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A COMPARISON OF INTERNATIONAL TAX VARYING POWERS

Proponents of a differential tax rate in Northern Ireland argue that it is necessary to enable competition with the Republic of Ireland in attracting foreign direct investment. However, this proposal would necessitate the devolution of *tax varying powers.* This paper compares the extent of these powers held by EU member states and the systems of fiscal federalism in Canada, Australia and the U.S.A.

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1. BACKGROUND

There is currently a Europe-wide focus on corporation tax rates (CTRs). In the wake of CTR reductions in Poland, Slovakia and Hungary before their EU entry in 2004, other European countries are seeking similar concessions[1]. France, Spain, Germany and Italy are currently amongst the main European proponents for lowering rates. The chief European economist with Goldman Sachs, Erik Nielsen, has declared: *"The gloves are off. Bigger countries are now competing on taxes[2]."*

On a local level, the ongoing drive for a reduction in the CTR focuses on geographical proximity to the Republic of Ireland (ROI), and the tax competition that this implies[3]. The significant rate differential between Northern Ireland (NI) (30%) and ROI (12.5%), and the fact that the two regions share a land border makes for a unique set of circumstances. A reduction in the rate discrepancy is therefore being advocated.

For both NI and Europe as a whole, the practicality of implementing the proposals for a lower corporation tax rate centres on individual regions' *tax varying powers*. This paper therefore begins by outlining the existing tax-varying powers of EU member states, and the (arguably increasingly stringent and enforced) constraints of Community law therein. To enable a comparative analysis, the systems of fiscal federalism in Canada, Australia and the USA are then considered.

2. THE EUROPEAN UNION (EU)

2.1 Tax-varying powers in the EU

There are currently 27 member states in the EU[4]. Taxation is considered a 'member state issue'; states retain full control over the formulation and implementation of their own corporate tax policy[5]. However, as discussed below, this 'fiscal independence' can only be exercised in accordance with EU community law.

Over the last twenty years, EU nominal tax rates have generally decreased[6]. A study by KPMG in 2006 found the EU to have the lowest average corporate tax rate out of various worldwide regions[7]. However, wide differences between members' rates remain; in 2006 there was a variance of 26%: from 10% (Cyprus) to 36% (Germany)[8]. Appendix 2 details the various nominal rates for member states[9].

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[1] Poland reduced its rate from 27% to 19%, Slovakia from 25% to 19%, Hungary from 18% to 16%
[2] "Tax-cut war widens in Europe", Simon Kennedy, Bloomberg News, 31 May 2007
[3] Other arguments are also proposed, such as the unique political circumstances pertaining in NI.
[4] Appendix 1 lists members
[5] This statement relates only to corporation tax –VAT is an EU tax, driven by EU directives
"No tax without misrepresentation", The Economist, 5 December 1998
"The EU and high taxation: Time for a new tax agenda", Damon Lambert, The Bruges Group
[6] "Corporate Income Tax in EU Countries Comparative Analysis", Djurovic, J. Economics and Organization Vol. 1, No 10, 2002, pp.57-66
[7] Other regions include the OECD, G7, the 19 countries in the Latin American/Caribbean (LAT) region
[8] "Corporate Income Tax Rates in the EU", KPMG Tax Practices in the EU – National tax legislations
[9] Nominal rates, while useful for indicative purposes, are not usually the basis of comparative studies; the *effective tax rate*, takes into account the tax base and is a more accurate measure. Effective tax rates are generally lower and the divergence between countries less pronounced.
"Corporate Income Tax in EU Countries Comparative Analysis", Djurovic, J. Economics and Organization Vol. 1, No 10, 2002, pp.57-66

State Aid Rules

A consequence of independent tax regimes (and the associated differentials in tax rates) amongst EU members is the potential of unfavourable tax competition[10]. Since taxation is not only a revenue-raising device, but can also be used in the creation of incentives, there is potential for members to use CTRs to compete in the attraction of economic activity. EU Community law seeks to address this eventuality, and governs the implementation of member states' direct tax systems.

'State Aid' rules are imposed within the EU to safeguard against unfavourable tax competition and the potential distortion of trade, which may result from *artificial transfer*. This occurs when a firm relocates for 'artificial' reasons; i.e. not for commercial purposes, but to avail of a lower tax rate. In 1998, the Commission set out its state aid policy on tax measures, which made it clear that it would not tolerate illegal state aid contained in national tax systems, (an example of this policy in practice is the Azores ruling[11]). In general, the EU considers tax measures to contain state aid when[12]:

(i) there is a *benefit* to a company or group of companies;
(ii) this benefit is *selective*, in that it does not apply equally to all taxpayers concerned; and
(iii) there is *no justification inherent in the tax system for excluding* a given company or group of companies from taxation.

