

POLICY PAPER

Competition or Coordination? Reassessing Tax in a Global Environment

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Summary

G20 leaders have proposed improved coordination between national authorities as a key aspect of restoring confidence in global financial regulation. But is there a need for similar action in the field of taxation?

This paper examines some of the most topical international tax issues and assesses whether, under current global economic conditions, tax policy has helped or hindered national economies, and whether greater global coordination between governments is a positive or negative influence on policy.

- Tax policy has encouraged companies to use debt rather than equity. This has inadvertently fuelled the global financial crisis, and is an example of how distortions in tax treatment of business activities should be removed.
- So-called ‘tax havens’ should provide freely information to governments about nationals who use those jurisdictions, but large nations should not focus attention on tax havens as a distraction from the need to sort out their own finances.
- European countries running flat-tax regimes should be left unhindered.
- To encourage inward investment, governments should seek to iron out inconsistencies of tax law rather than cutting headline corporation tax rates.
- To increase certainty for businesses the Organisation for Economic Cooperation and Development (OECD) and national revenue authorities should re-examine their policies on transfer pricing.
- Governments should design the appropriate place for green taxes in their national tax systems, with proper coordination to maximise their impact.
- Consideration should be given to independent tax committees playing a key role in the creation of tax policies.

1. Tax – has it fuelled financial crisis?

It has been argued by the International Monetary Fund that the global financial crisis has been exacerbated (though not caused) by tax policies which fuelled the credit boom that preceded the economic downturn. The IMF proposes¹ that governments should consider changing the rules that have encouraged companies to seek finance using debt rather than equity, and allowed individuals to take out larger mortgages. Many tax regimes allow companies to deduct interest payments against tax but not against returns on equity; this has resulted in an increase both in leveraged buy-outs by private equity organisations and in the holding of debt rather than equity by other financial institutions. The IMF argues that ‘corporate level tax biases favouring debt finance including in the financial sector are pervasive, often large and hard to justify given the potential impact on financial stability.’

So what is to be done? Given the political delicacy involved in eliminating the tax deductibility of interest payments, the IMF suggests creating deductibility for the notional cost of equity financing – effectively giving banks tax deductions on Tier 1 capital, thus encouraging them to hold more capital reserves. Countries such as Croatia and Belgium have adopted so-called ‘Allowance for Corporate Equity’ rules. There is much to be said for this although it can, and has, reduced the amount of tax available to national governments at a time when they are already under financial strain.

DISTORTIONS

But the bigger issue here is that tax distortions are artificially incentivising certain kinds of economic behaviours over others. It illustrates why tax neutrality should be such a fundamental aspect of any good tax system. The IMF points out that ‘securitisation and other devices can amplify the economic costs of those tax distortions (for example by reducing the costs of subprime financing) and their use to secure favourable tax treatment contributes to opaque financial instruments’. This cannot be in society’s interest.

Solutions, the IMF says, are not easily found given the scale and profundity of both debt bias and the general divergences in national tax rates, bases and practices. ACCA argues that governments must seek to remove the distortions in their own national tax systems and work together to try to iron out the differences in tax bases which give rise to tax arbitrage. For example, in the European Union (EU) there are still many barriers which frustrate the workings of the Single Market. The sharing of best practice and knowledge between countries, of the sort envisaged by the G20 in the new era of financial regulation, could certainly be useful in the international tax world. It is important, however, that this does not stretch into cartel-like behaviour which would damage the global economy.

RECOMMENDATION

Governments should address national tax rules which distort behaviour, and reward one financing route over another. Care should be taken, however, to avoid sudden changes, as this could require significant wholesale restructuring that could have unintended consequences.

1. ‘Debt Bias and Other Distortions: Crisis-related Issues in Tax Policy’. IMF staff paper, June 2009.

2. Tax havens

One area where leading nations have joined together is in demanding action against some low-tax jurisdictions, the so-called 'tax havens'. These generally small nations have been the target of Western governments, who have accused them of encouraging tax evasion by allowing individuals and companies to thwart their own countries' tax laws by hiding assets in private wealth centres. After a decade of slow pressure for more transparency, exerted by groups such as the OECD, 2009 has seen dramatic activity. President Barack Obama put action against tax havens high on his election agenda, and has continued that campaign in the G20 summit meetings this year. The result of such high-level focus has been a flurry of concessions issued by private wealth centres, with Austria, Hong Kong, Liechtenstein, Luxembourg, Singapore, Switzerland and others, all agreeing to adopt the OECD's tax transparency standards and information exchanges.

