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MPIfG Discussion Paper 07/2

Taxation and Democracy in the EU

Steffen Ganghof and Philipp Genschel



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Abstract

Is corporate tax competition a threat to democracy in the EU? The answer depends crucially on a positive analysis of the effects of tax competition on national policy autonomy. Most analyses focus on *direct* effects on corporate tax rates and revenues. We contend that this focus is too narrow. It overlooks the fact that corporate tax competition also has important *indirect* effects on the progressivity and revenue-raising potential of personal income taxation. We elaborate on these indirect effects theoretically and empirically, and explore the implications for the normative debate on the EU's democratic deficit. Our findings show that European integration can constrain national redistribution in a major way: the democratic deficit is real. Greater political contestation over the EU's policy agenda is desirable in order to mitigate this deficit.

Zusammenfassung

Wie bedrohlich ist der Unternehmenssteuerwettbewerb für die Demokratie in der Europäischen Union? Die Antwort hängt in entscheidendem Maße von einer empirischen Analyse der Effekte des Steuerwettbewerbs auf die nationale Gesetzgebungsautonomie ab. Bisher sind in der vergleichenden Forschung fast nur die *direkten* Effekte des Steuerwettbewerbs auf Unternehmenssteuersätze und -einnahmen analysiert worden. Dieser Fokus ist zu eng. So wird systematisch übersehen, dass der Unternehmenssteuerwettbewerb auch wichtige *indirekte* Effekte auf die Progressivität und das Aufkommenspotenzial der persönlichen Einkommensteuer hat. Diese indirekten Effekte werden theoretisch und empirisch nachgewiesen und ihre Implikationen für die normative Debatte über das Demokratiedefizit der EU erörtert. Die Analyse zeigt, dass die europäische Integration die Spielräume für eine eigenständige nationale Umverteilungspolitik erheblich beschränkt: Das demokratische Defizit ist also durchaus real. Eine stärkere Politisierung der europäischen Politikagenda wäre wünschenswert, um dieses Defizit zu mildern.

Contents

1	Tax competition, tax harmonization and democracy	5
2	The indirect effects of company tax competition: Theory	7
3	The indirect effects of company tax competition: Evidence	10
	Evidence for tax competition: Company tax rates and country size	10
	Tax competition and the tax rate gap effect	13
	Tax competition and the pull-down effect	15
4	Taxation and democracy in the EU	17
5	Conclusions	22
	References	23

1 Tax competition, tax harmonization and democracy

Tax competition features prominently in two closely related debates on European politics: a policy debate on the desirability and necessity of EU-level involvement in company taxation,¹ and a normative debate on the so-called democratic deficit. The policy debate focuses on the issue of tax harmonization: Should the EU engage in (minimum) tax rate harmonization in order to reduce the scope for tax competition among the member states, as proposed, for example, by the Ruding Report (1992: 209) or the German and French governments in 2004 (Financial Times 2004)? The debate on the EU's democratic deficit centers on the question of the redistributive consequences of European integration: Are EU policies redistributive, and if so, should there be more political contestation about the EU policy agenda (e.g. Follesdal/Hix 2006; Scharpf 2006)?

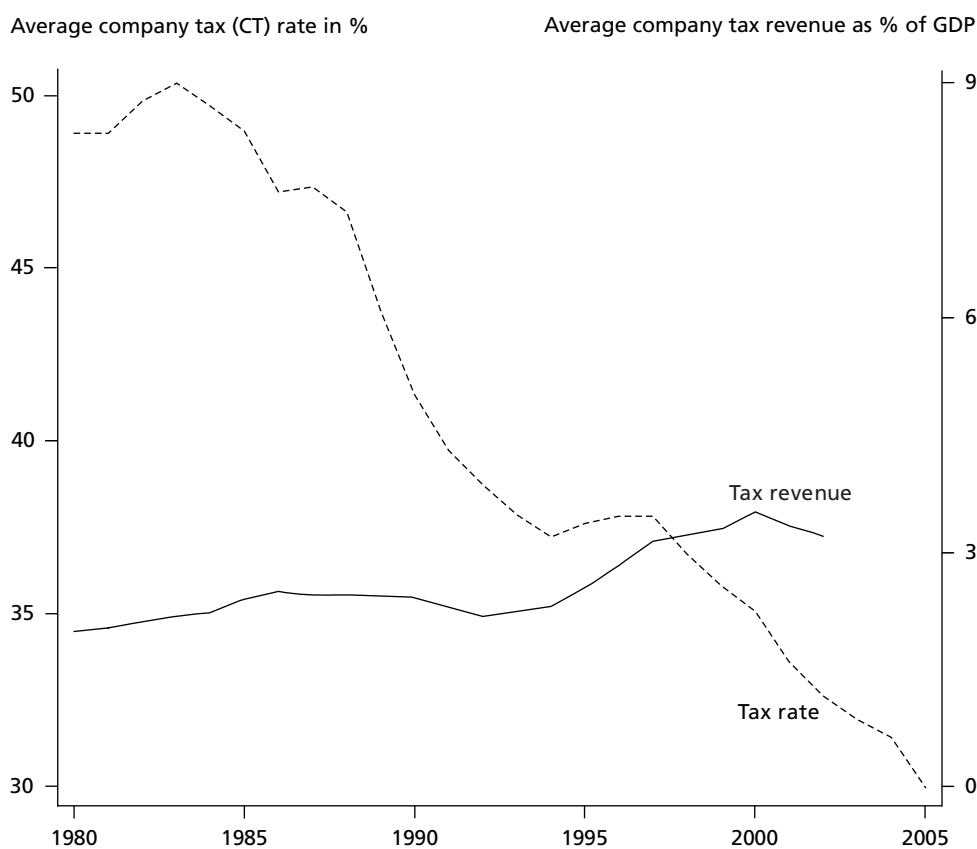
Both debates are riddled by contradictory evidence on the effects of tax competition. As Figure 1 shows, the average statutory company tax rate of the EU-15 countries has fallen continuously since the 1980s. This allows proponents of a minimum tax rate policy to point at a “mad race” to the bottom in corporate taxation that needs to be stopped (Strauss-Kahn 2004: 60). Those concerned about the redistributive consequences of European integration can cite the downward trend as evidence of democratic control of national tax policy choices being eroded by competitive constraints in the Single Market (e.g. Scharpf 2003b). Figure 1 also shows, however, that the general drop in company tax rates did not result in a similar drop in company tax revenues. To the contrary, the unweighted average of revenues actually increased over the 1990s. This seems to vindicate those policy experts, including the European Commissioner for Taxation László Kovács, who doubt the need for a minimum tax rate (e.g. Kovács 2004). It also seems to prove those authors correct who contend that European integration is either not redistributive or guarantees centrist policy outcomes (Majone 1998; Moravcsik 2002).

