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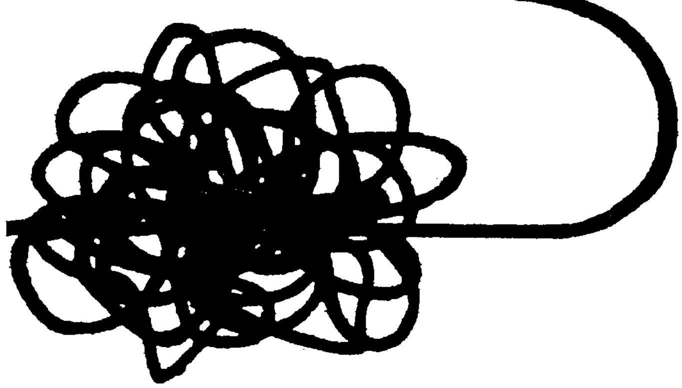
Towards a better tax system



Practical consideration of the ten tenets by the Tax Faculty

The Tax Faculty is the focus within the Institute of Chartered Accountants for England and Wales for those Chartered Accountants working in the area of tax. It is a centre for excellence and the authoritative voice for the 116,000 members of the Institute on taxation matters. The Tax Faculty makes representations to Government and other authorities, and public pronouncements on major tax issues. To find out more about the Tax Faculty call 020 7920 8646 and ask for a prospectus.

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Tenet Ten – Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in, and with, the UK.

Tax Competition: Liberation or a flaming liberty?

Simon McKie , former Chairman of the Tax Faculty and the principal in McKie & Co considers how the tax system can be healthily competitive.

Are you in favour of multi-national businesses and the mega rich manipulating tax laws to avoid paying their fair share of tax? To put it another way, do you think it is right that governments should band together in a cartel to create artificially high tax rates?

The question of tax competition is in the air. Or rather, the problem of tax competition, for the current debate sees tax competition as an evil to be combated. The European Union (EU) has set up a committee to examine 'unfair' tax competition, as has the Organisation for Economic Co-operation and Development (OECD) appointing our own Dawn Primarolo as its enthusiastic chairwoman. David Edwards has delivered a report on the offshore financial business of the Channel Islands which has sent shudders through those islands, and fourteen of the fifteen countries of the EU are agreed that a single uniform withholding tax should apply to payments of interest throughout the EU.

In response to the disagreement over withholding tax and in order to impose uniformity of taxation, the EU Commission has proposed the abolition of the Member States' veto in relation to all taxation proposals that impinge 'on the proper functioning of the internal market'. The issue hangs like a black cloud over the UKs financial markets and our Government has been cast in the uncomfortable role, so familiar to Lady Thatcher and John Major, of being in a minority of one in the EU on an issue with profound implications for national sovereignty.

'Taxation in the European Union'

On the 20 March 1996, when the European Commission published a paper entitled ***'Taxation in the European Union'*** for an informal meeting of ECOFIN Ministers, the issue of tax competition was just a small speck on the horizon. When I analysed the paper in a debate on the role of the EU in direct taxation (The Tax Faculty's Wyman debate in 1997), my opponent derided the idea that the Commission's paper would ever be of practical importance. In fact, the paper's approach informs the assumptions which are accepted, as least publicly, by every Government involved in the current discussion. It is interesting, therefore, to analyse in detail the view of tax competition which underlies the Commission's paper.

The paper begins by acknowledging that 'fair competition' is a key component of the single market. It contrasts fair competition with 'unfair competition in the tax area'. Indeed, it seems to be an assumption of the paper that there is no such thing as fair competition in taxation amongst Member States.

The paper then goes on to notice a significant change in the relative burden of taxation across EU countries. The burden has shifted from capital yields to employment earnings. The paper suggests that the resulting increased cost of labour in the Union has lead to increasing rates of unemployment. It suggests that this shift has been caused by increased international mobility of capital arising from the creation of international capital markets and the resulting reduction in the ability of Member States to regulate capital movements. Acknowledging that if the current system continues there will be a continual erosion of the power of Member States to tax capital yields and assuming that it is impossible for Member States to significantly reduce their public expenditure it suggests that, unless action is taken, a crisis will be reached when 'labour's capacity to absorb the tax burden has been exhausted'.