ACCA strongly believes in transparency and the right of governments to pursue suspected tax evaders. Some offshore centres have not helped themselves by pursuing the letter, rather than the spirit of internationally agreed rules aiming to increase transparency. But, given that the development of tax havens has been accelerated by the rapid growth of offshore banking carried out by large Western banks, these centres could legitimately respond by pointing to the serious financial regulatory failures of the leading countries, as revealed by the global economic crisis.

DOUBLE STANDARDS

It is also true that many leading nations offer similar concessions as tax havens in terms of gross interest paying bank accounts, and providing a tax-friendly regime for rich non-domiciles who bring wealth to those nations while having their tax base in their countries of origin. For example, London and New York both offer gross interest paying accounts to those who are not tax resident. In addition, the UK has the highly beneficial (even allowing for the contentious recent addition of the annual £30,000 per annum levy) non-domiciled special tax regime which only taxes UK income and gains.

There is a strong suspicion that the attack by leading nations on tax havens (most of which are smaller, developing nations) is driven by dislike of the downward pressure on tax rates that they engender. This has been made worse by global economic conditions, which have caused declining levels of economic activity and hence collapsing tax yields in many countries. Anything which threatens an exodus of the remaining tax revenues will be bitterly opposed by national governments. But tax competition is an inherently efficient phenomenon and puts an onus on governments to be disciplined and not to indulge in wasteful public spending.

SELF-ASSESSMENT

Tax havens need to come out either individually (as some, such as the Channel Islands, have done forcefully during 2009) or collectively and take a clear public stand against tax evasion in all its forms. Tax evasion is a crime and cannot be defended in any shape or form. Perceptions are all-important and any suggestion that low-tax jurisdictions are indifferent to tax evasion will be a red rag to the G20 bulls. Havens should avoid this charge by demonstrating transparent self-policing so that all can see that they adhere to the highest standards. A system of 'self-assessing' their regimes, and proactively seeking to root out any institutions and individuals who are using their jurisdiction to avoid tax in another jurisdiction would be a step in the right direction.

We do not hear of tax prosecutions in low-tax jurisdictions. This is not, perhaps, surprising given that there are few taxes to be paid, but major nations are looking to tax havens to supply them with the names and details of those who are using offshore locations to evade taxes in their countries of origin. Tax havens need to volunteer as much information as possible to head off the threat of a prescriptive approach being taken by the larger economies as they seek to prevent individuals and businesses using these locations. But in return for this openness and self-policing the rest of the global economy needs fully to accept these jurisdictions, and not act out of pique at efficient low-tax economies.

President Obama's tax policies have not just been directed at tax havens. In his determination to protect the US tax base from multinationals allegedly keeping artificially high profits in low-tax jurisdictions, he has incurred the wrath of countries such as Ireland and the Netherlands, as well as the more familiar targets of the Cayman Islands and Bermuda. The US government has proposed applying an average tax rate to all foreign income to prevent what it regards as artificial avoidance, while also limiting the deductibility of expenses that companies incur in the US to support foreign operations that have paid no American tax. While levelling the playing field is a worthy objective, populist campaigns against firms 'creating jobs abroad rather than at home' are not. It is essential to bear in mind the fundamental difference between illegal tax evasion and legitimate tax planning which all companies must pursue to minimise costs and maximise profits.

RECOMMENDATIONS

Tax havens should instigate systems of 'self-assessment' and volunteer as much information as possible to governments in respect of their nationals using those havens.

Large nations should refrain from pursuing low-tax jurisdictions where this is done principally to distract attention from the underlying reasons for their budget deficits.

3. Flat-tax jurisdictions

While tax havens are generally associated with small island nations in various parts of the world, the epicentre of another low-tax phenomenon is in Europe – specifically Eastern Europe and the Baltic states. Many of the former communist countries have adopted so-called ‘flat-tax’ systems, under which one uniform income tax rate is charged to all taxpayers regardless of relative wealth. This system is the converse of the ‘progressive’ tax systems favoured in Western Europe.