We contend that both debates suffer from a one-sided conception of the effects of company tax competition. They proceed from the implicit assumption that the only potentially important effect of tax competition is the *direct* effect on company tax revenue. By contrast, we argue that tax competition also has important *indirect* effects on *personal income taxation*. The corporate tax not only serves as a revenue-raising instrument in its own right but also as a kind of backstop for the personal income tax. In the absence of a separate tax for corporations, companies could be used as tax shelters for personal income. By helping to prevent this, the corporation tax protects the personal income tax base. Tax competition undermines this backstop function of the corporate tax by

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1 The terms “company taxation” and “corporate taxation” are used interchangeably in this paper.

Figure 1 Average corporate tax rates and revenues of EU-15 countries, 1980–2005



Sources: Tax rates: various sources, see Ganghof (2006: Appendix); tax revenue: OECD (2004).
Notes: Unweighted averages. Tax rates are for retained corporate profits and include temporary surcharges as well as local business taxes.

pushing corporate tax rates down. Hence tax competition indirectly constrains the revenue-raising potential and/or the progressivity of the personal income tax.²

In sections 2 and 3, we demonstrate first theoretically and then empirically that company tax competition has significant indirect effects on personal income taxation. In section 4, we discuss the implications for the related debates on the democracy deficit and on company tax harmonization in the EU. We endorse calls for greater political contestation about the EU's policy agenda (Follesdal/Hix 2006). While the processes for *deciding* policy issues cannot become much more politicized and "majoritarian" in the near future, the processes for *defining* policy issues can and should be changed in this direction. This would still have to lead to proposals that can muster broad support. But

2 The revenue-raising potential and the progressivity of the personal income tax are closely related. If income tax rates are cut across the board, revenues might fall while progressivity remains unchanged. Conversely, if income tax rates are only cut at the top of the income distribution, revenues might remain more or less unchanged while progressivity is reduced.

these proposals would differ from the ones pursued in a depoliticized policy debate. We illustrate this point by sketching a proposal for tax harmonization that focuses on the much neglected backstop function of company taxes. Section 5 summarizes the main points.

2 The indirect effects of company tax competition: Theory

In order to gain theoretical understanding of the indirect effects of company tax competition, we first introduce a somewhat abstract, but crucial, distinction between two types of profits: *normal* and *above-normal* profits. Equipped with this distinction, we can better understand the nature of company tax competition, the nature of the company tax's backstop function and the consequences of tax competition for this backstop function.

From an economic perspective, there are two types of what is usually called "capital income": normal and above-normal. The normal return to capital is the return to deferring consumption, i.e. the (risk-free) return to wealth. For instance, if someone buys a machine, she wants this investment to generate at least the return she would have received from buying government bonds. This is the normal return. Above-normal returns go beyond this level. They include various things, such as returns to innovation, returns to market power or returns to entrepreneurial skill. Bill Gates' income from his share of profits from Microsoft consists mostly of above-normal returns (Slemrod/Bakija 2004: 203–204).

The distinction between normal and above-normal profits helps to understand why the pressure of tax competition is particularly strong on *statutory* company tax rates – regardless of the definition of the tax base. A low statutory rate not only serves as a highly visible signal of a business-friendly general tax climate and a disincentive for cross-country profit-shifting, it is also instrumental for attracting foreign direct investment (Devereux/Sørensen 2006). Foreign investment is usually premised on the expectation of significant above-normal profits. Above-normal profits, however, tend to imply a high exposure to taxation at the full statutory company tax rate. Companies at low levels of profitability are not very sensitive to the statutory tax rate if generous investment tax credits, depreciation schedules or other forms of tax relief are available. By contrast, companies at high levels of profitability are highly sensitive because they have lots of profits which are taxable at the statutory rate. Hence, to the extent that countries compete for *profitable* investment, they face strong incentives to cut the statutory corporate tax rate – even if this cut is paid for by broadening the corporate tax base (Bond 2002).

Note that this account of tax competition is fully compatible with "ideational" explanations of income tax reforms (for a detailed discussion, see Ganghof 2006: Ch. 3–4).

These explanations state that, in the 1970s, policymakers had become increasingly dissatisfied with taxation systems that intervened in the *structure* of savings and investments and thus, in the 1980s, started to move toward more “market-conforming” systems by lowering statutory rates and broadening tax bases (Swank 1998; Steinmo 2003; Stewart/Webb 2006). These explanations are no challenge to the tax competition hypothesis because, even if “market conformity” is the goal, there are good reasons to maintain relatively high company tax rates on *above-normal* profits. One reason is that, in standard public finance theory, taxing above-normal profits is less harmful for domestic investment incentives than taxing normal profits. Shifting the tax burden from normal to above-normal profits may thus increase tax efficiency.³

The second argument for a relatively high tax rate for above-normal corporate profits draws on the backstop function of the corporate tax mentioned above (Mintz 1995). Because company income differs from personal business income in legal form but not in material substance, the exemption of company income from taxation would create a significant loophole in the tax system. High-income taxpayers could reduce their personal income tax burden by storing part of this income in a corporation. One purpose of the company tax is to plug this loophole. It does so most effectively if the company tax rate is equal to the top personal income tax rate (Stotsky 1995: 282; Tanzi/Zee 2000: 310). For if the company rate is much lower than the top personal rate, an incentive remains for high-income earners to shift income into the corporate sector. Therefore, to the extent that a high top personal income tax rate is desired, the company tax rate has to be kept high too in order to avoid a large rate gap between both taxes.

