IN-DEPTH ANALYSIS

Requested by the FISC subcommittee

European Parliament

Harmful Practices and Competition in the Area of Personal Income and Wealth Taxation

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
Authors: David GSTREIN, Elena HEROLD, and Florian NEUMEIER
PE 703.343- January 2022

EN

Harmful Practices and Competition in the Area of Personal Income and Wealth Taxation

Abstract

Economic globalisation and integration led to an increase in the mobility of taxpayers and aggravated tax competition in the area of personal income and wealth taxation. This study sheds light on the two main instruments used to compete for mobile taxpayers – (top) tax rates and preferential tax arrangements. In addition, this study reviews the evidence on tax-induced mobility.

This document was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the Economic and Monetary Affairs Subcommittee on tax matters (FISC).

This document was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the Economic and Monetary Affairs Subcommittee on tax matters (FISC).

AUTHORS
David GSTREIN, ifo Institute for Economic Research at the University of Munich
Elena HEROLD, ifo Institute for Economic Research at the University of Munich
Florian NEUMEIER, ifo Institute for Economic Research at the University of Munich

ADMINISTRATOR RESPONSIBLE
Dirk VERBEKEN

EDITORIAL ASSISTANT
Irene VERNACOTOLA

LINGUISTIC VERSIONS
Original: EN

ABOUT THE EDITOR
Policy departments provide in-house and external expertise to support European Parliament committees and other parliamentary bodies in shaping legislation and exercising democratic scrutiny over EU internal policies.

To contact the Policy Department or to subscribe for email alert updates, please write to:
Policy Department for Economic, Scientific and Quality of Life Policies
European Parliament
L-2929 - Luxembourg
Email: Poldep-Economy-Science@ep.europa.eu

Manuscript completed: January 2022
Date of publication: January 2022

This document is available on the internet at:
http://www.europarl.europa.eu/supporting-analyses

For citation purposes, the publication should be referenced as: Gstrein, D. et Al., Harmful Practices and Competition in the Area of Personal Income and Wealth Taxation, Publication for the Subcommittee on tax matters (FISC), Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg, 2022.

CONTENTS

LIST OF ABBREVIATIONS

EU	European Union
GDP	Gross Domestic Product
HNWI	High Net Worth Individuals
NHR	Non-Habitual Residents

LIST OF FIGURES

EXECUTIVE SUMMARY

Background

Economic globalisation and integration have substantially decreased mobility costs. As a result, taxpayers are becoming more mobile and traditional tax bases more sensitive to taxation. This development puts governments worldwide under pressure to reduce personal income and wealth-related taxes.

Aim

This study pursues two main goals. The first goal is to describe the evolution of personal income and wealth tax rates in the EU as well as preferential tax arrangements adopted by EU member states targeted to foreigners. The second goal is to review the existing empirical evidence on the relevance of personal income and wealth-related taxes on the location decision of income and wealth-rich individuals.

Key Findings

Governments use two instruments to compete for taxpayers and mobile tax bases in the area of personal income and wealth taxation: (top) tax rates and preferential tax arrangements targeted to income and wealth-rich foreigners. Top personal income tax rates have been steadily declining over the past 25 years and the number of special tax arrangements for foreigners has been increasing in the EU. Existing empirical evidence suggests that there is considerable scope for competition, as tax-induced mobility is high among income and wealth-rich taxpayers. Countries reducing their top tax rates and adopting preferential tax arrangements have successfully increased the share of income and wealth-rich immigrants.

1. INTRODUCTION

The process of global economic integration has led to an increase in the mobility of 'traditional' tax bases. This development aggravates international tax competition and has made the collection of tax revenues substantially more difficult. Potentially harmful effects include an erosion of tax bases, allocative inefficiencies, and a distribution of the tax burden that is considered unfair as higher taxes may have to be imposed on immobile bases to secure public funds.

Traditionally, when it comes to harmful tax practices and/or harmful tax competition, the focus has been on corporate income taxation. However, in general, harmful tax practices may become a concern whenever the tax base is mobile. This also applies to personal income taxes and certain wealth-related taxes. Especially among high-skilled top-income earners, low levels of taxation can lead to migration and an international reallocation of personal wealth. Hence, lowering effective personal income and wealth-related taxes is an additional tool to attract tax bases from other countries. In this case, tax competition may cause distortions in labour, savings, and investment decisions, and restricts governments' scope for redistribution.

This report aims at identifying harmful personal income and wealth-related tax practices among EU member states. By reviewing the literature and evidence on the elasticities of tax bases, we also shed light on the potential impact of such tax practices on tax revenue and evaluate the mobility of wealth-related assets. Our main findings can be summarised as follows. First, EU governments rely on two instruments to compete for mobile taxpayers: on the one hand, (top) personal income and wealth tax rates, which have substantially declined since the 1990s; and, on the other hand, preferential tax arrangements targeted to foreigners, which are becoming increasingly popular. Second, existing empirical evidence suggest that especially income and wealth-rich individuals are highly sensitive to tax incentives. Tax rate differentials as well as preferential tax arrangements in the area of personal income and wealth taxation can trigger notable migration responses. In combination, these findings suggest that there is a large potential for tax competition in the area of personal income and wealth taxation. However, most recent estimates indicate that currently, the fiscal costs associated with tax competition in the EU are relatively small. It should be noted, though, that estimates of the fiscal costs do not take larger scale economic costs into account that may arise, for instance, from a shortage of skilled labour resulting from the emigration of professionals.

The remainder of this report is structured as follows. The next chapter provides a definition of harmful tax practices. In chapter 3, we take a look at the evolution of tax rates in the EU to provide some suggestive evidence for an increase in international tax competition in the area of personal income and wealth taxes. In chapter 4, we describe the role of special tax arrangements adopted by EU member states for international tax competition. In chapter 5, we review the empirical economics literature on tax-induced mobility. Chapter 6 concludes.

2. CHARACTERISATION OF HARMFUL TAX PRACTICES

One consequence of global economic integration is a substantial increase in the mobility of taxpayers and tax bases. This, in turn, is threatening governments' efforts to raise tax revenues and secure public funds. Many countries have responded to the increasing mobility by lowering their tax rates or adopting preferential tax regimes for highly mobile tax bases. The consequence has been an increase in tax competition and a downward spiral in tax rates. Adverse effects include an erosion of tax bases, allocative inefficiencies, and an unfair distribution of tax burdens at the expense of immobile tax bases. Moreover, the pressure to lower tax rates constrains the adoption of progressive tax schemes and governments' capacities for redistribution.

To counteract these threats, the EU and OECD both released reports on harmful tax competition in 1997 and 1998, respectively. The EU Code of Conduct and the OECD report on harmful tax competition both include criteria to assess whether a tax regime must be considered harmful. The main criteria are:

- No effective tax rate or significantly lower than the statutory level of taxation in the country;
- Tax incentives for activities that are wholly or partly isolated from the domestic economy and therefore have no impact on the national tax base (ring-fencing);
- Tax benefits that are reserved for non-residents;
- Tax advantages for operations and arrangements which do not involve any real economic activities;
- Lack of transparency of the regime;
- No active exchange of information with other jurisdictions; and
- Other criteria: artificial definition of the tax base; failure to adhere to international transfer pricing principles; foreign source income exempt from resident country taxation; negotiable tax rate or base; existence of secrecy provision; access to an extensive network of tax treaties.