A study of ACCA members² across Central and Eastern Europe (CEE) in late 2006 revealed widespread support for the introduction of flat-tax regimes, and a strong belief in the importance to countries in that region of having competitive tax systems. Focus groups in Romania and Slovakia (countries which had flat-tax regimes at 16%) strongly supported the retention of those systems and feared that they might come under pressure from ‘Old Europe’ to raise their tax levels. They regarded this possibility as a threat to their countries’ success in attracting inward investment, and saw it as the only potential downside in joining the EU, a move which they otherwise strongly supported.

In October 2006, an IMF report³ confirmed the views of ACCA CEE members. ‘Slovakia’s simple and efficient tax system has become a hallmark of its recent economic success and an attraction for investors.’ The ACCA study concluded that it was ‘crucial that the EU, under pressure from its older, higher-taxing members, do not ‘lean’ on Slovakia to change this regime in the name of unity or harmonisation’. In Romania too, there was concern that such pressure might be applied, especially given that the IMF⁴ and the European Commission pointed to the need for that country to ‘permanently strengthen budget revenue’ in order to meet its infrastructure needs and its co-financing of EU projects.

The depth of the recent economic problems to hit many of the Eastern European countries and the Baltic states, and the scale of their large budget deficits, have led some critics to question whether flat-tax policies have provided the state revenues needed. An answer to that is that governments have the capacity to increase the flat-tax rate if more revenue is needed.

But it is encouraging that the EU itself has stuck by the words of its former Commissioner for Taxation, Laszlo Kovacs, who in 2005 described the flat-tax systems being introduced by the new EU entrants as ‘absolutely legitimate’ and asserted that ‘the EU does not tackle the issue of income and corporation tax rates’.⁵ Despite grumbles from some Western European states about the loss of jobs and investment to the east, and the G20’s crackdown on tax havens, ‘old Europe’ has not demanded higher tax rates in Eastern Europe. Tax bases should be harmonised where possible, but competition through tax rates should be maintained in a free global economy.

RECOMMENDATION

The EU and other leading nations should act to iron out the remaining barriers to free trade, and continue to refrain from pressuring ‘flat-tax’ countries to raise their tax rates in the name of ‘harmonisation’. National sovereignty in tax policy should be respected.

2. *Enterprise Europe: An ACCA Central & Eastern Europe Members’ Survey on SME Issues*, ACCA, 2006.

3. *Slovak Republic*, IMF Staff Visit report, 3 October 2006.

4. *Romania*, IMF Staff Visit report, 10 October 2006.

5. *The Independent*, 4 May 2005.

4. Tax competition

It has been seen that tax yields in many countries have fallen due to economic downturn. But it can also be because companies choose to use their mobility and relocate their headquarters if the tax regime is insufficiently attractive in the country where they are based

CORPORATE TAX RATES

Though corporate tax rates are an obvious place to start when comparing the tax-friendliness of one country against another it must be remembered that it is only one part of the overall cost of production which the tax charge comprises. Nonetheless, governments have increasingly regarded it as having a symbolic importance in terms of attractiveness of the location and so rates have come steadily down. An average of near 50% in the 1980s fell to 30% in the 1990s and since the turn of the millennium even a 30% rate has been regarded as high.

The totemic power of the corporate tax rate means governments are still loathe to raise it. The Irish government's 'austerity budget' of April 2009 – in which personal taxation was raised in an effort to combat the deficits caused by property crash and bank failures – left corporate rates alone. Japan last year also preferred to raise VAT on individuals. And Canada, Germany, Russia and Singapore have all cut corporate rates. People are regarded as much less mobile than corporations and so a more tempting tax target.

A recent IMF paper stated, however, that 'we find evidence that lower corporate income tax rates and longer "tax holidays" are effective in attracting Foreign Direct Investment (FDI), but not in boosting gross private fixed capital formation or growth'.⁶ In other words, such tax cuts generate initial interest and investment but not long-term commitment.