The problem is that a high company tax rate that applies to all company income alike, significantly reduces domestic investment incentives. In the absence of tax competition, however, this problem could be dealt with by aligning only the company tax rate on *above-normal* profits with the (high) top personal tax rate. By contrast, the tax rate on *normal* profits could be set at a much lower level. This tax rate could even be zero, which would turn the income tax into what economists call a “direct consumption tax.” For, in this case, the income tax base would consist mainly of above-normal profits and wages, and, thus, be essentially identical to that of a European-style value added tax.

Hence by maintaining a relatively high tax rate on above-normal company profits, governments can potentially achieve a rather efficient form of company taxation *and* back up a high progressive personal income tax. They can set the tax rate on above-normal profits with one eye on their preferred level of the top personal income tax rate, while setting the tax rate on normal profits with the other eye on domestic investment incentives. Italy’s “dual income tax” (1998–2004) approximated to such a system along crucial dimensions (Bordignon/Giannini/Panteghini 2001): firms’ normal return on

3 Of course, there is significant disagreement about the relative efficiency of different tax structures. For a discussion of different dimensions and notions of tax efficiency, see Ganghof (2006).

(new) equity was taxed at a rate of 19 percent, whereas above-normal returns were either subjected to the corporate tax rate of 37 percent or, in the case of unincorporated businesses, to the top personal tax rate of 46 percent. In the absence of corporate tax competition, this type of dual income tax would have been attractive for many national governments trying to implement a progressive but nevertheless market-conforming income tax (Ganghof 2006).

Given tax competition on statutory corporate tax rates, however, a high corporate tax rate is a competitive disadvantage – even if this rate only applies to above-normal profits. Company tax rates have to fall so that the attractiveness of the Italian-style dual income tax is undermined. In fact, this system has been abolished in Italy rather than being copied by other countries.

The conclusion is that, by pushing down company tax rates, tax competition reduces the ability of governments to design corporate taxes that are efficient and provide an effective backstop for personal income taxation. Efficiency is more difficult to achieve because lower corporate tax rates mean that corporate tax bases have to be broadened in order to defend revenue. Broader bases, in turn, reduce the scope for exempting normal profits from (full) taxation. The backstop function is undermined because lower corporate tax rates imply that governments have either to accept a widening tax rate gap between corporate and (high) top personal income tax rates, and hence wasteful arbitrage between the personal and the corporate sector (*tax rate gap effect*), or to lower top personal rates in step with the corporate rates (*pull down effect*). Both effects impair the progressivity and revenue-raising potential of the personal income tax.

One complication should be noted at this point. Even in the face of tax competition, national policymakers do not have to abandon the idea of taxing above-normal profits higher than normal profits. Rather, they can shift the taxation of above-normal profits from the level of the corporation to the level of the shareholder. The idea, in other words, is to tax above-normal profits in the form of dividends and realized capital gains. Indeed, there has been a trend within the EU of shifting the tax burden away from the level of the corporation and onto the level of the shareholder. What is more, Norway (as a non-EU country) has recently introduced a type of dual income tax that systematically distinguishes between normal and above-normal profits: most normal capital income is taxed at a uniform tax rate of 28 percent, labor income is taxed at progressive rates of up to 43.5 percent (61.1 percent if social security contributions are included), and above-normal profits are taxed at the shareholder level at 48 percent (Sørensen 2005a).

This new Norwegian system can partly be understood as a pragmatic adaptation of the Italian-style dual income tax to the reality of tax competition. However, the taxation of above-normal profits at the level of shareholders tends to be administratively much more complex and costly than at the level of the corporation (Sørensen 2005b). Therefore, the Norwegian system does not solve the problem outlined above: competitive pressure to reduce tax rates on retained company profits tends to undermine the

backstop function of company taxation and thus increases the costs of progressive income taxation. Hence continuous cuts in company tax rates will sooner or later lead to reduced income tax progressivity or revenues – or both.

3 The indirect effects of company tax competition: Evidence

In this section we present qualitative and quantitative evidence supporting our theoretical argument. We start by showing that the comparative patterns of company tax rate cuts are well explained by tax competition. We then move on to empirically explore two effects of corporate tax cuts. We show that lower corporate tax rates are associated with higher tax rate gaps between corporate and personal taxation (*tax rate gap effect*) and that they tend to pull down personal income tax rates (*pull-down effect*), everything else being equal.

Evidence for tax competition: Company tax rates and country size

There is some econometric evidence that tax competition has been a contributory factor in falling corporate tax rates (e.g. Swank/Steinmo 2002). Instead of surveying the relevant literature (for a recent review, see Devereux/Sørensen 2006: 17–20), we focus on a simple indicator to demonstrate that competitive incentives significantly affect tax rate choice: country size. The rationale for this indicator is provided by the theoretical standard model of tax competition (see e.g. Baldwin/Krugman 2002; Rixen 2006). One prominent result of this model is that small countries have more to gain from tax cuts because their domestic tax base is small compared to that of the rest of the world (e.g. Kanbur/Keen 1993). The chances are, therefore, that the revenue loss from the rate cut – i.e. revenue forfeited from the domestic base – will be more than compensated for by the revenue gain from the inflow of foreign tax base. As a consequence, small states have lower tax rates in equilibrium.

It follows that we should not necessarily expect *absolute* convergence of tax rates, i.e. a shrinking tax rate distribution as measured by the coefficient of variation. Rather, theory leads us to expect *conditional* convergence as measured by the correlation coefficient between corporate tax rates and country size (Ganghof 2006: 140).

The evidence is in line with this expectation. Table 1 compares company tax rates in 1980 and 2006. It shows that the drastic fall in the average tax rate shown in Figure 1 was not accompanied by absolute convergence. The coefficient of variation for the EU-15 countries was even slightly higher in 2006 than in 1980. However, as Figure 2 demonstrates, conditional convergence increased strongly. While the correlation between com-