As stated by the OECD guidelines, a zero or lower effective rate is a necessary but not sufficient condition for a regime to be classified as harmful. Whenever a low rate is coupled with other factors that constitute harmful tax competition, regimes are classified as either tax havens (generally impose no or only nominal taxation on income, and thus collect little revenue from the income tax) or as preferential tax regimes (provide favourable tax treatment in the context of a general income tax system). Collectively, the report characterizes tax havens and harmful preferential tax regimes as harmful tax practices.

Both the OECD guidelines and the EU Code of Conduct focus on corporate income taxation only. However, in general, harmful tax practices become a concern whenever the tax base is mobile. In recent years, there has been an increase in international tax competition in the area of personal income and wealth taxation. Symptomatic for this is the growing popularity of preferential tax arrangements for foreigners, most of which aim at attracting income and wealth-rich immigrants. Tax-induced mobility of skilled labour and capital is a concern as it may cause distortions in labour, savings, and investment decisions. In general, the criteria established by the OECD and EU to identify harmful corporate income tax practices also seem suitable for the identification of harmful tax practices in the area of personal income and wealth taxation.[1] As we will see in chapter 4, many preferential tax arrangements adopted by EU member states meet the criteria of harmful tax practices.

[1] Note that the European Parliament recommends an extension of the Code of Conduct.

3. THE EVOLUTION OF PERSONAL INCOME AND WEALTH TAX RATES IN THE EU

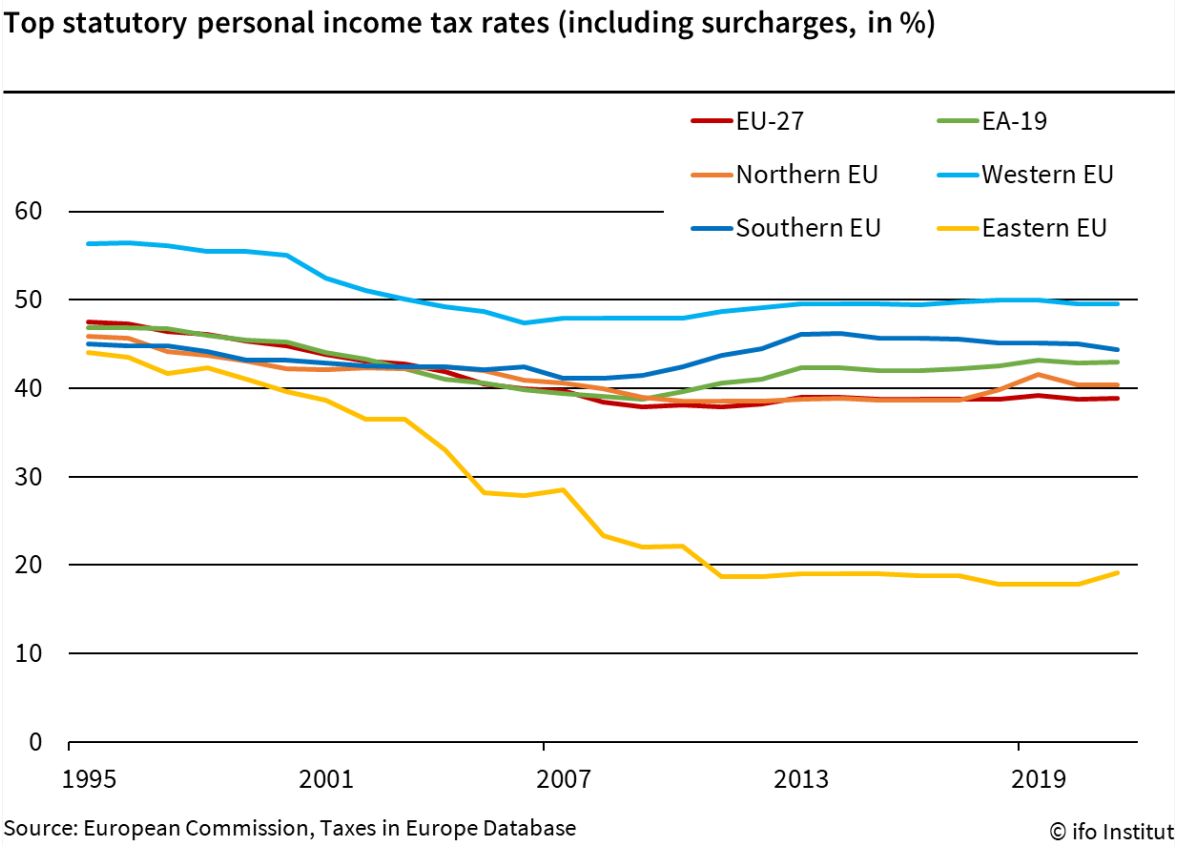
The decline of statutory corporate income tax rates over the past decades is often interpreted as evidence for growing corporate tax competition. However, in recent years, countries increasingly relied on other measures to reduce the corporate tax burden and attract firms. These include, inter alia, tax exemptions and preferential tax regimes for certain types of corporate income.

In the area of personal income and wealth taxation, there is a similar pattern. Statutory tax rates are not the only instruments governments use to attract income and wealth-rich individuals. They also increasingly rely on preferential tax arrangements for foreigners, leading to a wedge between the tax burden for domestic citizens and foreigners. In this chapter, we investigate the evolution of income and wealth tax rates and revenues since the 1990s. We focus on top tax rates since taxpayers in the top tax bracket are likely the most responsive to tax rate differentials. Similarly, governments are arguably most interested in attracting high-income earners. A steady decline in tax rates and revenues might give a first indication of downward pressure on income and wealth taxes caused by international tax competition. In chapter 4, we take a look at preferential tax arrangements adopted by EU member states in order to attract foreigners.

3.1. Personal Income Taxes

Figure 1 displays the evolution of average top statutory personal income tax rates in the EU from 1995 to 2021. Within the EU-27, top income tax rates have declined steadily over the period from 1995 until the global financial crisis in 2007/2008. The average top tax rate was 47.5 percent in 1995 and 38.9 percent in 2008. Since then, though, the average top tax rate has remained almost constant. However, closer inspection reveals that both trends and levels are considerably heterogeneous across EU member states. Over the past 25 years, Western European countries constantly had the highest average top income tax rates. The average top tax rate was about 56 percent in 1995 and about 50 percent in 2019, which leaves them 11 percentage points above the EU average. In contrast, Eastern European countries always had the lowest tax rates. They also exhibit the steepest decline over the past 25 years. The average top income tax rate was about 44 percent in 1995 and declined by almost 25 percentage points since then, standing now at 19.2 percent. For example, Bulgaria has reduced the top tax rate from 50 percent in 1995 to 10 percent. Arguably, these large reductions in top personal income tax rates provide a first indication for increasing competition in the area of personal income taxation.