OTHER COMPETITIVE TOOLS

One point worth highlighting from the IMF statement quoted above is that tax holidays are now rarely used by developed economies. In the EU, for example, tax holidays are considered inconsistent with a single market and are treated as amounting to 'unfair tax competition'. And China, in its corporate income tax reforms of 2008, reduced many of its tax holiday incentives. It may be that regional choices can cause the introduction and subsequent disappearance of certain tax incentives, as neighbours feel they need to directly compete with each other using similar competitive tools. However, the use of tax holidays is still considered a useful or necessary tool to attract FDI in Sub-Saharan Africa.

It begs the question of how significant these 'competitive tools' used to attract FDI or increase business activity actually are. The main results of the tax breaks are likely to be reduced costs on the business and hence lower prices for the consumer; but as shown above, they also lead to a shift away from corporate income tax to personal taxes so that governments can maintain revenue levels.

EFFECTIVE RATES

While the corporate tax rate may be, say, 28% the effective rate might be very different. If a government is willing to offer investment incentives, for research and development, for example, or significant or enhanced allowances for capital asset investments, the effective rate may turn out to be nil, negligible or even negative. Some jurisdictions, such as the UK, even offer relief for investment in intangible assets, which further recognises the way in which modern economies operate.

Where a tax system incorporates a large number of additional credits or allowances for different types of behaviour, extra complexity is inevitably generated. This in turn encourages greater tax-avoidance activity. A business tax environment that is as simple and homogeneous as possible can help create greater certainty for the tax base which a government has to rely upon, and engender less debate between the business lobby and the government over special treatment of certain groups of taxpayers.

It is this quality of the underlying tax system – rather than a simple focus on comparative tax rates – which is of interest to companies. An ACCA study of the tax systems in Hong Kong, Singapore, the US, UK, Australia and Canada in 2008 revealed that accountants believed the first two fared clearly better than the others on key issues such as tax fairness, complexity, transparency and above all, sheer volume of tax laws. Retrospective changes to tax laws and stealth taxes were also criticised and the situation was exacerbated by lack of communication and an aggressive attitude on the part of the tax authorities to taxpayers. If this perception takes hold for long enough with no effective action to ameliorate it, a country's tax system could seriously damage prospects for inward investment and competitiveness.

RECOMMENDATIONS

Governments should address substantive issues of tax law that cause distortions, rather than relying on headline corporate tax rates and 'holidays' to attract FDI.

By keeping the system as simple and homogeneous as possible, the certainty which business needs will be provided.

6. Alexander Klemm and Stefan Van Parys, *Empirical Evidence on the Effects of Tax Incentives*, IMF publication, 1 July 2009, <http://www.imf.org/external/pubs/cat/longres.cfm?sk=23053.0>

5. Transfer pricing

Transfer pricing, the way in which multinationals charge other companies within the group, is one of the most contentious issues in international tax – and one in which the attitude of the national tax authority can be of major significance. Revenue authorities have followed the US Internal Revenue Service (IRS) and become increasingly aggressive in their auditing of intercompany transactional flows. As part of his general corporate tax avoidance crackdown, President Obama's 2009 budget has made provision for the hiring of hundreds of additional IRS international examiners, with more due in 2010, so transfer pricing is now one of the most risk-laden areas of tax law for most multinational operations.

The development of the OECD Model Tax Convention and the rules it encapsulates are recognised as the benchmark for policing transfer pricing within global trade by most of the world economy. ACCA supports the OECD's so-called 'arm's length' principle to test related-company pricing, but would urge the OECD to produce assurance measures which require less onerous and time-consuming documentation. Most multinationals feel obliged to hold extensive records and surveys, well beyond what is necessary in case of a challenge by their revenue authority.

COST BURDENS

ACCA considers it appropriate that the OECD should seek to streamline many of its pronouncements across the whole Convention, so that there can be cost reductions not only for the fiscal authority in a jurisdiction but also for the businesses involved. For example, it would be an important step if the OECD would pronounce upon which types of compliance frameworks might be appropriate and reasonable.

ACCA, as a global body, has noted that some developing nations may impose prices upon imported goods, usually from affiliates, which are above the import cost, even where the actual cost can be demonstrated from bank transfer records. This is clearly likely to lead to double taxation as well as higher indirect taxation levels being applied to the goods. There is a real problem here in terms of implementation which occurs in some jurisdictions.