Decisions on the requirements of Community law (which include State Aid rules) are made by the European Court of Justice (ECJ). Rulings have been occurring with increasing frequency over the last 5 years, with the ECJ having applied an arguably aggressive interpretation of the Treaty of Rome (its "constitution"), to strike down numerous Member State tax rules, on the basis of them being 'discriminatory'. For example, the ECJ ruled that Finland could not grant tax credits for corporate tax paid to Finnish shareholders. In another case, the ECJ struck down Germany's rules that restricted the deductibility of interest to foreign lenders, even though the rules also applied to tax exempt domestic lenders[13].

Arguments for EU Tax Harmonisation

There have been recent moves towards a fiscal straightjacket for EU governments, which would mean that taxation was no longer a Member-State issue. The higher tax jurisdictions of western Continental Europe are particularly in favour of this proposal, known as 'EU tax harmonisation', (since this would eliminate any comparative disadvantage they might currently perceive)[14]. Harmonisation would involve the standardisation of tax rates across the EU.

There are various rationales for tax harmonisation. It is suggested that it is one of the main outstanding issues for a well functioning Single Market. The diversity of the current EU regime is criticised on the basis that it deflects the attention of companies from *profitability* to *tax (minimisation)*, which is considered unproductive and

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[10] This type of competition is generally referred to as 'unfavourable', however, many economists regard tax competition as beneficial.
[11] www.tax-news.com/archive/story/ECJ_Rules_Against_Portugal_On_Azores_Tax_Cut_In_Key_State_Aid_Case_xxxx24783
[12] Hansen, Ysendyck, Zuhlke, " The coming of age of EC state aid law: a review of the principal developments in 2002 and 2003", European Competition Law Review, 2004
[13] "Comparative Fiscal Federalism", Avi-Yonah, University of Michigan, October 2005
[14] "Time for a new tax agenda", The EU and high taxation, Bruges Group, www.brugesgroup.com/news.live?article=230&keyword=9
(Bruges Group, formed in 1989, is an independent, all party think-tank– their debates / conferences have been attended by various MPs and economists, further details at http://www.brugesgroup.com/about/index.live)

economically inefficient[15]. Furthermore, in theory, it would resolve what has been described as the "harmful" or "unfair" tax competition stemming from favourable CTRs in states such as Ireland and Estonia[16].

Arguments Against EU Tax Harmonisation

The argument for standardised tax rates is built around the premise that tax collection within the EU is a *net sum game*[17]. This implies that increased revenue in one location will be balanced by an equivalent reduction elsewhere. However, this assumption is debatable. It might be argued that the low rate of tax in ROI has resulted in investment that would otherwise not have come into the EU, hence there has been a net gain to revenue.

Harmonisation also assumes the superiority of government (over local firms) in the ability to make financial decisions. It might, however, be argued that a company's ability to earn profits is a good indicator of that company's ability to create sustainable jobs, stimulate competition and develop economic welfare. This anti-interventionist argument implies an optimal tax rate of zero per cent, on the basis that if Ireland's 12.5% rate is preferable to Germany's 40%, then why not take this one step further?

Finally, the 'one step suits all' approach to taxation ignores any potential benefits of diversity. Member states have individual fiscal requirements, yet this would mean one solution being applied, regardless of this individuality. Tax harmonisation, and the resultant lack of diversity, might prevent intra-EU comparisons of the relative success of different tax regimes. [18]

2.2 Tax-varying powers of individual UK regions

As a member state of the EU, the UK has full control over tax policy, but must comply with Community law. Ten years ago, the impact of the ECJ on corporation tax in the UK had been minimal. Since then, there have been significant changes to group loss relief, foreign tax credit rules, transfer pricing, etc.; all implemented to enable compliance with Community law[19].

In terms of the individual devolved administrations within the UK, no existing powers are held in respect of varying corporation tax rates. The Scottish Parliament is unique in that it does hold some tax-varying powers, but these apply only to the basic personal income tax rate[20]. Amendment of CTRs would therefore first necessitate the devolution of tax varying powers, and thereafter, compliance with state aid rules.

