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**Tax Policy**



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## COMMENTS ON SESSION III: TAX COMPETITION AND TAX HARMONISATION

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Thank you very much for the invitation to come to this conference and be a discussant. I start by apologising for what will be a rather uneven treatment of papers. Five of the papers are about fiscal federalism and/or about tax competition; the Weale paper is – as was explained earlier – rather different.

The first thing I want to do is to describe my personal interest in this topic. The United Kingdom has traditionally been a very centralised state with a very dependent system of local government, central government being extremely dominant. But in the peripheral parts of the United Kingdom – Scotland, Wales and Northern Ireland – there are now devolved administrations with many of the characteristics (in terms of their expenditure responsibilities) of Australian states and Canadian provinces. These, however, are funded by a block grant system. It doesn't really look as though there are going to be substantial changes to that kind of funding system, though in the Scottish elections due on 1 May 2003 there is likely to be very substantial discussion around a rather loosely described "greater fiscal autonomy". So these topics, quite apart from the question of European enlargement and integration, have great salience in terms of the contemporary United Kingdom.

We need to pay some attention to what kind of criteria we want to address these questions with, and I think that becomes much more important when we start talking comparatively among different countries. One very quickly starts acquiring a substantial list of criteria that are relevant. If you look at the traditional public finance literature, this strongly emphasises issues about efficiency – I'm not going to say much about this now but I will come back to it. Equity is a much more complex topic than people usually recognise. One of the points that was made almost in passing at a previous session is the important distinction between horizontal equity and vertical equity. As soon as you get into a fiscal federalism situation, with different levels of government having expenditure and tax responsibilities, horizontal equity issues become very complicated. There are distributional issues about equalisation, where you have to be careful about whether you are talking about equalisation among individuals or equalisation among sub-national governments (*i.e.*, among geographical areas). Interpersonal equalisation and geographical equalisation aren't the same. One of the ways in which the Weale paper does link in is that it emphasises that there are intergenerational equity issues as well. I don't have time in 15 minutes to spend much time on that, but I just want to emphasise quite how complex the equity issues are.

There are also other issues that are attracting attention. "Accountability" is a term that people keep using in this kind of discussion. It is often linked to the

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concept of autonomy but we need to be very careful about terms. I want to make two quick points. The first point is that there is a prior tax assignment issue – the question of which level of government actually gets particular taxes. There may well be a mismatch between expenditure responsibilities and tax revenue raising at the sub-national level, but it is not necessarily obvious that it's the fault of the sub-national level; there has to be a willingness of the national level to let go of important taxes. And the second point I want to make is that you have to be very careful that you don't set up twin requirements which cannot both be met. The United Kingdom's previous experience with devolution was in Northern Ireland between 1921 and 1972; the political violence connected with Northern Ireland has rather drawn attention away from the important fiscal federal implications of that failed experiment. But one thing that happened is that Northern Ireland was told to finance its own expenditure, and make what was then called an "Imperial contribution" towards United Kingdom responsibilities. At the same time, it was told that it had to provide the public services associated with the British welfare state.

There are important issues, which emerge very clearly from the German paper by Christian Kastrop, concerning the transparency of the fiscal equalisation system. Systems that people don't understand and can't explain cannot be transparent. The comprehensibility of fiscal systems in the context of decentralised governments is a very important issue to be addressed. One of the interesting points which Paul Boothe's paper made very clearly is the importance of transaction costs, which include taxpayer compliance costs. In a system with three levels – central government, sub-national government and local government – the question of transaction costs becomes important.

Before I go on to talk more about individual papers, I just want to emphasise that I think that institutions matter, I think culture matters, I think path dependence matters. Policy reformers don't start with a clean slate – one has an inherited historical position. And I think there are also important issues that come up about whether constitutions are there to be kept or constitutions are there to be changed. One of the arguments for having formal constitutions is that they create a degree of predictability and stability, and if constitutions are always going to change that loses one of the purposes they are supposed to fulfil. The final general point I would like to make is that I have been coming to international conferences long enough to notice a cycle of national moods. Twenty years ago, one saw a very confident mood from Japanese speakers and from German speakers, and a much less confident mood from Australian speakers and from British speakers, but one sees something of a cycle. Different countries have, at different points in history, a sense of whether their institutions are working well or working badly.