Table 1 Company and personal income tax rates in the EU

Country	1980			2006		
	Company	Top Personal	Rate Gap	Company	Top Personal	Rate gap
EU-15						
Austria	61	62	1	25	50	25
Belgium	48	72	24	34	54	20
Denmark	40	67	27	28	62	34
Finland	59	67	8	26	51	25
France	50	60	10	33	56	23
Germany	62	56	-6	38	44	6
Greece	43	60	17	29	40	11
Ireland	45	60	15	13	42	29
Italy	36	76	40	37	43	6
Luxembourg	47	58	11	30	39	9
Netherlands	48	72	24	30	52	22
Portugal	55*	80	25	28	42	14
Spain	33	66	33	35	45	10
Sweden	60	87	27	28	57	29
UK	52	60	8	30	40	10
NMS-10						
Cyprus	n.a.	n.a.	n.a.	10	30	20
Czech Republic	n.a.	n.a.	n.a.	24	32	8
Estonia	n.a.	n.a.	n.a.	0	23	23
Hungary	n.a.	n.a.	n.a.	22	40	18
Latvia	n.a.	n.a.	n.a.	15	25	10
Lithuania	n.a.	n.a.	n.a.	19	27	8
Malta	n.a.	n.a.	n.a.	35	35	0
Poland	n.a.	n.a.	n.a.	19	40	21
Slovenia	n.a.	n.a.	n.a.	25	50	25
Slovak Republic	n.a.	n.a.	n.a.	19	19	0
EU-15 average	49	67	18	30	48	18
EU-15 CV	0.18	0.13	0.68	0.2	0.15	0.49
EU-25 average	n.a.	n.a.	n.a.	25	42	16
EU-25 CV	n.a.	n.a.	n.a.	0.35	0.26	0.57

Notes: Rounded to the nearest percentage point.

n.a. = not available; * = data for 1982; CV = Coefficient of Variation.

Sources: See Ganghof (2006: Appendix).

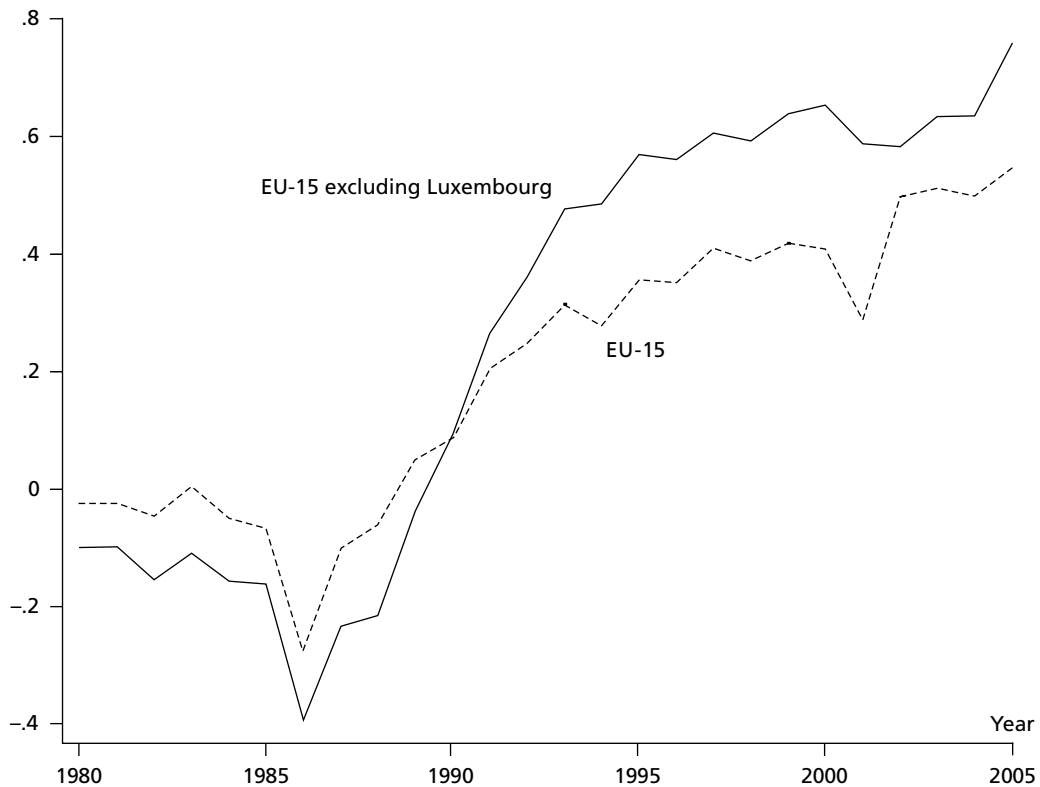
pany tax rate and country size was essentially zero in the early 1980s, it increased almost continuously after 1986. In 2005 the correlation coefficient (Pearson's r) was .55 – and as high as .76 if the special case of Luxembourg is excluded (about which, see below).⁴ This strong pattern of conditional convergence clearly corroborates the tax-competition explanation of company tax cuts.

Figure 3 shows that Eastern enlargement has not substantially changed the empirical picture. The correlation between country size and tax rates also holds for the EU-25.⁵ But there are outliers. Poland, for example, is large in size but has a fairly low tax rate. Luxembourg and Malta, in contrast, are small but have relatively high tax rates. One reason is that both countries relied heavily on preferential tax regimes in the past – a

4 Due to missing population data for 2006, the time series of correlation coefficients ends in 2005.

5 Note that the correlation between country size and company tax rates also shows up in much larger samples and is robust to the inclusion of economic control variables such as total tax levels, GDP per capita or capital controls (Ganghof 2005).