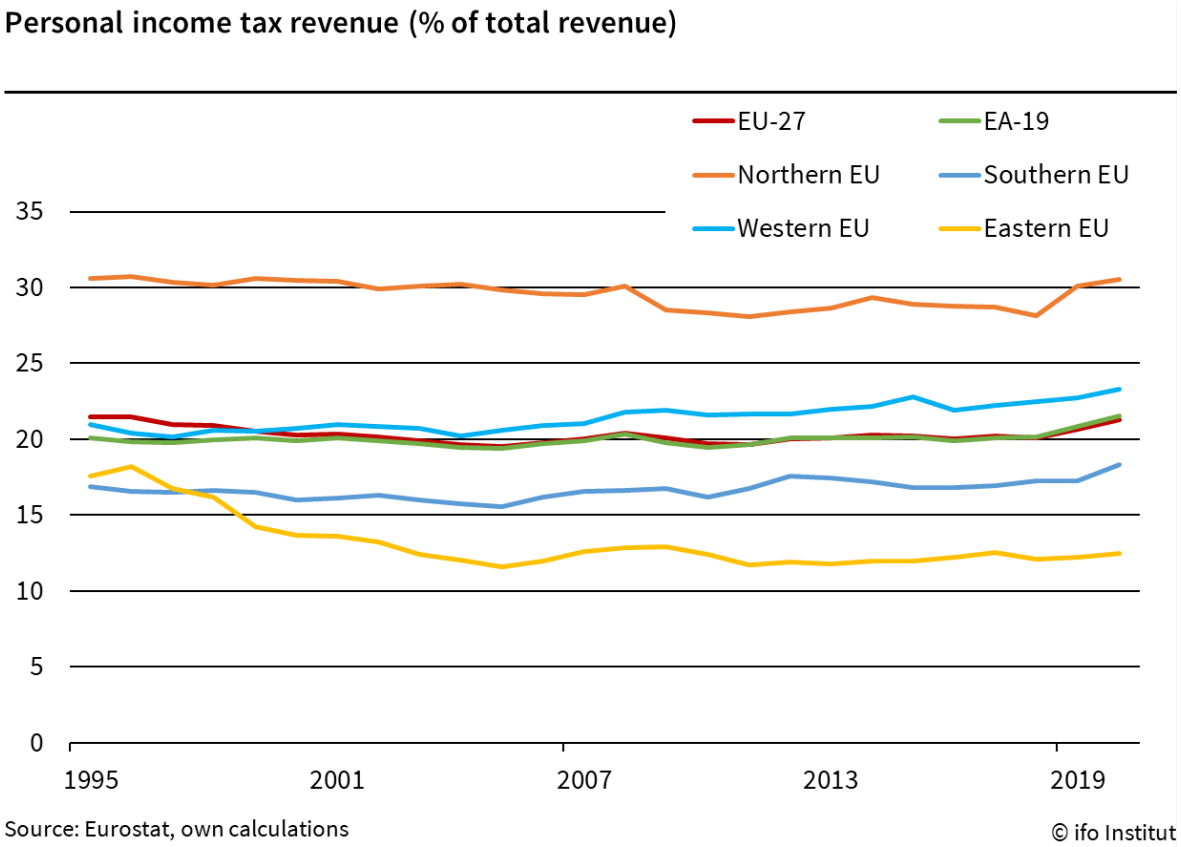
Figure 1: Evolution of top personal income tax rates



Note: Northern EU: Denmark, Estonia, Finland, Latvia, Lithuania, Sweden, Ireland. Western EU: Austria, Belgium, France, Germany, Luxemburg, Netherlands. Southern EU: Croatia, Cyprus, Greece, Italy, Malta, Portugal, Slovenia, Spain. Eastern EU: Bulgaria, Czechia, Hungary, Poland, Romania, Slovakia.

Figure 2 displays the evolution of personal income tax revenue in relation to GDP. Despite the reductions in top tax rates, personal income tax revenues remained remarkably stable. The only exception is Eastern Europe, where the importance of the personal income tax decreased substantially over time. In general, the personal income tax is still a major source of tax revenue, but the tax burden has potentially shifted away from the top of the income distribution.

Figure 2: Evolution of personal income tax revenues

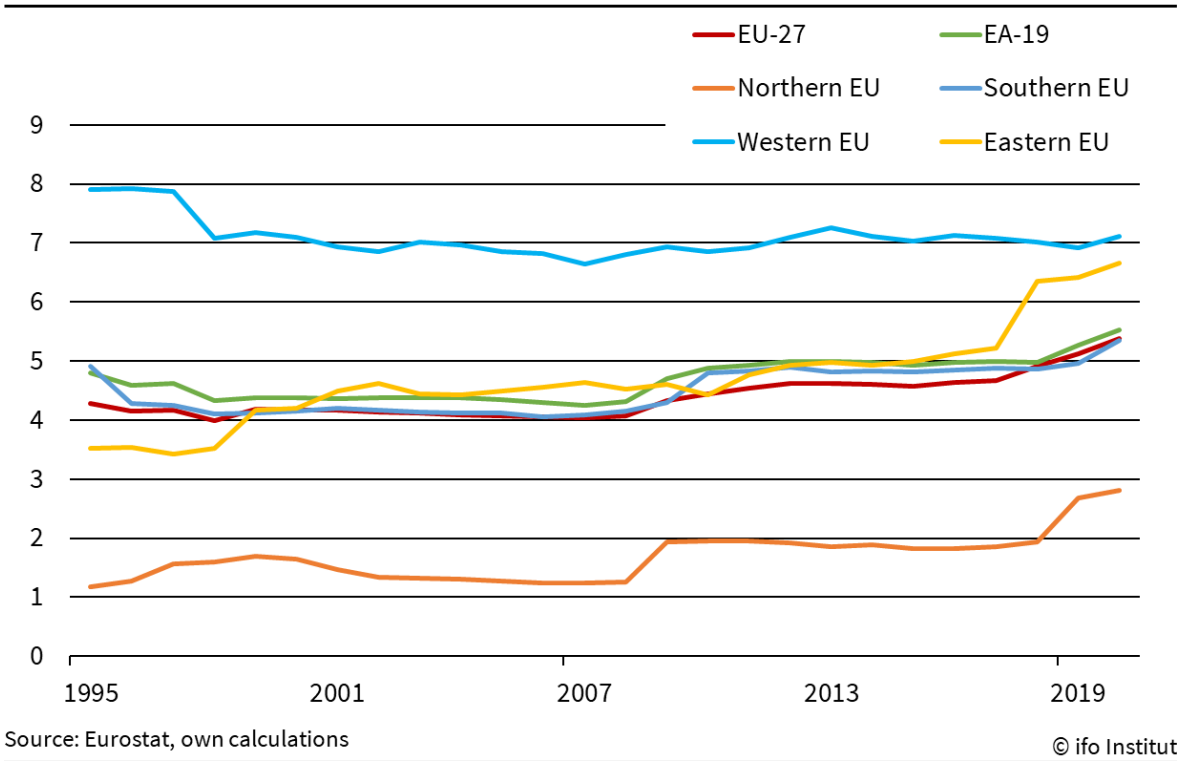


Note: Northern EU: Denmark, Estonia, Finland, Latvia, Lithuania, Sweden, Ireland. Western EU: Austria, Belgium, France, Germany, Luxemburg, Netherlands. Southern EU: Croatia, Cyprus, Greece, Italy, Malta, Portugal, Slovenia, Spain. Eastern EU: Bulgaria, Czechia, Hungary, Poland, Romania, Slovakia.

