TAXATION UNDER CONDITIONS OF ECONOMIC GLOBALIZATION

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Over the past ten years, the trend of globalization has been observable in almost every area of socio-economic life. As the interconnectedness of nations increases – in the technological and social fields, and also culturally – it is notable how these changes are reducing the economic isolation of nations and are undermining the effect of policies fundamentally mistrustful towards foreign transactions.

Globalization [10] may be seen as the development and deepening of international economic relations at the international level, a trend which is contributing to growth in technological progress, while being supported by liberalization and rising competitiveness, especially in communication and transport services.

Globalization processes are reflected mainly in an increase in the mobility of production factors between countries, as well as in the growing number of companies operating in more than one country. This, naturally, allows for better utilization of global resources and the opportunities stemming from the different technological and economic environment in individual regions, which ultimately leads to higher quality in satisfying the needs of final consumers

As far as taxation is concerned, the principal features of globalization may be identified as:

- increased activity of multinational companies,
- internationalization of the way business is organized,
- considerable growth in the countries involved in the process,
- greater complexity in foreign transactions,
- substantial reduction in the significance of geographic borders in international trade owing to a revolution in communication technologies. [9]

Positive and negative consequences of globalization

Globalization trends are, however, accompanied by both positive and negative consequences that are, in the area of taxation too, reflected in many contradictory facts. The consequences are further exacerbated by the increase in capital mobility, by sensitivity to taxation differences between individual countries, and by obviously increasing difficulties in collecting taxes from "international income". [5] It is clear that the disappearing borders within integrated economic systems will be reflected in the economic and tax policies of each participating entity.

National governments must address the principal contradiction that, on the one hand, efforts to lure foreign investment require a tax rate which is not high, and, on the other hand, it is necessary to meet the income requirements of the state budget. Setting such an optimum border for the taxation of foreign transactions is not a simple matter. The result has been that a large number of large multinational firms and many of their investors do not pay a proper share of taxes to the relevant country. The problem may be seen in the fact that countries, although they are cooperating to eliminate tax avoidance, are often in a position of mutual tax competition (in order to profit as much as possible from tax benefits).

The positive results of globalization can be said to include production economies of scale for multinational companies, the greater wealth accruing to people through the better utilization of resources and temporarily free capital, and the overall improvement in the economy's performance, which ultimately delivers a higher tax revenue to the state.

On the other hand, the interconnection of the world allows taxable entities to transfer a large chunk of their profits (tax bases), often in illegal ways, to countries which have a lower tax burden, and also, with the greater mobility of profits, to exploit various tax treaties (treaty shopping). While this may be an advantage for taxable entities, it leaves domestic public budgets with lower tax revenue and is therefore negative.

Among the other consequences of globalization that may be considered negative, from the view of both tax entities and the state, is undoubtedly the multiple or double taxation of the same income or assets. This problem may be solved through bilateral or multilateral agreements to prevent double taxation between countries.

Taxation within the international environment is accompanied by various processes, such as adaptation, competition, coordination and harmonization.

Adaptation and competition are used primarily by closed countries with high initial tax rates; they monitor surrounding countries and apply specific measures aimed at protecting their own economic interests or at luring taxable entities away from other countries

Coordination comes in both a formal and informal shape. Informal coordination may be described as the occasional contacts between tax authorities of different countries, where they exchange experience on how to solve certain problems or seek agreement on how to exchange information on taxable entities in an effort to eliminate tax avoidance. Formal coordination may be represented by high-level meetings between countries' representatives, where they consult with each other over draft amendments to tax legislation in order to prevent amendments that could adversely affect other countries. Coordination at the international level is conducted through the OECD's Committee on Fiscal Affairs, which is composed of representatives from the tax authorities of each OECD Member State. Although there are grounds for this form of cooperation, its reach extends only to OECD Member States.

Harmonization is the process of approximating and adjusting national tax systems on the basis of compliance with agreed common rules, where certain countries agree mainly to bring the rates and bases of core taxes into line with them. A typical example is the attempt to harmonize the tax systems of the European Union. This process is not, however, simple and there are both advocates and opponents of its necessity.

Tax harmonization in the European Union

Tax policy is one of the most complex areas of the integration process. The development of the harmonization process in the EU may be divided into the following stages:

• The first stage consists of efforts towards overall harmonization of tax systems, not merely structural harmonization but also the harmonization of rates. Attempts at practical implementation and professional studies in this area have, however, revealed the huge complexity of the harmonization process as understood in this way, and especially in regard to direct taxation. The problem has been shown to be not only the different tax systems in individual Member States, but also the difference in the economic level and the social and economic preferences from country to country, as well as a reluctance to place a part of national sovereignty over taxation into the hands of the Community.

• In the second stage, following a reassessment of the original positions on harmonization, a narrower view was taken of the process in this area and attention was focused solely on the harmonization of those tax provisions which would otherwise prevent the functioning of the single market or would adversely affect economic competition.