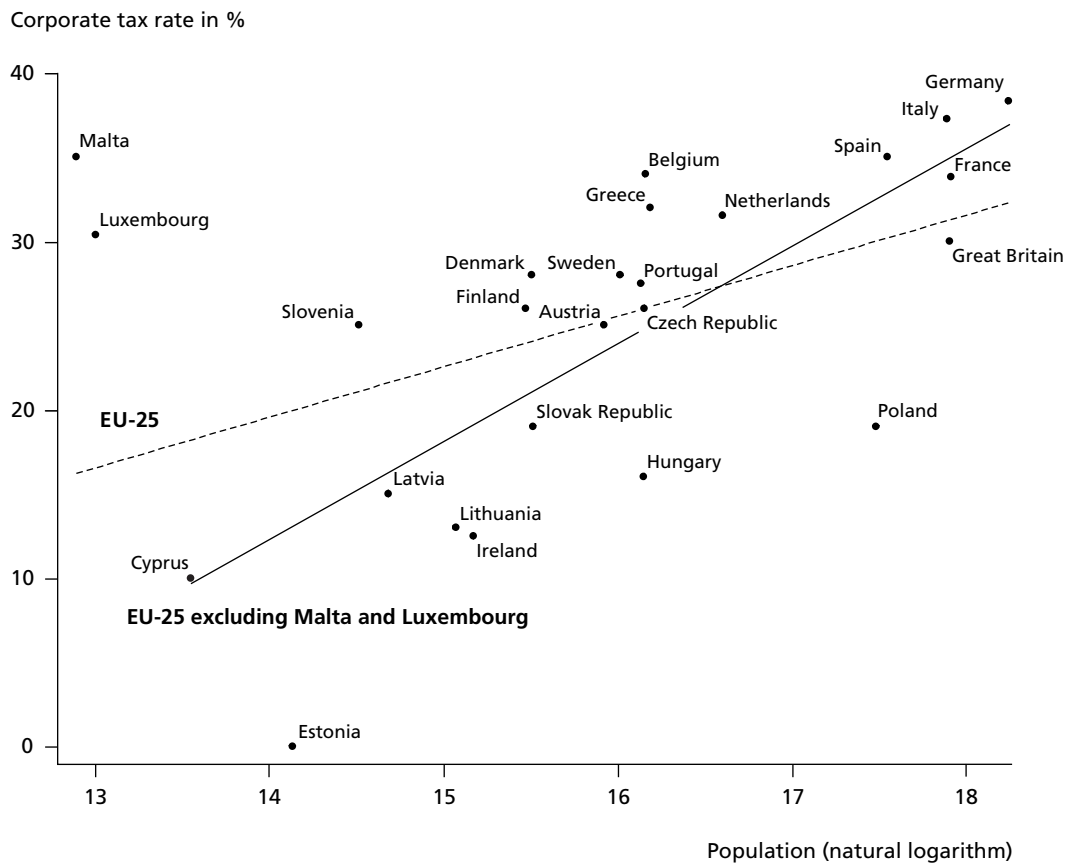
Figure 2 Correlation between company tax rates and country size, 1980–2005

Correlation coefficient (Pearson's r)

Sources: Tax rates: various sources, see Ganghof (2006: Appendix); population: World Bank (2003).
 Notes: Country size = $\ln(\text{population})$. Missing population data for recent years is replaced by the values for the latest available year.

competitive strategy that has recently come under serious attack from the EU's code of conduct in business taxation and the Commission's competition policy (Genschel 2002: 220–231). Another reason is precisely the backstop function of the company tax. Preferential regimes have made it easier for both countries to keep general corporate tax rates up in order to maintain small tax rate gaps and thus reduce *domestic* economic distortions (Table 1). In Malta, the tax rate gap is actually zero, and shareholders receive a full tax credit for taxes already paid at the level of the corporation (full imputation system). This system, first introduced in Germany in 1977, was once seen as the most advanced option for market-conforming company taxation at the domestic level (Ganghof 2006). Given tax competition, however, such a system is virtually impossible to maintain in high-tax countries. Malta, being a relatively low-tax country relying on preferential regimes, has greater degrees of freedom. As preferential regimes are increasingly phased out, however, the competitive disadvantages of a relatively high general corporate tax rate will increase, while the costs of maintaining domestic market conformity will rise (European Commission 2006).

Figure 3 Company tax rates and country sizes of EU member states, 2005



Sources: Tax rates: various sources, see Ganghof (2006: Appendix); tax revenue: OECD (2004); population: World Bank (2003)

Tax competition and the tax rate gap effect

As Table 1 shows, the tax rate gaps between company and personal taxation have not been reduced. One prominent interpretation of these gaps is that “EU member states do not seem to prefer a tight link between corporate and personal tax rates” (Sørensen 2004: 106). The problem with this preference explanation is that it is in many ways observationally equivalent to the explanation that member states do have a clear preference for a tight link between corporate and personal tax rates but are heavily *constrained* in acting upon this preference. In this section we argue that this tax-competition explanation is superior.

First, the preference for a small tax rate gap follows logically from two generally accepted premises discussed above: that policymakers have sought to make tax policy more neutral or market-conforming since the 1980s and that a small tax rate gap is conducive to this goal.

Second, Ganghof (2006: Ch. 1) uses time series data for a sample of 21 OECD countries to show that the average tax rate gap was indeed almost cut in half, from around 20 to around 10 percentage points, between 1975 and 1989. After 1989, however, when company tax competition had become more acute, the average tax rate gap widened again, to more than 15 percent in 2004, with corporate tax rates being cut more heavily than top personal rates.

Third, detailed investigation of the *timing* of tax rate changes in particular countries provide further support for the tax-competition explanation of tax rate gaps. For example, in 1977 Germany deliberately introduced a zero tax rate gap but was forced to gradually widen it after the early 1990s. Similarly, the goal of aligning the company tax rate with the top rate on personal capital income was an important goal of Danish tax policy in the mid 1980s. For this reason, Denmark *increased* the company tax rate from 40 to 50 percent in 1986. Once the full force of competitive pressures became obvious, however, Denmark was forced to cut its company tax rate. By 2005, the company tax rate had dropped to 28 percent, creating a gap between marginal tax rates on corporate and personal capital income of more than 30 percentage points. Similar stories can be told about other member states (see Ganghof 2006).

Finally, we perform a simple regression of tax rate gaps, i.e. the difference between top personal income tax rate and company tax rate in EU member states.⁶ The most important prediction following from the preference explanation would seem to be that corporate tax rates are *unrelated* to tax rate gaps (Sørensen 2004: 106): countries with low company tax rates are as likely to choose a large (or small) tax rate gap as countries with high company tax rates. In contrast, the tax-competition explanation predicts that low company tax rates are systematically associated with high tax rate gaps: the more countries are constrained by tax competition, the more difficult it becomes to maintain a small gap. To compare these two hypotheses, we have to control for other variables that potentially influence the setting of top personal income tax rates. To keep the model simple, we focus on two variables. The first is the total tax level as a percentage of GDP. As Ganghof (2006) shows, total tax burdens are positively related to labor tax burdens, and high labor tax burdens tend to translate into high top personal income tax rates. The second variable is country wealth, i.e. GDP per capita (natural logarithm). This variable summarizes a variety of relevant differences between member states but also captures an important observation about the recent spread of “flat taxes,” and hence small tax rate gaps, in Central and Eastern Europe: flat taxes mainly serve to signal a favorable business climate – a signal that poorer countries may feel more pressured to convey (Keen/Kim/Varsano 2006).