Figure 3 shows the development of employee social security payments in relation to GDP. The importance of social security contributions has generally increased in the EU since 1995. Especially in Eastern EU countries, the decline in income tax revenues has been mitigated by increased social security contributions. In most tax systems, social security contributions are proportional to wage income and are capped at some income level. Therefore, a lowering of top income tax rates and an increase in social security contributions generally reduces the progressivity of the tax system. This is consistent with a shift in the tax burden from the more mobile high-income earners to less mobile middle and low-income earners. The descriptive results are no definitive evidence of tax competition in personal income taxes, but they clearly provide suggestive evidence.

Figure 3: Evolution of employee social security payments

Social security contributions of households (% of GDP)



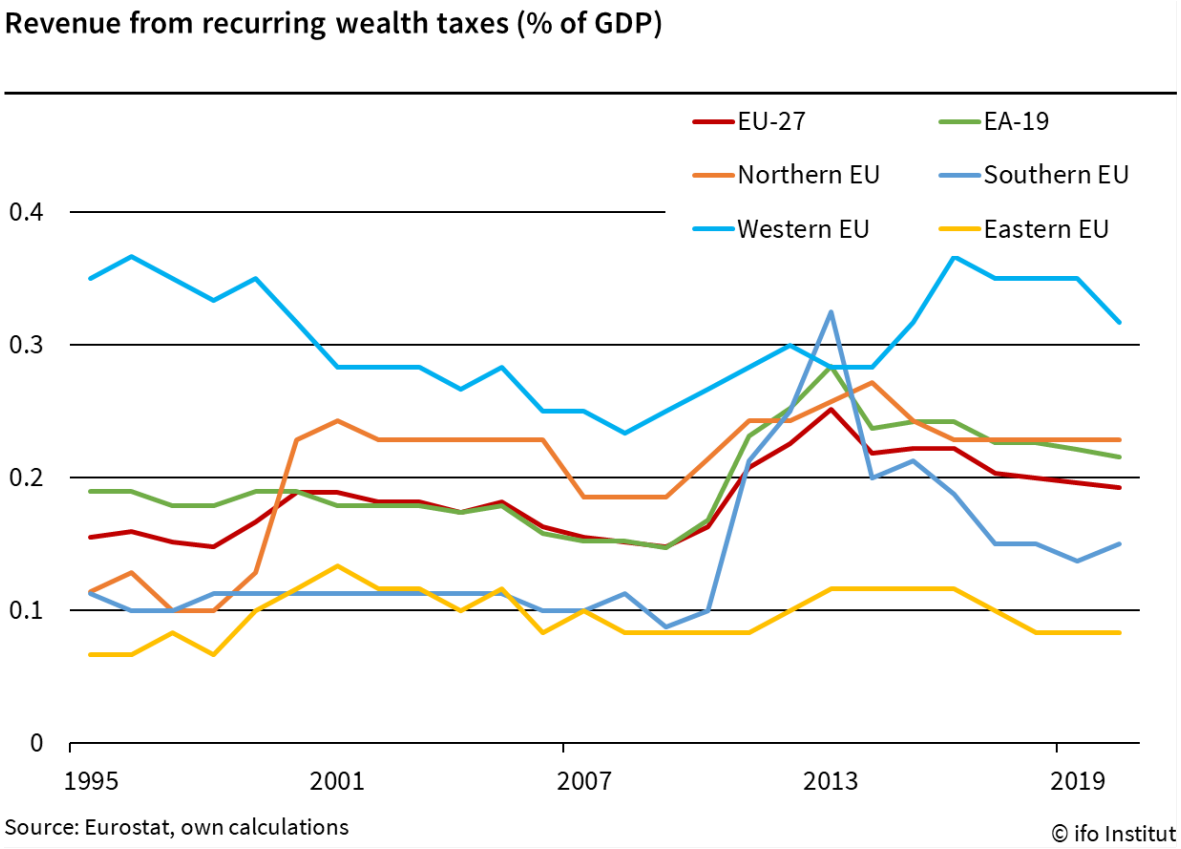
Note: Northern EU: Denmark, Estonia, Finland, Latvia, Lithuania, Sweden, Ireland. Western EU: Austria, Belgium, France, Germany, Luxemburg, Netherlands. Southern EU: Croatia, Cyprus, Greece, Italy, Malta, Portugal, Slovenia, Spain. Eastern EU: Bulgaria, Czechia, Hungary, Poland, Romania, Slovakia.

3.2. Recurrent Wealth Taxes

Next, we focus on recurrent wealth taxes. Data on tax rates is difficult to interpret in this case because tax bases differ across countries. In some countries, wealth taxes only apply to real estate; in others, they only affect corporations. And even if the definition of the tax base is similar, valuation procedures might differ. Hence, tax rates are not very informative about the economic significance of a wealth-related tax. Due to that, we use the ratio of wealth tax revenue to GDP as a proxy for the relevance of wealth taxation. A decline in this measure could point towards downward pressure on wealth taxation potentially caused by tax competition.

Figure 4 shows the evolution of tax revenues from wealth taxes. In general, wealth taxes only make up a relatively small share of total revenue. The importance of wealth taxes has remained quite constant over the period we study. In 1995, no country collected more than one percent of GDP from wealth taxes and only four countries collected more than 0.5 percent (Greece, France, Luxemburg and Finland). In 2020, there was only one country with a share greater than one percent (Luxemburg) and four countries with a share greater than 0.5 percent (Denmark, Greece, France and Finland). The share of wealth taxes to GDP decreased for six countries, increased for eight countries, and remained the same for thirteen countries. During the whole period there have been many countries with very low or no wealth taxes and only very few countries with substantial wealth taxes. Hence, it seems that tax competition in wealth taxes has not increased over the last 25 years.