That takes me to Christian Kastrop. I never thought I would live long enough to hear a German speaker talk about the German model in terms of the German disease. My knowledge of the German fiscal equalisation system is rather superficial, but I think there is a tendency to exaggerate both the scale of problems and the extent of reforms that have recently been taking place. Essentially what the



German fiscal equalisation scheme is concerned about is how to distribute assigned revenues; there is a great deal of debate and a great deal of complexity in terms of how the revenue-sharing system should operate. The German federal system is dramatically different from the Canadian system. Where there is genuinely tax discretion at the provincial level in Canada, the German system is a revenue-sharing system of taxes essentially governed at the central level. What strikes me, as an outsider, is that the German Länder would be in a very weak position if it weren't for the strength derived from their representation in the Bundesrat. I also think there is a danger of underestimating the benefits of the expenditure-side autonomy of the German Länder and of the devolved administrations in the United Kingdom.

Turning specifically to Paul Boothe's paper, I think one of the really intriguing points, counterpointed by the conference, is why Australia and Canada are so different. Greg Smith's interesting paper on Australian tax policy yesterday said almost nothing about the relationship between the Commonwealth and the states. You have two countries which will both tell you very quickly that they are federal, but federalism in Canada and federalism in Australia mean very different things. They are both very big countries geographically, so it's not just size which makes them different from European Union countries. Canada, which has the very fragmented system of government, has the high public expenditure/GDP ratio, whereas you might have expected the opposite relationship, and in Canada you get very big variations between tax and expenditure levels among provinces. I think that the Boothe paper really brings out very clearly the tax assignment issues about who actually has which taxes. Alberta has control over oil revenues, but Scotland does not. Who has access to particular tax bases is obviously a fundamental question. My own instinct is that the Canadian example is much more relevant to Europe than is the German experience. An enlarged Europe, even the present European Union, does not have the degree of cohesion that Germany has.

Turning very briefly to the other papers, I found the Ederveen and de Mooij survey of the effect of taxes on foreign direct investment to be very interesting, because an important question has been the role that foreign direct investment has played in the Republic of Ireland. Rightly or wrongly, the Irish economic miracle after 1988 is perceived to have been partly to do with the way in which it played a small-country game with corporation tax, relative to the United Kingdom. And certainly in Scotland and Northern Ireland this issue of the level of Irish corporation tax relative to the United Kingdom corporation tax is perceived to be very important. The Ederveen and de Mooij paper is a very careful review of the literature, trying to standardise the results on a topic which, from my United Kingdom policy perspective, is really very important. That leads me to the Catenaro and Vidal paper: one of the things that I focused on was their emphasis on asymmetry in country sizes, and the issue of positioning. If Scotland became independent, one of the first things it would do is harmonise its corporation tax system with the Republic of Ireland and try to gain a competitive tax advantage over the United Kingdom.

Turning to the Haughwout paper, one of the things that this reminds us of is that there is a long tradition in the public finance literature of stressing an efficiency

basis for intergovernmental transfers. There is currently a tendency to think that equalisation transfers are essentially for equity reasons. What comes out very clearly from the Haughwout paper is that one solution to the problem in the Philadelphia metropolitan area is consolidation, merging all the authorities into a metropolitan area government; the other possibility is to deal with the spillover effects through an intergovernmental transfer system. There's a very interesting footnote in the paper on page 384, which emphasises that you don't get the same effects in the model if you increase the incomes of the residents of the central city. The form of the externality means that the policy response must take a specific form to generate the benefits to the suburban economy. So it's very important that one doesn't think that equalisation systems are just about equity – there are also very important efficiency issues.

Martin Weale's paper is well outside my field of competence. I would just like to highlight that we are coming back to my earlier point that there are different dimensions to be considered: the interpersonal; the territorial and the intergenerational.