6 The regression is for the year 2004, due to restricted data availability for some of the explanatory variables.

Table 2 Explaining the tax rate gap in EU-25 countries in 2004

Independent variables	Dependent variable: tax rate gap (2004, top personal minus corporate tax rate)	
	Model 1	Model 2
Company tax rate (2004)	-0.86*** (0.15)	-0.90*** (0.14)
Total tax ratio (2002)	0.94*** (0.25)	0.89*** (0.22)
GDP per capita (2002, natural logarithm)	4.06** (1.81)	5.49*** (1.68)
Constant	19.23 (16.10)	28.91* (14.66)
Observations	25	24
Excluded outliers	None	Luxembourg
Adjusted R-squared	0.63	0.71

Notes: Ordinary Least Squares estimation; standard errors in parentheses; * significant at 10%, ** significant at 5%, *** significant at 1%.

Sources: Tax rates and population: various sources (see Ganghof 2006: Appendix), total tax ratio: Eurostat (2004).

The results presented in Table 2 clearly support the tax-competition explanation of tax rate gaps. The coefficients for all three independent variables are sizeable and statistically highly significant, and the overall model fit is good. The three-variable model explains more than 60 percent of the variance in the tax rate gap (model 1) and, if Luxembourg is dropped as an outlier, the explained variance increases to more than 70 percent (model 2). More importantly, the company tax rate has a strong negative effect on the tax rate gap. In fact, if we believed model 2 to reflect the true causal structure, we could conclude that every cut of the company tax rate by one percentage point increases the tax rate gap by 0.9 percentage points, all else being equal. This clearly corroborates the tax-competition explanation: large tax rate gaps reflect to a significant extent the stringency of competitive *constraints* rather than the lack of domestic *preferences* for small or zero gaps.⁷

Tax competition and the pull-down effect

The evidence presented in the previous section suggests that the dominant effect of lower company tax rates is to increase tax rate gaps between company and personal taxation. However, it follows logically from these results that lower company tax rates

7 Note that a large tax rate gap is also likely to have an effect on company tax revenues. A standard explanation of the seeming paradox of decreasing average statutory company tax rates and *increasing* average company tax revenues (figure 1 above) is that the broadening of corporate tax bases more than compensated the revenue loss from the tax rate cuts (Stewart/Webb 2006). While this is possible, it is also likely that the rise in company tax revenues partly reflects *domestic* income shifting from the personal to the corporate sector, induced by a large tax rate gaps (Fuest/Weichenrieder 2002). Australia provides a good non-European example of this causal mechanism (Ganghof/Eccleston 2004).

also tend to *pull down* personal tax rates on high incomes. If a one percentage point cut in the company tax rate leads to a .9 percentage point increase in the tax rate gap, it also leads to a cut in the top personal income tax rate of .1 percentage points. While this value is not large, it certainly conceals significant cross-national variation (Table 1). Some countries continue to pursue their general preference for small tax rate gaps, and this certainly has important consequences.

The German case is a good example (Ganghof 2006: Ch. 7). A reduction in the personal income tax rate was *not* a priority goal of German policymakers in the early 1990s. The top personal rate was not particularly high by international comparison (53 percent in 1990), and the fiscal burden of reunification strongly discouraged any tax giveaway. Company taxation was a different matter. The company tax rate stood at a relatively high level of 58 percent in 1990, and, as tax competition developed, this was increasingly perceived as a crucial handicap for the German economy. Because Germany had long had a strong preference for a small tax rate gap, the competitive pressure on the company tax rate spilled over forcefully into personal taxation: the top personal rate was cut to 44 percent in order to allow the company tax rate to fall to 39 percent (Table 1). The result was a mixture of reduced progressivity and reduced income tax revenues. The Red-Green government (1998–2005) put the overall net tax reduction achieved by its tax reforms – income and other taxes – between 1998 and 2005 at almost € 60 billion.

Tax competition's pull-down effect on the personal income tax rate significantly constrained German governments in their effort to adapt the country's tax structure to various economic challenges. There is broad consensus that one of the biggest obstacles to increasing employment is high social security contributions, especially for the low-skilled (Scharpf 2000; Kemmerling 2005). The Red-Green government (1998–2005) pondered over shifting the tax burden away from social security contributions and onto progressive income taxes, which imply lower taxes on the low-skilled. However, tax competition made such a shift all but impossible. Given the commitment to a small tax rate gap, the competitive pressure on the company tax rate meant that personal income tax revenue had to be *reduced* rather than increased. Revenues from value added taxation could be increased but could not be fully used to pay for reductions in social security contributions because they had partly to offset the former income tax cuts. The new "Grand Coalition" between Christian and Social Democrats (in power since 2005) decided to increase the value added tax by three percentage points, but only one third of this increase was earmarked for reducing social security contributions. Also, the government now plans to further cut the company tax rate to 30 percent. This will most likely not only stimulate a new round of tax cuts in smaller member states but also prompt new debates about the level of personal income tax rates in Germany. But even if German personal income tax rates fail to drop further, shifting more of the overall tax burden onto income taxes is out of the question.

The example of Slovakia is in many ways similar. In 2003 the government introduced a flat-rate income tax in order to align the income tax rate with the company tax rate,

which, for reasons of competitiveness, was set at the low level of 19%, thus seriously constraining the revenue-raising potential of the personal income tax. This weakness manifested itself when, in light of Slovakia's high unemployment, the OECD recommended that the government should reduce social security contributions for low incomes, rather than income taxes for high incomes, in order to increase employment. Bound by the flat-tax reform, the authorities argued that "fiscal constraints mean that this must be delayed" (Brook/Leibfritz 2005: 14). But these fiscal constraints were to a significant extent the indirect effect of company tax competition, which led the government to choose such a low tax rate in the first place.

To be sure, Germany and Slovakia are special cases. The focus on keeping the tax rate gap between corporate and personal taxation small is particularly strong, and, hence, the pull-down effect is particularly pronounced. Other countries seem less concerned. In Denmark and Norway, for instance, tax rate gaps were allowed to grow considerably in response to tax competition. Still, the fear of not letting the rate differential grow too large was an important reason why both countries cut their top personal income tax rates by around 15 percentage points each between 1983 and 2005. The pull-down effect was smaller than in Germany or Slovakia but still significant (Sørensen 2005a; Ganghof 2007).