Figure 4: Evolution of revenues from recurring wealth taxes

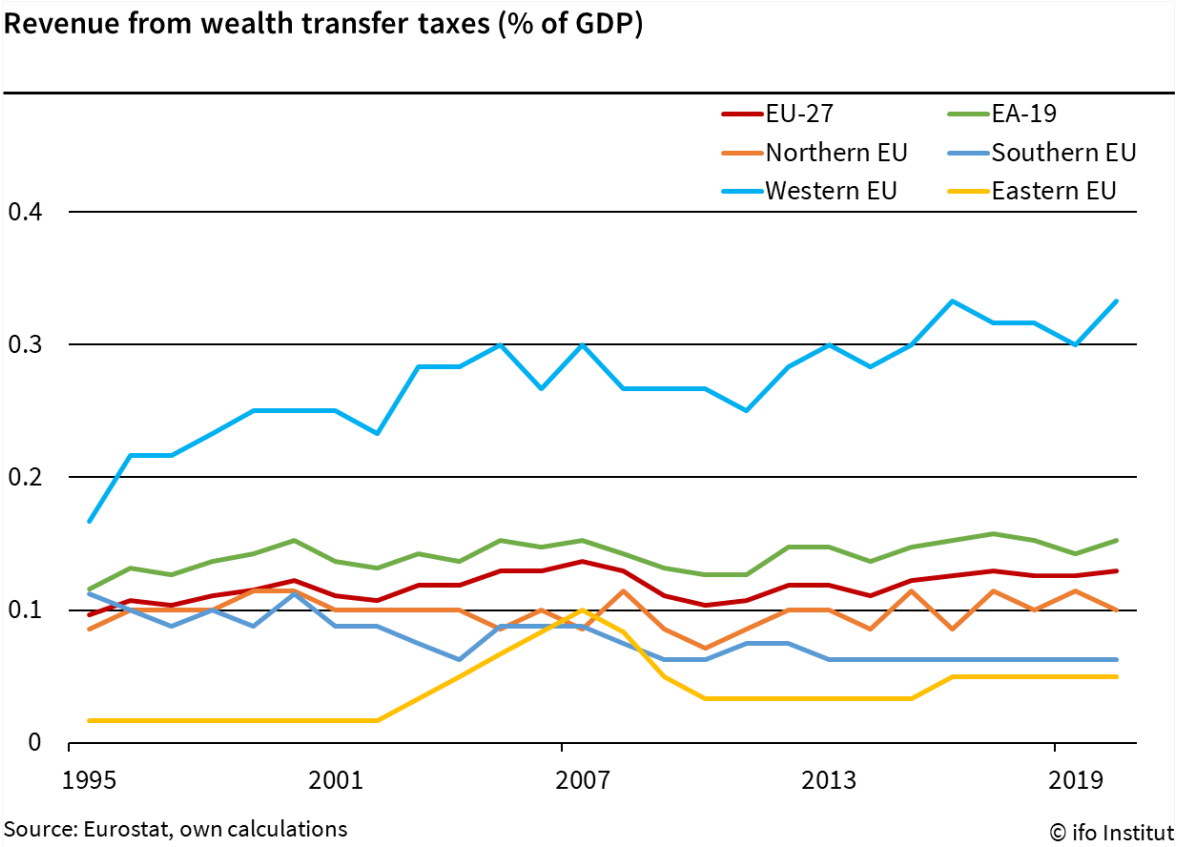


Note: Northern EU: Denmark, Estonia, Finland, Latvia, Lithuania, Sweden, Ireland. Western EU: Austria, Belgium, France, Germany, Luxemburg, Netherlands. Southern EU: Croatia, Cyprus, Greece, Italy, Malta, Portugal, Slovenia, Spain. Eastern EU: Bulgaria, Czechia, Hungary, Poland, Romania, Slovakia.

3.3. Wealth Transfer Taxes

Similar to recurrent wealth taxes, wealth transfer taxes vary considerably with regard to the definition and valuation of the tax base. Therefore, we focus again on the tax revenues collected from those taxes instead of tax rates. Figure 5 shows the evolution of the ratio of tax revenue from wealth transfer taxes to GDP. Like recurrent wealth taxes, wealth transfer taxes are only of minor importance for overall government revenues. The revenues have remained relatively constant at about 0.1 percent of GDP for the EU. The revenues are substantially higher and have increased in the Western European countries. This does not point to an increase in tax competition. Wealth transfer taxes already were of minor importance for revenue in 1995 and this has not changed. In 1995, no country collected more than 0.5 percent of GDP through wealth transfer taxes. In 2020, wealth transfer tax revenues accounted for more than 0.5 percent of GDP only in two countries (Belgium and France). The ratio of wealth transfer taxes to GDP decreased for five countries, increased for eight countries, and remained the same for fourteen countries. These descriptive statistics do not provide evidence that tax competition is considerably inhibiting revenue collection of wealth transfer taxes.

Figure 5: Evolution of revenues from wealth transfer taxes



Note: Northern EU: Denmark, Estonia, Finland, Latvia, Lithuania, Sweden, Ireland. Western EU: Austria, Belgium, France, Germany, Luxemburg, Netherlands. Southern EU: Croatia, Cyprus, Greece, Italy, Malta, Portugal, Slovenia, Spain. Eastern EU: Bulgaria, Czechia, Hungary, Poland, Romania, Slovakia.

4. PREFERENTIAL TAX ARRANGEMENTS IN THE EU

This chapter describes preferential tax arrangements for foreigners adopted by EU member states in the area of personal income and wealth-related taxation.

4.1 Personal Income Taxation

Most countries apply residence-based taxation on worldwide income.[2] Conditions to become a tax resident differ but commonly require a minimum period of time spent in the country (183 days being the standard). To avoid high personal income taxation, individuals either must move to or acquire a new tax residency in another jurisdiction.

The most straightforward method to attract foreigners is to reduce statutory tax rates. As shown in chapter 3, there are significant differences among EU countries ranging from high income tax rates in Denmark to low rates of around 10-25 percent in Eastern EU countries. However, these low rates apply to both domestic citizens and foreigners and are potentially a compensation for an otherwise relatively less attractive economic environment. Unless low tax rates trigger a race to the bottom in the EU (see chapter 3), one can therefore argue that these tax regimes fall under non-harmful tax competition.

An instrument in international tax competition that has gained importance in recent years is offering preferential tax arrangements to immigrants while taxing the domestic population at a regular rate. Such preferential tax arrangements can be broadly divided into three categories:

- Preferential treatment of previously non-domestic workers or taxpayers: These regimes offer a lower effective tax rate on domestic income to a specific group of newly arrived workers or taxpayers who fulfil certain requirements. See, for instance, Denmark;
- Exemptions on worldwide income: These regimes offer tax exemptions for certain foreign-sourced income, enabling double non-taxation. See, for instance, Italy; and
- Pension schemes: Foreign retirees benefit from lower taxation on foreign-source pension income. See, for instance, Portugal.

Trautvetter and Winkler (2019) as well as Flamant et al. (2021) both provide an overview of the prevalence of these measures in the EU. Flamant et al. (2021) also assess the harmfulness of the regimes.