Unique cases: The Isle of Man/Guernsey/Jersey

The Isle of Man is an internally self-governing dependency of the British Crown and its people are British citizens. It is not a part of the United Kingdom, but is a territory for whose international relations the UK is responsible in international law. In terms of the relationship with the EU, the Island is neither a member state nor an associate

[15] "Corporate Income Tax in EU Countries Comparative Analysis", Djurovic, J. Economics and Organization Vol. 1, No 10, 2002, pp.57-66
[16] "Time for a new tax agenda", The EU and high taxation, The Bruges Group, www.brugesgroup.com/news.live?article=230&keyword=9
[17] "Time for a new tax agenda" The EU and high taxation, The Bruges Group, www.brugesgroup.com/news.live?article=230&keyword=9
[18] "Time for a new tax agenda", The EU and high taxation, The Bruges Group, www.brugesgroup.com/news.live?article=230&keyword=9
[19] "Comparative Fiscal Federalism", Avi-Yonah, University of Michigan, October 2005
[20] Section 73 of the Scotland Act 1998 allows Parliament to apply, for one tax year, an increase / decrease in the basic income tax rate of not more than 3%[20]. (Federalism and the Role of the States: Comparisons and Recommendations", Federal-State Relations Committee, Parliament of Victoria)

member. Resultantly, the Isle of Man does not contribute to, nor receives, EU funding[21].

Similarly, Guernsey and Jersey are crown dependencies and not members of the UK, nor the EU. Guernsey does not impose Value Added Tax (VAT), and does not form part of the fiscal area of the EU[22]. It is this fiscal independence that enables fiscal autonomy – by relinquishing the right to receive any EU funding, these islands have achieved a tax unique position. The respective CTR rates are as follows: the rate in the Isle of Man is 15% for trading companies and 18% for non-trading companies; in Guernsey companies will be subject to income tax at 0% from the 2008 tax year[23]; and in Jersey, a rate of 20% is payable (with a maximum rate of 30% for international businesses)[24].

3. Fiscal Federalism in Canada

Canada is normally regarded as comprising of five regions, as follows[25]:

- The Atlantic region (Newfoundland, Price Edward Island, Nova Scotia and New Brunswick)
- The central region (Quebec and Ontario)
- The prairies (Manitoba, Saskatchewan, Alberta)
- The Pacific coastal region (BC)
- The sparsely inhabited north

However, the basic units of Canadian federalism are its ten provinces (bracketed above) and three territories: Northwest Territories, Nunavut and Yukon.

In Canada there are shared federal-provincial tax powers. The Constitution grants the Federal Government an exclusive power to tax[26]. It also grants the Provinces the power to apply direct provincial taxes in order to raise revenue for local purposes[27]. The division of taxation responsibility does not restrict the range of taxes the provinces may apply, so a relatively high degree of flexibility is enjoyed. As a result of the constitutional division *"the federal government do(es) not even have 50% of the taxing capacity…"* , rendering Canada *"a very decentralised federation with strong provinces"*[28].

The Canadian provinces are responsible for financing a higher proportion of their own expenditures than is the case in the U.S.A. In Canada, the provinces have full discretion over the choice of their tax systems, however they are able to participate freely in federal-provincial income tax and sales tax harmonisation arrangements. The result is a reasonably harmonised income tax system, but otherwise a set of provincial tax regimes that differ substantially[29].

Implications for Tax Competition

In Canada, sub national jurisdictions are free to compete for investment. However, the federal corporate tax rate puts a floor on tax competition and the incentive to

[21] Isle of Man Government http://www.gov.im/isleofman/externalrelations.xml
[22] Guernsey has been obliged to apply the EU's Savings Tax Directive 2005
[23] However, businesses regulated by the Guernsey FSC will be charged 10%
[24] http://www.lowtax.net
[25] "Fiscal federalism in Canada", Nuffield College Politics Working Paper, 2003 – W17, University of Oxford
[26] Constitution Act 1867 (Canada), s 91 (3)
[27] Constitution Act 1867 (Canada), s 92 (2)
[28] "Meeting Transcript", FRSC, Ottawa, June 16th 1998
[29] Broadway and Watts, "Fiscal Federalism in Canada, the USA and Germany", Working Paper 2004, Queens University

compete is reduced by federal transfers, which are designed to compensate lower levels of government for their different tax capacities[30].

