Commentary

Editor's Notebook

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Taxing Income from Moveable Capital in the EEC after 1992

The move by the EEC to a single market, in addition to complicating the taxation of business income (see last month's Editor's Notebook, 2 *Tax Notes Int'l* 241) will complicate the taxation of other forms of income currently subject to direct taxation in many EEC countries. Taxation of wages will be more complicated, due to the increased pressure on the residence rules. But there is a general consensus on the source of wage income, and EEC countries that choose to do so can administer a wage tax through withholding. The taxation of capital gains and periodical income from moveable capital under a personal income tax will become nearly hopeless unless the EEC puts into place some multinational mechanisms for assisting member states in the administration of their personal income tax systems.

In theory, an EEC central government could adopt a uniform personal income tax applicable to all residents of member states and then disburse the revenues raised from that tax among those states by formula. A per capita formula might be used if the European Community were to decide that it wished to reduce the disparities in wealth among its member states. A formula tied to the relative net national incomes of the member states would be appropriate if the EEC should decide to preserve those disparities. Any formula would include some arbitrary elements. But in a rational political system, the selected formula would advance the EEC's consensus political goals, whatever those goals may be.

The Moribund Withholding Tax Proposal

Formulary apportionment of tax revenues from a unified EEC personal income tax is not on anyone's short-term or medium-term political agenda. The more realistic political objective is to shore up the domestic tax systems of member states. It was to achieve that limited goal that the European Commission made its troubled proposal for a uniform 15 percent withholding tax on interest income. That proposal, if adopted, would tend to limit the ability of low-tax countries within the EEC to use their tax policies to suck investment funds from the other EEC countries.

The EEC commissioner for tax policy, Christiane Scrivener, has recently offered her support for an EEC withholding tax on interest income of not more than 10 percent. (*See* 2 *Tax Notes Int'l* 321, 322 (April 1990).) I hear some low rumblings of support in the United States for a five percent withholding tax, and Japan already has in place a 20 percent withholding tax on interest. The development of some consensus among the major industrial powers on withholding tax policies is probably crucial to the adoption of withholding taxes in the EEC. The German withholding [*462] tax debacle seems to have convinced most European governments that unilateral action presents unacceptable risks of capital flight.

Adoption of the European Commission's 15 percent withholding tax proposal, or some lower-rate multinational substitute, would help member states solve their post-1992 enforcement problems. It would also contribute to a solution of the enforcement problems that they now have, which almost certainly will increase if the plan to remove national controls over capital flows on July 1 of this year is carried out.

A flat withholding tax on gross income, however, is very far from an ideal solution to the problems of enforcing a tax on capital income. A 15 percent withholding rate is too high for many taxpayers, particularly financial intermediaries and taxpayers subject to low tax rates (low-income individuals, tax-exempt pension funds, charities, and the like). It is too low for most middle- and upper-income individuals earning interest income on their investments. A good technical solution would be to couple a five percent withholding rate with an effective information-reporting system. Unfortunately, effective information reporting is even less acceptable to some EEC member states (e.g., Luxembourg and the United Kingdom) than withholding.

The EEC 15 percent withholding tax proposal did not provide for a uniform tax on all gross income from moveable capital. Because of political constraints, it had more holes than a wedge of Swiss cheese. An effective withholding tax would need to include interest on Eurobonds and other bearer instruments, and it would need to include within its scope other forms of capital income, such as rents and royalties. Otherwise, the tax-savvy investment community would use back-to-back transactions and other tax-planning techniques to avoid its bite. The scheme could work quite well if all taxpayers were required to obtain identity numbers and all withholding agents were required to file information returns that included those numbers with the appropriate tax authorities. The European Commission did not even dare to dream that such a comprehensive scheme would be acceptable to the EEC member states.

Requirements for Harmonizing Personal Income Taxes

The remaining way to cope with the enforcement problems awaiting in 1992 is to harmonize personal income taxes within the European Community. Full harmonization of taxes is neither necessary nor even desirable, given the differences in social goals and economic status among members of the European Community. Differences in revenue needs, for example, would justify differences in tax rates. What is needed is enough harmonization to eliminate gross differences in the tax treatment of income within the European Community.

I list below what I consider to be the three requirements for the harmonization of personal income taxes within a common market. By listing these requirements, I am just about saying that harmonization of those taxes within the EEC will not happen as long as each member state can veto any harmonization plan. Several member states of the EEC have traditionally followed beggar-thy-neighbor tax policies and undoubtedly are planning to continue in the same manner after 1992.

The first requirement is that all of the member states agree to impose and effectively enforce a personal income tax. The tax should be applicable to all income derived within the European Community by residents of member states, and uniform rules should be developed for taxing income derived outside the common market. There can be no toleration of member states acting as tax havens with respect to income derived by residents of member states within the European Community.

Second, the member states must agree on uniform rules for determining who is subject to tax within each member state. The inclination of EEC members is to define tax jurisdiction over individuals by reference to their residence. I believe, however, that residency rules will become increasingly difficult to administer after 1992. My solution would be to use citizenship as the primary test for determining national claims to income within the European Community. I will attempt to defend this position in a later column.

Third, the member states must agree to impose approximately equal effective tax rates on their taxpayers. They need not agree to the use of identical tax rates. The problems of resource displacement within the European Community will arise only if effective rate differentials among member states are substantial. All member states must agree, however, to keep their rates within certain bounds. For example, a spread of 10 percentage points might be allowed for the top and the bottom rates. With relatively uniform rates throughout the European Community, individuals will have only modest incentives to shift income from one member state to another.

To achieve relatively uniform effective tax rates, the members of the European Community will have to harmonize their definitions of taxable income, to at [*463] least some degree. The consensus of the academic community is for a broad tax base. The member states are not likely to have much difficulty agreeing on a broad tax base as their goal, although they may face insuperable political difficulties in enacting the requisite domestic legislation.

Harmonizing Family Taxation Rules

Member states also must harmonize their family taxation rules if they are to achieve relatively uniform effective tax rates. Indeed, differences in family taxation rules may be the single most important source of differences in effective tax rates among the EEC countries that administer a personal income tax.

There is no consensus among academics on the appropriate design of family taxation rules. I have long contended that marital income-splitting should be made the cornerstone of an ideal system of family taxation. The basic argument is that the tax liability of an individual should be a function of that person's material well-being, measured after voluntary family sharing has taken place. My impression is that marital income-splitting has gained support within the academic community during the 1980s and that it has slowly been shedding its image — its false image — of being unfair to working women.

Although some recent reforms in EEC member states might appear to be a sharp move away from marital income-splitting, the appearance is deceiving. Consider, for example, the recent changes in family taxation just now going into effect in the United Kingdom. Under prior U.K. law, husbands and wives were required to file jointly and pay tax on their aggregate income at the rates applicable to single persons. Significant (but badly designed) family allowances were provided, however, to offset, in whole or in part, the effects of aggregation. The new system provides for separate filing for working wives. Although the resulting system has been described as a separate filing system, it is a hybrid of joint and separate filing elements that is probably closer than prior law, in its distributional results, to full marital income-splitting.

Marital income-splitting is already the rule in several major European countries, including France. It would provide an elegant solution to the constitutional problems that joint filing without splitting has created in Spain. (For a discussion of those problems and the ad hoc attempt by the Spanish government to arrive at a solution, see 2 *Tax Notes Int'l* 119 (February 1990).) Given the constitutional constraints in several European counties, including Germany, on the choice of family taxation systems, it is the only principled system that could be adopted uniformly throughout the EEC.