Given that the EU is not yet functioning like a single state organization, tax policy may be seen as a symbol of national sovereignty and a part of the overall economic strategy of each Member State. It is entirely up to the Member States to decide which taxes to impose in their territories. Since the approval of tax measures at the EU level requires the support of each Member State, and each Member State therefore wields a de facto veto, the European Commission's role in this area is basically just to ensure that the tax systems of the individual countries conform with treaties adopted in the EU. In no case does this involve an attempt to unify national tax systems.

Although the tax field is regulated by European Council documents of varying legal force, these serve to ensure no more than the proper functioning of the single market.

As regards tax harmonization, legislative norms are adopted mainly through directives and with regard to the particular legal treatment of taxes and the different tax systems of individual Member States. Directives are binding on all Member States to which they are addressed, and a Member State may choose the manner and methods of implementation which it deems most suitable. Directives stipulate the time limit for their transposition into national law. Given the uniqueness of each country, directives are particularly suitable in that they leave space for harmonization with domestic law. [3]

Tax harmonization versus tax competition

Although the need for tax harmonization has been spoken about since the end of the 1950s, and its requirement in relation to the single market is undeniable, this process has kept running into opponents. Indeed, some voices consider tax harmonization to be not just unnecessary but actually harmful.

In regard to the creation of the single market and the increasing number of countries that have either joined or are on course to join the European Union, the relationship between tax harmonization and tax competition is becoming a debated issue. While one side argues that tax harmonization is harmful, the other side says the same about tax competition.

Among those who consider tax harmonization to be harmful is the prominent American expert on tax policy and tax reform, Daniel J. Mitchell, who is seen in the United States as one of the staunchest opponents of measures developed by the EU, OECD and United Nations in the direction of tax harmonization: "Tax harmonization policies are designed to hinder the flow of jobs and capital from high-tax nations to low-tax nations. This is a form of cartelization – akin to an OPEC for politicians. The policies being advocated by the EU are contrary to economic liberalization, and they would insulate government from the discipline of market pressure. More importantly, these policies would deny people the benefits of economic growth. Tax harmonization is designed to protect jurisdictions with high tax rates and pervasive double taxation. Tax competition, by contrast, pushes lawmakers to make the right decisions – choices that will lower tax rates and reduce double taxation."[4]

It may be said that tax harmonization basically stifles tax competition, in other words, it prevents competition between countries and often results in tax rates being set higher than they would be amid tax competition. Tax competition, however, is created not only by different tax rates, but also by a different construction of the tax base, and various tax stimuli, such as special tax regimes, tax relief tax credits, tax holidays and so on. Using preferential tax regimes, countries therefore attempt to attract foreign investors and ensure economic growth.

It should be noted that although competition is generally considered to be beneficial (in economic theory) on the grounds that it provides for the most efficient allocation of resources, this claim is arguable when applied to tax competition. In fact, the task field could be spoken about in terms of market failure, since taxable entities do not receive equivalent countervalue for their tax contributions.

Attempts to define harmful tax competition have been made by some authors. For example, Sedmihradský: "Harmful tax competition means the application of lower or zero rates of tax to income from activities conducted exclusively outside the domestic economy and where there is no exchange of information with the countries in which this income was earned. The objective of such minimal taxes is above all to attract economic activity at the expense of other countries." [7]

In assessing whether tax competition is harmful or not, it matters how the principles of fairness and neutrality are incorporated into the particular tax system. It is important whether the same conditions are provided for the taxation of all taxable entities in the given country. One cannot reproach a country in which the tax system respects the conditions of a functioning single market economy while also supporting the business activity of all the entities within its territory. If, however, special tax regimes are created only for specific companies that earn their income mainly from economic activity outside the country, then this is basically a typical example of the tax system as a "tax haven".

Opposition to tax competition is coming from several executive representatives, especially from the "older" EU Member States. Their concern is that as a result of tax reforms in some of the new Member States, they will be forced to reassess tax policy in their own countries. It is perhaps paradoxical that tax systems in the new Member States, although they naturally have their shortcomings too, are more transparent and provide conditions for a lower tax burden on taxable entities in comparison with the old Member States. Tax competition can result in a reduction of income for the state budget, which should then lead to reining in of public sector spending. In dealing with this, however, government representatives act with a mixture of caution and aversion.

In an attempt to eliminate harmful tax competition, the European Council approved a tax package on 1 December 1997 consisting of three basic parts:

1. A code of conduct for business taxation;
2. Measures to abolish withholding tax on interest and on royalties between companies;
3. Measures aimed at the integrated taxation of savings.

The Code includes a guideline on which measures in the tax field are to be considered harmful. Account should be taken of whether tax benefits are provided exclusively to non-residents, whether they are provided in the absence of actual business or economic activity in the given country, and whether the procedures for determining profit are based on internationally accepted principles. The Code also requires Member States to inform each other about existing and proposed measures in the tax field. Since the Code is not legally binding, however, it relies entirely on cooperation between the Member States.