The Commission's answer to this frightening process is to prevent erosion of the tax base on capital yields which it refers to as 'degradation of the tax base'. It proposes to do this by preventing 'unfair' tax competition amongst Member States through the creation of uniform tax systems in the Union and in particular uniform taxes on capital yields. It is that analysis which has led to the present attempts to create a single withholding tax on interest payments throughout the Union.

Inevitable failure

The first point that occurs to the reader of the paper is that its solution is, of course, doomed to failure. For tax competition in the modern world is not confined to competition amongst the member countries of the Union, or even of Europe, but is worldwide. There is worldwide competition not only in relation to the taxation of capital but also in the taxation of business profits and, linked to that, in the taxation of individual earnings. Since the Commission's paper was published, the development of Internet trade has hugely increased the mobility of business enterprises, whilst the accelerating economic development of China is bringing a huge new source of increasingly skilled labour into the world economy.

Tax: the price of a country's amenities

So perhaps it is worth rethinking our approach to the whole problem. Is tax competition necessarily a bad thing? One might argue that where there is competition amongst nations as to the tax burdens on people and businesses which are able to choose in which country to base themselves, tax becomes the price which a country places upon its amenities.

Tax oligopoly

Looked at in that way, attempts by groups of countries, such as the EU or the countries represented in the OECD, to impose a uniform tax regime is an attempt to create an oligopoly.

Now, if you ask an oligopolist if he is in favour of the continuance of his oligopoly, it is not entirely surprising if he says 'yes'. But if you ask the consumer of the oligopolists' goods or services whether he would prefer the oligopolists to compete with each other, he may give you another answer. Perhaps it is not surprising, therefore, that a debate which has been carried on primarily by governmental organisations has been primarily concerned with preventing competition. Wide awareness of the threat to the UKs financial markets and employment in the City represented by the proposal to impose a uniform European withholding tax has alerted the UK public to the fact that attempts to prevent competition in taxation may not be universally beneficial.

Indeed, why should they be? For, if taxation is the price which a Government puts on a country's amenities, why should a price cartel in taxation be any less harmful to tax payers than a price cartel in legal or accountancy services or in cars or supermarket goods?

Is it reasonable to regard taxation in this way? If a business has a choice of establishing itself in, say, the UK or in the Cayman Islands, the availability of trained staff, an educated population, a large local market, good communications, and a sophisticated legal and business structure will favour the establishment of the business in the UK. Given a cost free choice between the two countries there is no doubt that normal businesses would establish themselves in the UK. Even if the UK imposes high taxes on the profits of a business enterprise, the business will still choose the UK rather than the Cayman Islands. If, however, it imposes a penal rate of taxation which outweighs the UKs many advantages, the business will locate itself elsewhere, even though the facilities offered by the UK are clearly superior. Of course, the choice is not just between the UK and the Cayman Islands. In an increasingly global economy, it is between the UK and other countries throughout the world.

Now that is all very well in relation to businesses and to capital but what about people? Well of course we have seen the creation of a class of international executives and businessmen who reside in several different jurisdictions. In relation to that restricted class of people there is already real direct competition amongst nations in relation to the taxation of individuals. But, what about the mass of people? The partial answer is that there is ever increasing mobility of people at all levels but the main answer is that if people themselves are not mobile, jobs are. A country which over-taxes labour will find jobs moving to more accommodating regimes.

That, of course, is the exact problem which the Commission's paper addresses. But strangely it finds that process of competition on the taxation of employment earnings unfair, whereas it has long been accepted that international competition in labour rates is a perfectly normal and fair part of the workings of an international economy. It would be thought grotesque to try to impose on third world countries a labour rate which is uniform with the developed world. We congratulate ourselves on our increasing international competitiveness on labour rates. Plainly, taxes on income are part of the average labour costs of national workforces. Why is it acceptable for individuals to accept lower rates of pay in order to win work, but unacceptable for governments to apply lower rates of tax to capital yields, business profits or employment earnings for the same reason?