4 Taxation and democracy in the EU

The previous sections have demonstrated theoretically and empirically that tax competition has important indirect effects on personal income taxation. Pushing down corporate tax rates, it forces governments to choose between two options: accepting a widening tax rate gap between company and top personal rates, and hence wasteful tax arbitrage between the personal and corporate sector (*tax rate gap effect*), or lowering the top personal rate in step with the company rate (*pull down effect*). These effects limit the revenue-raising potential and/or the progressivity of the personal income tax, and, by extension, of the tax system as a whole. In this section we discuss these findings in the light of the debate on the EU's democratic deficit. We start by reviewing three prominent positions in this debate.

The first position is closely associated with the work of Giandomenico Majone (e.g. 1998) and Andrew Moravcsik (e.g. 2002). It holds that there is no democratic deficit because the EU is institutionally constrained to pursue policies that are either Pareto-improving – i.e. leaving no-one worse off – or centrist, and have low political salience. Highly salient redistributive tax and spend policies are systematically excluded from the EU's policy agenda and, with few exceptions, remain under the firm control of the democratically accountable national governments of the member states. Hence, there is no need for a democratization of EU policymaking.

The second position is associated with the work of Fritz Scharpf (e.g. 2003b, 2006). It holds that there is a democracy deficit in the EU because the EU's drive toward market integration constrains the redistributive policies of the member states – directly through the legal force of the four freedoms and the European competition policy, and indirectly through economic competition. The effect of these constraints is not centrist but tends to be “neo-liberal.” The way to deal with this predicament is not, however, to move to majority rule at the EU level because, given the lack of a strong European *demos*, this could undermine the legitimacy of EU policy processes. Rather, Scharpf's recent work highlights two options. First, reforms at the *national* level should increase national problem-solving capacities. Second, the procedures for “enhanced co-operation” should be improved so that “high-tax countries might harmonize profit taxes at least among themselves” (Scharpf 2003a: 55).

The third position has recently been advanced by Andreas Follesdal and Simon Hix (Follesdal/Hix 2006). It largely shares Scharpf's characterization of EU policies as redistributive and challenges the characterization of these policies as centrist. In addition, Follesdal and Hix highlight that the saliency of political issues as well as voters' preferences on these issues are partly *endogenous* to the political process. They are not simply given but emerge from the public debate, which is a by-product of political competition. Hence what matters for democracy is the matching between policy outputs and the policy preferences that “have a chance of being created or modified within arenas of political contestation” (2006: 556). To improve *this* matching at the EU level, the authors recommend a number of incremental institutional and behavioral changes that would move the EU polity from a hyper-consensual system to a slightly more majoritarian form of government. The crucial reform proposal is to move toward a more open political contest for the presidency as well as the policy agenda of the Commission.

How does our analysis of tax competition contribute to this debate? In what follows we claim that the first position is refuted by the empirical evidence and argue that the latter two positions are more complementary than contradictory.

The refutation of the first position follows directly from the above analysis: the race toward the bottom in company tax rates constrains national taxation systems in important ways. The sphere of competitive tax rate setting in corporate taxation and the sphere of domestic redistribution – of which personal income taxation is a crucial element – cannot be separated as much as policymakers would wish and Majone and Moravcsik seem to assume. It is difficult to argue, therefore, that the output of the EU multi-level system is not redistributive or centrist.

While this conclusion is in line with Scharpf's analysis, the scope of his suggestions is limited. First, we have shown that *national* tax reforms can at best mitigate, but not transcend, the constraints of international tax competition. It seems somewhat exaggerated, therefore, to say that Scandinavia is “immunized against international tax competition by the dual income tax” (Scharpf 2006: 856). The dual income tax permits larger tax rate

gaps than other income tax models, but the economic connection between corporate and personal income tax rates remains. Second, the *diversity* of member states seems too large to allow for company tax harmonization among homogenous subgroups of member states. There is not only the high-tax/low-tax cleavage, but also the large/small and rich/poor cleavages – and perhaps others as well. Therefore, the group(s) that could pursue enhanced co-operation in company taxation would probably be too small to make this co-operation worthwhile. If tax harmonization within the EU can reduce the force of company tax competition, it must be harmonization among all or most EU member states. And since both tax harmonization and the lack thereof involve redistributive conflicts at the EU level, Foellesdal and Hix are correct to suggest greater political debate and contestation about the EU policy agenda.

But note that the positions of Scharpf and Foellesdal/Hix are more complementary than contradictory. Scharpf (2003b: 19) is opposed to changing the formal rules for deciding policy issues (too much) in favor of majority rule. Foellesdal and Hix (2006: 553–555), by contrast, partly focus on behavioral changes and on the rules for publicizing information and filling legislative and executive offices. This is important because it means that any proposals created by more “majoritarian” contestation and debate would still have to be passed in supermajoritarian decision-making institutions. This implies that any proposal for company tax harmonization that could emerge as an integral part of a larger policy program would have to be in the spirit of Scharpf’s analyses. That is, it would have to maximize national autonomy by increasing the *national* “problem-solving capabilities” of some member states without hurting those of other member states (too much).

Why, then, is it useful to move toward more political contestation and debate at the EU level? The crucial point is that disagreement in democratic politics not only concerns different positions on well-defined issues but the very *definition* of issues. How issues are defined and linked can be crucial for outcomes, but this implies that political conflicts extend straightforwardly to this definition and linkage. Hence even if the best that can be done at the EU level is to guard *national* “problem-solving capacities,” there will be inevitable and deep political conflict over what constitutes a policy problem – in taxation and elsewhere – and what constitutes a European solution that guards the policy autonomy of different member states roughly equally. Hence the issue is not political contestation *instead of* broadly agreeable solutions but political contestation *about* what might be considered to be widely agreeable solutions.