A proposal for measures to abolish withholding tax on interest and on royalties between companies constitutes the second part of the tax package for eliminating harmful tax competition, since withholding tax on such income has several negative consequences for corporate entities (tax administration costs, an adverse effect on cash flow, and, in certain cases, double taxation). The proposal is now incorporated into Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States. The Directive was adopted on 3 June 2003 and entered into force on 1 January 2004.

The third part of the tax package provides for the integrated taxation of savings within the EU, while also attempting to restrict tax discrimination against natural persons when working or investing in another Member State.

Tax competition between Member States needs to be understood in the context of worldwide tax competition. The European Union must therefore address harmful tax competition not only between Member States, but also in relation to other countries.

In 1998, the OECD also declared a fight against harmful tax competition when it approved a report entitled: "Harmful Tax Competition – An Emerging Global Issue." Initiated in 1996, the Report was drawn up by the Committee on Fiscal Affairs in cooperation with OECD member countries. It includes criteria for identifying harmful tax competition as well as a wide range of recommendations on how to prevent the use of such practices. In conclusion, it proposes a coordinated procedure to be followed by OECD member countries in counteracting harmful tax competition, which according to the OECD comes in the following forms: preferential tax regimes in OECD member countries, tax havens, and the manifestations of harmful tax practices in non-member economies. The OECD has compiled four basic criteria to be used in identifying preferential tax regimes: [6]

- No or low effective tax rate on income,
- Fictitious activity,
- Lack of effective exchange of information,
- A differential approach to the taxing of residents and non-residents, i.e. denying the benefits of a preferential tax regime to residents or, conversely, denying access to the domestic market to investors that benefit from preferential tax regimes.

As for identifying tax havens, the same criteria apply except with two modifications: instead of the criterion of a differential approach to residents and non-residents, the OECD has chosen the non-performance of a substantive activity as a criterion, and instead of the criterion of a low effective tax rate, there is the criterion of a zero or nominal tax rate.

The additional criteria are based on legal definitions of the tax base in various countries, where certain laws take into account inflationary effects or a reduction in the number of incomes subject to double taxation (using the method of inclusion in or exclusion from double taxation), or they take a different approach to deductible items or to the taxation of different entities. Also taken into consideration is non-compliance with international transfer pricing rules for dependent companies and inconsistent compliance with the arm's length principle, as referred to in the 1995 OECD Guideline on multinational companies and tax administration.

In June 2000 the OECD published a list of those undesirable tax regimes in OECD member and non-member countries which it deemed "uncooperative tax havens". Member countries undertook to abolish or modify such regimes by April 2003. Non-member countries which undertook to cooperate with the OECD were to bring their tax regimes into line by 31 December 2005, while each year taking steps towards rectifying the existing situation. The uncooperative tax havens published in the list (comprising 35 small countries) had until 31 July 2001 to enter into cooperation with the OECD, or else face countermeasures not only of a fiscal nature. [7]

Measures adopted at the level of the EU and OECD are designed to coordinate member countries' legislation in order to abolish harmful tax competition through a common approach. What should be particularly crucial in this regard is cooperation in the effective exchange of tax information on residents to whom the non-transparency of tax havens has guaranteed anonymity and enabled the avoidance or evasion of tax payments. Yet to find a clear boundary beyond which transparent tax competition may be deemed harmful is in many cases a demanding task.

The debate over tax harmonization has been running now for several years, and there is still no consensus on whether tax policy should be left at the national level or harmonized at the level of a broader grouping.

László Kovács, the European Commissioner for Taxation and Customs Union, has commented on this matter as follows: "There are various forms of tax competition. And there are also many forms of co-operation. Harmonization of tax rules is only one of these forms, probably the most extreme one. Harmonization involves the adoption of common rules eliminating national differences. Economists often stress that eliminating differences between Member States' tax regimes is not ideal when such differences are justified by objective factors. Harmonization is the most difficult form of cooperation to achieve when unanimity is required to take decisions. For these reasons EU tax harmonization efforts have focused on very specific areas where there were strong arguments for harmonizing. This was particularly the case for indirect taxation of goods and services, where a degree of harmonization was needed in order to complete the internal market and in particular to eliminate border controls." [2]

One may also come across the view that "it is not harmonization that is necessary, but the improvement of tax systems" [1] applied in individual countries.

There are, of course, genuine reasons for taking a negative stance to harmonization in this area. The arguments against include, for example, the disproportionate political and administrative costs related to the approximation of tax systems, rates and tax bases. A further reason is that harmonization of tax systems in the EU could prompt a search for tax advantages outside Europe, which would involve an undesirable outflow of capital.

To conclude, here is a thought of Adam Smith, the Founding Father of Economics, which Mitchell cited in his lecture: "An inquisition into every man's private circumstances, and an inquisition which, in order to accommodate the tax to them, watched over all the fluctuations of his fortunes, would be a source of such continual and endless vexation as no people could support... The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour would necessarily be more or less diminished by its removal." [8]

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