4.1.1. Classification of preferential tax arrangements

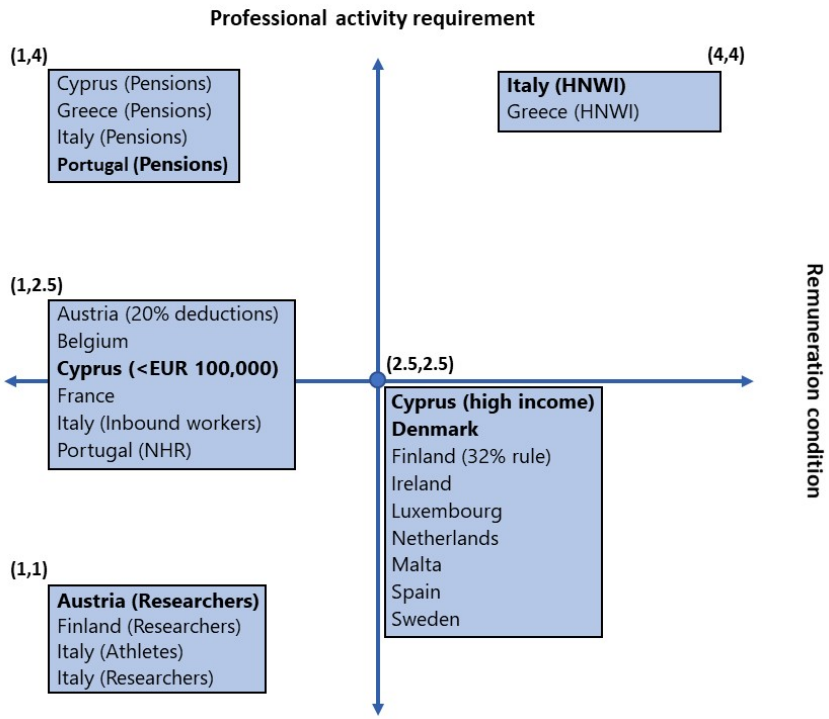
Figure 6 classifies the regimes listed in Flamant et al. (2021) based on two characteristics: remuneration condition and professional activity requirement.[3] The x-axis indicates the scope in terms of remuneration levels; the further one moves to the right, the higher is the income or wealth threshold for eligibility. On the left, remuneration conditions are low, and countries located here basically offer preferential tax treatment to all immigrants irrespective of their income or wealth level. On the right side, in contrast, are regimes targeted toward income and wealth-rich individuals. The y-axis indicates the scope of the arrangements in terms of professional activity requirements; the further one moves

[2] Some countries also tax certain income irrespective of if the individual is a tax resident. Bilateral Double Tax Agreements (DTA) are implemented to manage taxation conflicts in this context.

[3] Flamant et al. (2021) define remuneration as the explicit and implicit income thresholds needed by any applicant to benefit from the regime. They apply a score of 1 for regimes where no remuneration conditions apply; a score of 2.5 for thresholds below EUR 200,000 taxable income per year; and a score of 4 for higher conditions. Professional activity requirement describes the spectrum of allowed professions. Here, a score of 1 indicates that only a specific professional segment is targeted; 2.5 that regimes target all labour income earners, and 4 that the regime does not require any real economic activity (including pensioners).

up the y-axis, the laxer is the professional requirement and the more foreigners are eligible. In contrast, countries whose regimes are targeted to specific professions are located at the bottom of Figure 6.

Figure 6: Classification of Preferential Tax Arrangements



Source: Own illustration based on Flamant et al. (2021).

Based on this classification, it is fair to say that regimes located in the upper-right panel of Figure 6 mainly aim at increasing a countries tax base. They do not have an economic rationale for the adoption of a preferential tax arrangement. On the other hand, regimes in the lower-left panel mainly aim at combating a shortage of skilled labour in certain industries. Arguably, this indicates that the corresponding tax arrangements mainly have an economic rationale. Attracting skilled labour is key for promoting long-run economic activity. Examples of regimes that can be placed in category 2 (upper-right area) are those adopted by Italy and Greece. Both target high-income earners irrespective of their profession or employment status and exempt foreign-sourced income. The upper-left area covers regimes targeted toward retirees (category 3). The bottom-left only contains regimes that target specific professions (category 1). In the following, one regime from each group will be described in depth.

4.1.2. Italy's foreign-sourced income lump-sum tax for HNWI

In 2017, Italy introduced a lump-sum flat tax of EUR 100,000 on foreign-sourced income. This tax regime is available to all returning Italians or foreigners that become residents after being Italian non-residents for at least 9 of the last 10 preceding years. Tax residency and access to the regime is acquired by living in Italy for more 183 days per year.

Opting for the regime allows individuals to tax their worldwide income acquired outside of Italy with a flat tax of EUR 100,000 instead of the ordinary progressive tax rates, while Italian sourced income is subject to the regular Italian tax rules.

The regime lasts for up to 15 years and includes an extension to family members (spouses, children, parents, and siblings) that allows a yearly lump sum of EUR 25,000 if they also fulfil the requirements.

On top of that, the tax regime also exempts individuals from donation, gifts, and inheritance taxes on assets and real estate owned abroad, taxes on real estate properties owned abroad, and from wealth taxes on foreign financial investments.[4]

The regime is an example of a category 2 preferential treatment and can be considered harmful for two reasons. First, it does not have a specific income threshold but is targeted at high net worth individuals (HNWI) as a lump-sum tax of EUR 100,000 requires a certain amount of foreign income to be profitable. Second, although the regime was justified as to promote foreign investment and attract money spent on consumption, it also does not require any real economic activity.

Italy's tax system contains four additional preferential tax regimes. (i) A four-year 90 percent rebate on earned income on research and teaching activities to non-residents with a university degree who lived abroad for at least two years, (ii) a 5-year 50 percent rebate on earned income for athletes who stay for two years, working at least 183 days each year, and had been non-residents for 2 years prior, (iii) a 15-year 70 percent rebate on taxable income for workers that stay for two years, with activity mainly carried out in Italy and no fiscal residence in Italy for the two years prior. These regimes fall under category 1. (iv) Lastly, a six-year 7 percent flat-tax on foreign pensions and foreign-sourced income for foreign retirees (non-residents for the past five years with the last residence being an EU-member state) who are reallocating to a southern village of fewer than 20,000 inhabitants. The HNWI lump-sum regime cannot be combined with any of these regimes.

4.1.3. Portugal's NHR pension scheme

Since 2009, Portugal has offered a five-year preferential tax treatment on foreign retirement payments to non-habitual residents (NHR). At first, the scheme allowed a total exemption, but a reform in April 2020 changed the scheme to a ten percent flat tax on foreign-sourced retirement payments. Moreover, a tax credit is available for taxes paid abroad, limited to the taxes due in Portugal for such income.

The regime applies to all individuals who have been granted NHR status in Portugal. To be applicable, they must be non-tax-residents for at least five years prior to the qualification and live in Portugal for a minimum of 183 days per year or own residential property. Hence, buying or renting a house is enough to become a resident and obtain preferential tax treatment. This special feature makes the scheme more extensive than other European tax regimes. Due to the easy accessibility and former zero taxed-income, some EU countries raised their concerns, and Finland terminated its DTA with Portugal at the beginning of 2019 to retain the rights to tax Finnish pension payments.

The pension scheme is an example for category 3. However, it is part of the NHR regime that offers further preferential treatments classified under category 2. The NHR regime grants tax exemptions on most foreign-sourced income[5] for ten years, taxes Portuguese sourced income at only 20 percent (instead of the regular tax rates up to 48 percent) for professions with a high added value, provides an exemption of tax on gifts or inheritance to family members, and excludes individuals from paying wealth taxes.

[4] Fort the first five years, the regime does not apply to capital gains on qualified shareholding.

[5] Employment and self-employed income, royalties and income from financial assets, real estate income, and capital gains.

4.1.4. Denmark's *forskerordningen* tax

During the 1990s, many European countries established preferential tax regimes targeted at specific income levels or professions. Since June 1991, Denmark offers a seven-year (previously three and five-year) reduced flat tax rate of 32.84 percent on domestic salary (compared to a rate of up to 55 percent), bonuses, company car, free phone, and health care insurance to certain groups. To be eligible, taxpayers must work, but not necessarily live in Denmark, have been non-residents for at least ten years, and either be classified as a researcher[6] or a key employee by having a monthly income of over DKK 70,400 (after deduction of social security contributions).