In fact, we regard the EU debate about company taxation as a good example of how the lack of political debate and contestation leads to one-sided issue definition. As argued above, the EU debate on company taxation – with the European Commission as a crucial agenda setter within this debate – has ignored the indirect effects of company tax competition, even though it is arguably these indirect effects that have had the greatest ramifications. The best example is the German example discussed above. Company tax competition crucially contributed to quite “neo-liberal” tax reforms on the part of a

Red-Green government, but the links between this result and EU (non-)decisions remain unclear. The issue of indirect effects has not yet been politicized at either the EU or the national level.

This certainly has consequences for the debate about European solutions. If the issue of indirect effects were politicized more, the search for solutions would have to focus more on strengthening the backstop function of the company tax. In what follows we want to provide a rough sketch of how a focus on this backstop function might actually lead to more agreeable proposals for company tax harmonization.

The standard proposal for company tax harmonization is a common *minimum* company tax rate at the EU level (de Mooij 2004). A minimum rate *restricts* tax competition but does not *erase* it; it puts a floor under tax rate choice without eliminating all room for competitive tax rate setting. But the choice of the appropriate level of the minimum rate is still characterized by a zero-sum conflict between countries that prefer higher and lower company tax rates, respectively.

The situation seems less grim if the European policy debate is refocused on the backstop function of the corporate tax (Ganghof 2006: 158). Let us recall from section 2 that this backstop function of the corporate tax depends mainly on the level at which *above-normal* profits are taxed. This creates the opportunity to choose *different* minimum tax rate levels for normal and above-normal profits in order to reduce the conflict involved in tax rate harmonization. The minimum tax rate on above-normal profits could be set at a higher level in order to give (high-tax) member states more freedom to choose their preferred level and progressivity of personal income taxation; the rate on normal profits, in contrast, could be set at a lower level – or even at zero – in order to give (low-tax) member states more freedom to tax marginal investments at low rates in order to increase investment incentives.⁸

Note that such a differentiation of the minimum tax rate would require harmonization of the company tax base – something that is currently being pursued by the European Commission (2001, 2003, 2005). A standard method of distinguishing normal and above-normal profits would have to be defined, drawing on the experiences of countries that have experimented with dual income taxes (e.g. Italy, Scandinavia) or direct expenditure taxes (e.g. Croatia). While this would certainly be an ambitious reform project, the differentiation of minimum tax rates could further mitigate, though not eliminate, political conflicts over the adequate levels of these rates. This might increase the opportunities for agreement.

8 In a sense, this proposal would allow countries to react to the imposition of a minimum tax rate by narrowing the tax base (Klemm 2004). However, this would happen in a *systematic* and *transparent* way.

By way of illustration, let us assume that a minimum tax rate for above-normal profits is set at, say, 25 percent. This would make it easier for countries like Germany or Denmark to maintain relatively high personal income tax rates in the future. For if all capital income were also taxed at the personal level at a uniform tax rate of 25 percent, the combined tax burden on above-normal capital income would be 44 percent ($0.25 + [1 - 0.25] * 0.25$). Hence if the top personal income tax rate on wages were 44 percent (as currently in Germany), incentives for tax arbitrage would virtually disappear. If the top rate on wages were much higher (as currently in Denmark), incentives for tax arbitrage would still be much lower than in a situation with a company tax rate of, say, 10 percent or less – a tax rate that might easily materialize if tax competition continues unabated. At the same time, a minimum tax rate of 25 percent on above-normal profits would allow countries like Slovakia or Latvia to choose much lower top personal income tax rates – even lower than 25 percent – and to exempt above-normal profits at the personal level so that the overall tax burden on these profits would not increase beyond 25 percent. In addition, these countries would be free to further reduce the effective company tax burden by making normal capital income tax-exempt altogether.

Of course, this is only a very rough sketch and it concerns only *one* option for strengthening the backstop function of company taxation. The point of the discussion has not been to develop and analyze this and other options in detail, but to exemplify the importance of political contestation and debate. For even if EU policy initiatives need to protect national autonomy and thus be widely agreeable, the debate about such initiatives involves deep conflicts over how to define policy problems and solutions. Moreover, our point is not that some form of tax harmonization is necessary to mitigate the democratic deficit in the EU. Rather, whatever choice is made – for unconstrained tax competition or for some form of harmonization – it needs to be contested and debated.

The ultimate justification of majoritarian procedures is the fundamental democratic value of political equality (Dahl 2006). Part of the democratic ideal is to give citizens equal resources for deciding and linking political issues, and majority rule is under a broad range of circumstances the most egalitarian decision-making rule. It is the value of equality that explains why we care not only about EU citizens' existing policy preferences but also about those that might have been created in a more majoritarian process (cf. Follesdal/Hix 2006). While it is true that the current circumstances in the EU do not allow a simple move to majority rule in deciding policy issues, it may indeed allow slightly more majoritarianism – and hence more equality – in defining and linking them.

5 Conclusions

We have shown that company tax competition in the EU has important *indirect* effects on *personal* income taxation. Because company taxes serve as a backstop for personal income taxes, company tax competition severely constrains the revenue-raising potential and/or the progressivity of personal income taxation and thus is a crucial component of national revenue and welfare state systems.

This finding has important implications for normative debates on the democratic deficit and on tax harmonization. It shows that EU (non-)decisions can be clearly redistributive, implying that the democratic deficit is real. As a result, greater political contestation about the EU's policy agenda seems desirable even if decision-making rules have to remain supermajoritarian in order to provide sufficient protection for national diversity and policy autonomy. The reason is that the definition and linkage of policy issues can greatly affect political debates and outcomes. In other words, the issue is not political contestation *instead of* widely agreeable solutions but political contestation *about* what might be regarded as being widely agreeable solutions.

With respect to tax competition, we have shown that the lack of political contestation and debate has led to one-sided issue definition. To exemplify the point we have suggested that greater politicization of the indirect effects of company tax competition would likely inspire a search for new and better ways to reconcile pro-harmonization and pro-competition interests. As one example we have suggested a proposal for differentiated minimum rates for normal and above-normal profits, which focuses on the backstop function of the company tax while giving member states more freedom to determine their average effective company tax burden unilaterally.

We do not want to suggest, however, that political contestation would or should lead to tax rate harmonization – and hence that democratization goes hand in hand with harmonization. To the contrary, more open political debate about the redistributive consequences might lead to a more explicit decision in favor of a different option. The point is simply that this decision should be the end of a more open political contest over the definition and linkage of policy issues.

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