Overall, ACCA considers that there are more effective ways of creating a level playing field for global trade in the Internet era, and would suggest that the OECD considers options for lighter-touch transfer pricing rules.

RECOMMENDATIONS

The OECD should produce simpler and less time-consuming assurance measures for companies, and to update its approach to accommodate the far greater level of information which is now available on the Internet.

Revenue authorities should refrain from launching inquiries in the area of transfer pricing unless there is evidence to support a specific concern – and when they do they should seek a swift and equitable conclusion.

6. 'Tax shifting' – green taxes

ACCA believes that one of the most important areas where governments should step in is to change behaviour which can damage the environment. Accountants should play an active part in efforts to reduce global carbon dioxide emissions, and the concept of 'tax shifting' – by increasing carbon taxes on the use of fossil fuels but reducing them for payroll, income or corporate taxes – should be promoted.

Governments must find ways of using tax policy as an instrument of positive change by providing incentives to investment in new, cleaner technologies across a wide range of industries. When combined with other tax reductions, green taxes should be seen as a positive step rather than a threat to tax payers. Governments across the world are beginning to take significant steps to creating a low-carbon economy⁷ and accountants should help to identify the emerging fiscal incentives which will be a crucial part of that development.

Green taxation is one area where international co-ordination is particularly important, partly because of the global nature of the environmental problem and partly to prevent polluting companies moving their operations to avoid the taxes. Arbitrage opportunities here would defy the purpose of protecting the environment.

It should be recognised, however, that a significant shift in a tax base which places a great deal of reliance on green taxes will probably prove unsustainable in the long term. This is because where such taxes are imposed on emissions and general pollution, a successful system will destroy its own tax base. This is not merely theorising but a realistic medium-term prospect; for example, the UK government intends to reduce CO₂ emissions by 80% by 2050. Therefore, the way forward may be through a well-balanced and broad tax base as well as relying more on regulation to drive down pollution.

RECOMMENDATIONS

Governments must take a holistic view of the place of green taxes in their tax systems. These taxes do have a role to play, but too much reliance should not be placed on them.

Global coordination is needed to maximise the impact of environmental taxation.

7. *Is the Green Economy Coming?*, ACCA, 2009.

7. Tax policy formulation

All the above issues concern critical areas of taxation. But many countries suffer from over-complex tax systems – and this is one of the main reasons for the creation of flat-tax regimes as one antidote. So should the way in which tax law is created itself be changed?

In a research paper issued by ACCA in March 2009, the idea of an independent tax policy setting vehicle was examined. The proposal was that there should be a body of experts, separate from government – which would be tasked and empowered to formulate and propose tax policy. In addition, it would also have the express remit to seek to simplify tax systems which globally are far too complex.

Using this model, governments would set the overall economic framework of the tax environment. It would need to define the public policy objectives (eg environmental, social welfare) in terms of public finance demands and fiscal targets that taxation measures were designed to achieve. A tax policy committee (TPC) would work on adjusting the tax system as appropriate with a view to making it more effective, simple and transparent over the medium and long term.

COMPLEXITY

ACCA believes that most countries' tax systems suffer from political positioning in the creation of tax policy rather than taking account of what would be best for the economy. This inevitably leads to poorly thought-out legislation, instability and needless complication. And, owing to the complex and specialist nature of taxation, we tend not to see sufficient scrutiny of the draft legislation during the democratic processes in many regimes.

RECOMMENDATION

Serious consideration should be given by governments to setting up an independent tax policy committee as a major step to simplifying and improving the quality of tax legislation.

Conclusion

We believe the recommendations made in this report would go a long way to addressing some of the challenging current issues in the field of international tax. Tax policy is and must remain in the hands of sovereign national governments, which should be able to run regimes suited to their stages of economic development, such as the flat-tax systems in post-communist countries in Eastern Europe. Powerful nations should not seek to bully or influence low-tax developing nations; however, coordination can play a useful part in areas such as green taxation, where only international action will be successful in achieving societal objectives.

If the more intractable problems examined in this report continue to defy conventional measures, however, a more radical approach to taxation, such as the establishment of a tax policy committee, may be necessary in the long term.

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