Characteristics of effective tax competition

What would be the characteristics of a world economy in which there is effective tax competition? It would be one in which there would be differential rates of tax reflecting the different advantages which individual countries could offer to businesses and individuals who choose to base themselves, and invest, in that country. Countries that allowed their tax rates to rise above the level which reflected the value of the amenities they offered would find capital, businesses, jobs and finally people moving elsewhere.

Tax systems would be developed to attract particular categories of activities which were valued and considered economically promising by individual countries. Governments would find that raising taxes above a certain level was ineffective in raising additional revenues and so would have to adjust their expenditure to their income, rather than their income to their expenditure. All of this would be linked to the myriad other ways in which Governments compete with each other in providing environments which are welcoming and friendly to businesses and individuals.

Does all of this sound familiar? It is, of course, the state of affairs which exists today. The population of Britain has not emigrated to the Caymen Islands just because the personal tax rate is lower there than here. If Iran lowered its rate of tax on business profits to 1%, it would still find it difficult to persuade General Motors to locate its head office there. Nor would Governments be able to reduce their social spending to nil in order to reduce their rates of tax. Even if that were politically possible within the country concerned, it would be economically disastrous. For countries which had no support for the unfortunate would create social problems which would repel, not attract, the internationally mobile.

Recognising, therefore, that tax is the price which countries place on their amenities is merely to recognise the truth of our current situation. We should embrace that concept with enthusiasm not reject it with hostility. For just as competition amongst grocers has created the massive choice of food that we find in our current supermarkets and the burgeoning development of Internet ordering which is happening at the moment, so will competition in taxation force Governments to ensure that the price of what they provide is justified by its value.

To choose tax competition will not be painless. In previous ages, international mobility has been slight so that governments have had monopoly power in taxation. That has enabled them to charge a surplus over the value of their amenities, which they have used for redistribution of wealth in order, they would argue, to relieve misfortune.

As I have said, tax competition will not prevent expenditure on social welfare to the extent that it creates a society which is more attractive to those who create wealth. For wealth creators have no interest in living in a society in which the poor are so desperate that they are driven to crime or so unhealthy or uneducated that they cannot contribute to economic activity. Expenditure above this level, however would in the long term be impossible because an increase in the taxation rate would not be compensated by an increase in the quality of the amenities offered by the country concerned. In the long term, therefore, free tax competition will require a return of much charitable activity from government to private and corporate charitable giving.

Damage from attempting to restrict tax competition

In a world in which there are no national authorities capable of imposing harmonised (oligopolistic) rates of taxation, this process is inevitable. Why should we, therefore, be concerned about it? There are two reasons. First of all, we can do much economic damage to ourselves by attempting to impose local restraints on competition which will serve only to undermine our competitiveness with the rest of the world. Our Government, of whatever political complexion, should always assess the effect of its measures on our international competitiveness. No doubt in relation to specific investment incentives it does just that. But to what extent has the Treasury evaluated, for example, the effect of the massive increase in the complexity of our tax system and the resulting uncertainty as to its effect on our attractiveness to capital, business and labour? Most importantly, our Government needs to ask itself not, how do we restrict tax competition, but how do we ensure free competition amongst countries and our own competitiveness within that competition?

Tax Competition and liber ty

There is a further issue, however, which is fundamental; that of liberty. The power to tax is one of the great powers of government. Governments, and their constituent politicians, have a natural interest in creating a tax oligopoly. As it becomes obvious that individual countries and even individual federations of countries such as the European Union cannot do that on their own, there will be a pressure to create worldwide international structures, to impose tax rate uniformity. Do we see the first stirrings of that process in the various international initiatives on preventing tax competition? If so, that really is a frightening prospect for the new millennium.

Simon McKie is the founder and principal of McKie & Co the private client consultancy specialising in taxation advice to private clients and their advisers. He is a former Chairman of Tax Faculty. Simon is the current Chairman of the Faculty's Inheritance Tax & Trusts Committee and is a member the Capital Tax Committee of the CIOT and of the Tax Law Rewrite Consultative Committee.