The *forskerordningen* tax is an example of a category 1 tax regime. Part of the regime is targeted at attracting qualified researchers that might be deterred by the high personal income taxes. However, the scheme also targets high-income workers[7] with a high eligibility threshold for individuals irrespective of professional activity, increasing its harmfulness.

4.1.5. Cyprus's *non-dom* regime

In 2012, Cyprus established a deduction rule for people without a domicile (so-called *non-doms*) that have not been tax residents in Cyprus for at least three out of the prior five years. To become a tax resident, individuals either have to stay in Cyprus for at least 183 days or, alternatively, meet the following three criteria: (i) they stay in Cyprus for at least two months in a year, (ii) own or rent a permanent residence, and (iii) either have a business, be employed or hold an office for a tax resident in Cyprus at any time during the assessment year.

The regime has two stages. It contains a five-year 20 percent income tax exemption from all employment exercised in Cyprus for all workers with an annual salary below EUR 100,000. Individuals with a higher income are eligible for a ten-year 50 percent exemption from taxation on their income. On top of that, income from dividends, interests, and rental income is tax-free. Non-domiciled tax residents are also exempted from paying social security contributions. Since 2015, Cyprus has also offered a ten-year pension scheme that only taxes foreign pensions above EUR 3,420 at a rate of five percent.

The Cyprus *non-dom* regime falls under category 1. The low-income tax regime is classified as less harmful due to its availability to all income levels. Moreover, the exemptions are contingent on employment income and thus, individuals must provide economic added value. However, the exemptions for higher-income individuals are more extensive, indicating the attraction of mobile tax base. This scheme is also arguably one of the most extensive regimes in Europe as it offers a substantial tax reduction and a very short residence requirement.

4.1.6 Austria's researchers, athletes, and artists scheme

Foreign researchers moving to Austria profit from a five-year preferential tax treatment. The regime includes retaining the previous tax burden (but at least 15 percent) on foreign income and an additional tax allowances ("Zuzugsfreibetrag") of 30 percent of taxable income from domestic scientific activities. The first tax advantage is also applicable to artists and athletes.

To receive the advantage of retaining the previous tax burden, the individual must be a non-resident for ten years prior and exercise an activity of public interest.

[6] A person that carries out research at a university or a private company and has a postgraduate education at a minimum PhD-level.

[7] The threshold approximately corresponds to the 99th percentile of the Danish earnings distribution (Kleven et al., 2014).

Not being a resident for the past five years is sufficient for the tax allowance. The application for obtaining the tax benefit must be filed with the Austrian Ministry of Finance within six months of moving to Austria.

The scheme is classified as not harmful as it targets a specific group of workers that provide real economic value. The preferential treatment is attended at compensating expatriates for the additional expenses associated with reallocating.

4.2 Wealth-related Taxation

Over the past decades, most countries that had a net wealth tax abolished it. However, certain types of wealth as well as income derived from wealth, such as inheritances, gifts, real estate, dividends, or capital gains, are subject to taxation in most countries. Tax base definitions and rates differ notably across EU (but are typically lower than personal income tax rates), thus leaving room for tax competition. Some of these income sources are included in the preferential tax regimes described above (Cyprus, Italy, and Portugal).

Inheritance is taxed at different rates across Europe, which commonly depend on the degree of kinship. Exceptions are Austria, Cyprus, the Czech Republic, Estonia, Latvia, Malta, Portugal, the Slovak Republic, Sweden, and Romania. These countries do not have an inheritance (and sometimes gift) tax. Because many EU countries have an expatriation tax, inheritance is not a very mobile tax base and, thus, less prone to tax competition. However, no or low inheritance taxes can factor into the residence decision for the post-work life period.

Income from wealth such as interest, dividends, and capital gains are essential income sources for the very rich and mobile individuals. Capital gains are often taxed at a flat rate and include generous exemptions. Concerning dividend income, most countries first charge a tax on corporate profits and then tax the distribution of these profits at the personal level. In that sense, corporate taxation also becomes important due to the possibility of shifting between personal and corporate income by paying oneself less salary and making a higher profit instead to generate higher dividends. Countries that stand out regarding their capital gains, dividend, or corporate taxation are:

- Belgium: Only taxes capital gains that are regarded as professional income;
- Cyprus: Capital gains are not taxed in Cyprus with the exemption of domestic immovable property. As part of the non-dom regime, foreign tax residents are exempted on all interest and dividend income until they have reached tax residency for 17 out of the past 20 years;
- Luxembourg: Capital gains are tax-exempt if a moveable asset was held for over 6 months and is owned by a non-large shareholder. Luxembourg does not have a withholding tax on interest payments paid to non-resident individuals. The Luxembourg Leaks also revealed that many multinational corporations effectively pay a tax rate of less than 1% due to a tax agreement with Luxembourg;
- Malta: The preferential tax regime exempts non-domiciled individuals from paying tax on all capital gains as well as on income arising outside Malta unless received there. Moreover, interest and royalty income derived by non-residents is exempt from tax if certain conditions are fulfilled; and
- Spain: Non-residents pay a lower tax on capital gains (the reduced marginal top tax rate is 19% compared to a regular rate of 26%).

Belgium's, Cyprus's, Italy's, and Malta's tax systems feature a national interest deduction (NID), enabling companies to reduce their taxable profit. The reduced effective tax rate paid by shareholders facilitates tax reduction for individuals that can shift between personal and corporate income.

5. MOBILITY EFFECTS OF PERSONAL INCOME AND WEALTH TAXATION

There is a considerable amount of empirical research in economics estimating the so-called *tax base elasticity* of personal income taxes as well as wealth-related taxes. The tax base elasticity measures the percentage change in the tax base resulting from a one percent increase in the relevant net-of-tax rate (which is equal to one minus the relevant marginal tax rate). However, a large tax base elasticity is not necessarily indicative of a high international mobility of the tax base and, thus, a result of international tax competition. In fact, taxpayers may react to changes in the tax burden in very different ways. A decrease in personal income tax rates, for instance, may lead to an increase in labour supply as the incentives to take on a job or increase working hours increase, which would result in an increase in taxable income and yield a positive estimate for the corresponding personal income tax elasticity. In a similar vein, increases in taxes on net wealth are found to lead to a reduction in private savings, an underreporting of asset values, and offshore tax evasion, which explains why many studies report sizeable tax base elasticities for net wealth taxes.

To understand the consequences of international tax competition, it is more instruc-tive to look at migration responses to changes in the level of taxation. In this section, we review some of the existing empirical evidence on the mobility effects of personal income taxes as well as wealth-related taxes.