4. Fiscal Federalism in Australia

The units of Australian federalism are the six colonies, now the States, (New South Wales, Victoria, Queensland, Western Australia, South Australia and Tasmania) and the two Territories (Australian Capital Territory and the Northern Territory). The Australian federal system concentrates tax powers in the federal government, but responsibility for service delivery in state administrations (including local government).

It has always been the case that the States have more line responsibilities than the Commonwealth, but the latter has always controlled more of the tax base. In 2007, it was reported that the federal government accounts for 80% of total taxation revenue, while the states raise around 16%[31]. Yet, in terms of expenditure, the federal government is responsible for around 54% and the states 40%. This revenue-expenditure gap is well documented, and there have been calls for it to be addressed[32].

A report by the Business Council of Australia and the Corporate Tax Association, published in April 2007, suggested that Australia's business sector is being adversely affected by its complicated fiscal regime. The findings highlighted numerous problems with the current system, and in particular, those arising from the division between federal and state tax systems. Amongst the findings were the following[33]:

- Governments impose 56 different taxes on business including 21 federal taxes, 33 state and territory taxes and 2 local government taxes.
- This compares to a UK study, which found that in an economy three times the size of Australia's, business paid only 22 different types of taxes – less than half the number of taxes facing Australian businesses.

Of the 56 taxes identified in Australia, 51 are potentially borne by businesses. Of the 56, 16 are levied by the federal government, 33 by state and territory governments, and 2 by local governments. Furthermore, rules and regulations governing the same types of taxes differ across states, which means that the effective number of potential taxes is even higher. The report identified 182 potential taxing points, hence identifying a need for simplifying and consolidating the business tax environment.

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[30] "Fiscal relations within the EU", Economics Department Working Papers No.163, OECD, Paris 1996
[31] The remainder comes mainly from property taxes, raised by local governments.
[32] "Tax Nation: Business Taxes and the Federal-State Divide", The Business Council of Australia and the Corporate Tax Association, April 2007
[33] "Tax Nation: Business Taxes and the Federal-State Divide", The Business Council of Australia and the Corporate Tax Association, April 2007.

5. FISCAL FEDERALISM IN THE UNITED STATES OF AMERICA (USA)

5.1 Tax Varying Powers in USA

The American system is similar to the Canadian one in the diversity of individual States' tax-raising powers; both Congress and the States possess tax powers in the major areas. Most States levy their own corporate and personal income taxes, as well as their own retail taxes[34].

However, there are some significant differences between the US and Canadian systems. The US revenue system is much less decentralised; the States finance considerably less of their own expenditure. There is also no formal mechanism for tax harmonisation, resulting in considerable inter-state variances. Furthermore, there is no equalization system devoted to correcting the inevitable disparities between States which arise from State revenue raising ability[35].

5.2 A Comparison with the EU

In October 2005, a conference was held between a group of distinguished tax experts from the European Union and the USA, the purpose of which was to discuss the difference between the U.S. Supreme Court and ECJ approaches to tax jurisprudence. This conference was motivated by the increasing frequency (and perceived stringency) of ECJ decisions, in the previous five years. The comparison with the U.S. Supreme Court's treatment of State taxes was considered 'striking'[36]. In general, the U.S. Supreme Court has granted wide leeway to the States to adopt any tax system they wish, only ruling against the most extreme cases. Specifically relevant to the UK-EU case was the decision of the Supreme Court *not* to intervene against rampant State tax competition to attract business. This in direct contrast with the underlying basis of EU Community law and state aid rules.

An explanation for the difference in approach may lie in the source of tax revenues; most taxes in the U.S. are paid to the federal government, whereas all taxes in the EU are paid to member states[37]. However, the lenient attitude of the US to state taxes predates the introduction of federal taxes – federal corporate tax only began in 1909. Perhaps equally important is the focus of the ECJ in pursuing a meaningful single market, and the fact that discrimination in tax matters may represent a major obstacle in this respect.

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[34] Broadway and Watts, "Fiscal Federalism in Canada, the USA and Germany", Working Paper 2004, Queens University
[35] Broadway and Watts, "Fiscal Federalism in Canada, the USA and Germany", Working Paper 2004, Queens University
[36] "Comparative Fiscal Federalism", Avi-Yonah, University of Michigan, October 2005
[37] "Comparative Fiscal Federalism", Avi-Yonah, University of Michigan, October 2005