president risks losing his job if his tax calculations are incorrect), consistency and transparency. Some countries are moving away from a confrontation to a cooperative approach; providing advance rulings, reducing the time it takes to get a final closing of the tax accounts. The OECD's Forum on Tax Administration is looking at what countries can learn from tax administrations that have developed what has been referred to as an "enhanced relationship" with taxpayers.

How has the international community responded?

Both the EU and the OECD have adopted an approach to tax competition which can be characterized by:

- Endorsing tax competition as an economic reality of the 21st century.
- Recognizing that to get the full benefits of tax competition, we need internationally accepted rules on what is fair and what is unfair competition.
- And recognizing that these rules have to apply to as many countries as possible (Slovakia is not competing just against Austria and Hungary, but it is also competing against Korea, Mexico, China and India).

More than a decade ago, the EU and the OECD launched parallel and complementary projects to deal with harmful tax competition (the EU Code of Conduct and the OECD Harmful Tax Practices projects).

Whilst there were differences between the criteria used to decide what was fair or not – the EU putting more emphasis on the rate applied; the OECD on willingness to cooperate to counter abuse – broadly both organizations emphasized the benefits of non-discriminatory and transparent rules. And both initiatives were very successful. Almost all of the regimes identified as potentially harmful have been dealt with.

But, and it's a big but, this success may be short lived.

Countries are now designing regimes to get around the EU and the OECD criteria. Regimes which may comply with the letter but not the spirit of the rules, and regimes which are less transparent. What we are seeing is the emergence of a new form, a more subtle form of competition which involves more sophisticated regimes and a more creative use of tax treaties. Thus, it's a mistake to believe that this work is over, but it is unclear whether there is the political will to deal with it.

We must also recognize that tax competition will intensify because of new business models. Today large MNEs are primarily in the business of producing ideas not things. It is from know-how, intangibles and services that they derive their profits (75% of the wealth of the Fortune 500 companies is in intangibles). This, combined with a new emphasis on globally centralizing these activities – have one financial service centre, one R&D centre rather than centres in each country – means that these service activities are highly mobile, and therefore sensitive to tax differentiates. Clearly if a large pharmaceutical company is going to centralize its patents and intangibles, it will not put them in a high tax jurisdiction. That's why something like 20% of US intangibles are now held in Singapore, Switzerland and Ireland. This process of business restructuring or off-shoring poses difficulties for governments. Services are where the potential corporate tax base is, so lose your services and you have lost a significant part of your tax base, and usually in a way where the existing international rules have been respected. As we have seen from the debate in Germany – or the debate between the EU and Swiss cantons – governments are nervous about this prospect and some are already calling for a revision of the rules.

How does the EU debate on moving towards a common corporate tax base fit into this debate? In one sense, the CCCTB will constrain competition since countries will not be able to compete by means of special tax incentives or regimes, so it will provide a more level playing field. Countries like Ireland and Slovakia would benefit since their corporate income tax base is already very wide, but countries such as Austria, Netherlands and Luxembourg will face new constraints.

So in the short term, the CCCTB could restrain tax competition within Europe, but my feeling is that over a longer period, a CCCTB will produce more fierce competition since differences in the headline rates of corporate tax would then be a good indicator of differences in effective tax rates. These rates will be subject to intense downward pressures (once this occurs, we can expect that some European countries will then renew their call for the EU to establish minimum CIT rates).

<u>Tax Competition: the Liechtenstein factor</u>

As can, I hope, be seen from my earlier remarks, I strongly favour tax competition, primarily because it encourages governments to continually review their tax systems to ensure that, within the constraints of achieving a fair and simple system, tax does not act as a constraint on growth.

Yet there is one form of tax competition that is neither fair nor growth enhancing: that is competition which is based upon secrecy, non co-operation and discrimination. Where countries, such as Liechtenstein, use excessively strict bank secrecy rules as a way to encourage residents of other countries to evade or avoid tax in their chosen country of residence, this is not acceptable in today's highly integrated financial markets. As our Secretary-General said in March 2008, this type of secrecy is a "relic of the past".

Today, we find countries within the EU, notably Austria and Luxembourg, countries which are geographically close neighbours of the EU (notably Andorra, Liechtenstein, Monaco and Switzerland), as well as geographically remote tax havens (e.g. the Cayman Islands & Panama) and offshore centres (e.g. Singapore and Macao), which refuse to recognize this reality; fail to adapt to this new environment and are not prepared to accept the responsibilities that go with being players in a global financial market.

The international community is neither asking these countries to renounce their bank secrecy – all countries have provisions in place to protect the confidentiality of bank information – nor to lessen the strictness of their secrecy provisions vis-à-vis their own residents (a sovereign choice which should be respected). But there is little to justify this excessive secrecy being extended to non-residents. Let's be honest: one of the main justifications for refusing to provide bank information to the host country of non-residents with assets in secrecy jurisdiction is to assist such residents in evading their tax obligations. This is why so many of these jurisdictions are referred to as tax havens.

Some economists, particularly in the United States, have argued that tax havens are good for growth, because they enable corporations to lower their effective tax rates and that they enable high tax countries to maintain the competitiveness of their MNEs. Clearly where a MNE uses a haven to evade or avoid tax, its effective tax rate falls. But this is like saying that we want to stimulate growth at any price, including encouraging illegal acts. The same logic could be applied to business run by the mafia or Columbian drug dealers. If governments are concerned that their tax systems are putting their companies at a competitive disadvantage, then the correct response is to redesign their tax systems, rather than to turn a blind eye to non-compliance. In fact, offshore non-compliance constraints governments in lowering taxes for all citizens and in providing a fiscal environment which minimises tax-induced distortions.

It is still too early to learn the lessons from the Liechtenstein affair, but at a conference dedicated to enhancing competitiveness and growth, I suggest that we do need to reflect on how we deal with competition based upon secrecy:

- It will be difficult to reap the full benefits of the single market insofar as some EU countries continue to compete based on secrecy, rather than the service provided.
- The Savings Directive (to which Liechtenstein had signed up) can only be a partial answer to this problem, especially insofar as withholding tax is seen as an acceptable alternative to exchange of information.
- To maintain the competitiveness of EU financial markets will require encouraging financial centres outside of the EU, particularly Hong Kong, Singapore and Switzerland, and tax havens to play by the same rules. Recent discussions both by the OECD and the EU suggest that Asian financial centres will be very reluctant to implement effective withholding taxes or automatic exchange of information. They may, however, be prepared to accept exchange of information on request.

We have also seen that the Liechtenstein scandal has eroded honest taxpayers' faith in the integrity of the tax system, and reinforced the impression, as one well-known US tax evader said, that "only little people pay taxes". To me, this is the main reason why, as Commissioner Kovacs recently said, we must now move forward to broaden the debate beyond Liechtenstein to address the issue of excessive bank secrecy for tax purposes. If we fail to do this, we will find that it will become increasingly difficult to maintain high levels of voluntary compliance on which all modern tax systems rely for their effectiveness. Also within the EU, a coordinated offensive to address offshore non-compliance will assist countries in meeting the Maastricht conditions and will provide governments with new leeway on reconciling the demands placed upon public expenditures and the danger of increasing tax rates.

Concluding comments:

Europe must embrace tax competition, which should be seen as an integrated part of the Lisbon agenda. But countries within Europe and beyond have to recognize that to get the full benefits of tax competition, it must be transparent, cooperative and based upon service provided and not secrecy.