5.1. Mobility Effects of Personal Income Taxation

Kleven et al. (2020) provide an overview of the small but growing literature analyzing how personal income taxation affects the location decision of taxpayers. The majority of existing studies focuses on personal income tax induced migration at a subnational level, especially in the U.S., Switzerland, and Spain. I.e., these studies analyse whether changes in a region's tax schedule lead to in or out-migration from or to other regions in the same country. What is more, the analyses are typically restricted to specific population subgroups. The reported mobility elasticities are often very large. Martinez (2021), for instance, studies the migration of Swiss citizens in response to the introduction of a regressive income tax schedule in the canton Obwalden that significantly lowered the tax burden for top income earners. His findings suggest that a ten percent drop in the net-of-tax rate increases the share of top income earners by 15–20 percent. A somewhat smaller mobility elasticity is reported by Agrawal and Foremny (2019) in the case of Spain, where the 17 autonomous communities can set marginal income tax rates. For the top one percent of Spanish income earners, the authors report an average mobility elasticity of around 0.85, implying that a ten percent reduction in the net-of-tax rate increases the share of top income earners by 8.5 percent. However, further analyses reveal considerable heterogeneity across occupational groups and by industries. For instance, the estimated elasticity is considerably larger for self-employed individuals as well as for individuals working in the health sector, the IT sector, and the financial sector. Akcigit et al. (2016) study how inventors in the U.S. respond to changes in personal income tax rates. According to their estimates, a ten percent reduction in a U.S. state's net-of-tax rate reduces the likelihood that an inventor who is currently residing in that state will emigrate by 1–1.5 percent and increase the likelihood that inventors from other states will move there by 10-15 percent. The average mobility elasticity is 0.34. According to Moretti and Wilson (2017), 'star' inventors (defined as the top five percent of inventors in terms of the number of patents filed in a given year) are notably more mobile. For this group, the authors obtain a mobility elasticity estimate of 1.8 percent, implying that a ten percent reduction in the personal income tax rate leads to an 18 percent increase in the number of star inventors.

In contrast, evidence on the relationship between personal income taxation and international migration is scarce. One of the few studies investigating this relationship is Kleven et al. (2014), who analyse the migration effects of the Danish preferential tax regime for foreigners explained above. Their estimates suggest that the introduction of the regime has tripled the number of foreign top income earners migrating to Denmark. The resulting mobility elasticity is 1.6. Also of particular relevance is the analysis by Muñoz (2019), who estimates mobility responses for top 10 percent income earners across 28 European countries. The estimated mobility elasticities range from 0.7 to 1.6 for foreigners (i.e., the number of foreigners moving to a country increases by 7–16 percent in response to a ten percent personal income tax rate cut) and from 0.01 to 0.04 for domestic citizens (i.e., the number of domestic citizens leaving a country decreases by 0.1–0.4 percent in response to a ten percent personal income tax rate cut).

Egger et al. (2013) show that the personal income tax system can affect the location decisions of firms as well. Utilizing a data set covering 79 countries and more than 35,000 firms, the authors show that a pronounced progressivity of the labour income tax schedule as well as higher payroll taxation makes a country less attractive as a location for a firm's headquarters. More precisely, a one percentage point increase in the level of payroll taxation is associated with a 6.1 percent lower likelihood that a country will attract headquarters.

5.2. Mobility Effects of Wealth Taxation

To the best of our knowledge, there are only three studies so far that estimate the mobility effects of net wealth taxes.

Agrawal et al. (2021) study the consequences of the (re-)introduction of a decentralised wealth tax system in Spain for the location decisions of wealthy individuals. The system grants Spanish autonomous communities the right to set tax rates autonomously, yielding regional variation in the level of wealth taxation. The authors find that the introduction of the wealth tax system has led to a 10 percent increase in the number of wealthy individuals in Madrid, which was the only community choosing a tax rate of zero. For some autonomous communities, the associated loss in revenues from the taxation of wealth is as high as ten percent. On aggregate, tax-induced mobility caused a decrease in wealth tax revenues by roughly five percent. Moreover, the authors demonstrate that tax-induced mobility leads to a concentration of wealth in low-tax regions. In Madrid, the share of wealth held by the wealthiest one percent of the population almost doubled due to the immigration of wealthy individuals.

Similarly, Brülhart et al. (2021) exploit regional variation in wealth tax rates across Swiss cantons. The effects they report are substantial: Their findings suggest that a one percentage point drop in a canton's wealth tax rate leads to an increase in reported wealth by 43 percent over a period of six years. About one quarter of this effect can be explained by an influx of wealthy taxpayers, the rest is most likely due to an underreporting of asset values, tax evasion, and a decrease in private savings.

The only study that focuses on wealth-tax induced international mobility is Jakobsen et al. (2021). The authors analyse mobility responses to three wealth tax reforms in Scandinavia: a wealth tax cut in Denmark in 1988, the abolishment of wealth taxation in Denmark in 1996, and the abolishment of wealth taxation in Sweden in 2007. The estimated mobility elasticity amounts to 4.3, which implies that the number of wealthy individuals increases by 4.3 percent in response to an increase in the net-of-tax rate by one percent.

5.3. Mobility Effects of Inheritance Taxation

Existing evidence on the mobility effects of inheritance taxation is limited as well. For the U.S., Bakija and Slemrod (2004) as well as Conway and Rork (2006) report that high inheritance taxes have a rather modest effect on the number of tax returns filed in a state. Brülhart and Parchet (2014) provide a similar finding for Switzerland. Exploiting regional variation in bequest taxation across Swiss cantons, the authors document that differences in the level of bequest taxation only have little impact on the location decisions of retirees. These findings fit well to studies estimating the tax base elasticity of inheritance taxation. Glogowsky (2021) for Germany and Goupille Lebret and Infante (2018) for France obtain estimates for the tax base elasticity of around 0.1, indicating that bequests are rather insensitive to changes in the level of inheritance taxation.

5.4. Mobility Effects of Capital Income Taxation

Evidence on the tax or mobility elasticity of capital income is almost non-existing. One reason might be that in many countries, both labour income and capital income are taxed together, making it impossible to disentangle the two elasticities. Based on Danish tax record data, Kleven et al. (2014) obtain an estimate for the tax base elasticity of capital income of 0.10 to 0.14. In contrast, the estimated elasticity of wage income for self-employed persons is about 0.05 and 0.10. Hence, capital income appears to be more responsive than labour income. Bach et al. (2021) find large responses to dividend taxation in France. However, the effects are largely driven by intertemporal shifting and increased consumption within the firm rather than emigration of shareholders. Alstadsæter et al. (2019) show that many ultra-rich Scandinavians respond to capital income taxation by hiding their wealth in offshore tax havens instead of emigrating. They estimate that the top 0.01 percent evade about 25 percent of their tax liability through hidden wealth in tax havens. There is no evidence on mobility responses between non-haven countries, but there is certainly the possibility that people with high capital income locate in countries with lower taxes.

Another margin of adjustment could be to avoid the taxation of large capital gains. However, this issue has been addressed and many countries levy expatriation taxes. Capital gains are taxed in the home country when an individual leaves the country, or alternatively when the gain is realized. Hence, there is little potential to avoid already accrued capital gains through mobility.

6. CONCLUDING REMARKS: HARMFUL CONSEQUENCES OF INTERNATIONAL TAX COMPETITION AND PREFERENTIAL TAX ARRANGEMENTS

Our review of the empirical literature on tax-induced mobility suggests that there is indeed scope for international tax competition in the area of personal income and wealth taxation. Reductions in personal income and wealth-related taxes as well as special tax arrangements for foreigners trigger an inflow of income-rich and wealth-rich individuals, while tax hikes provoke a corresponding outflow. Since one's gain must be someone else's loss, such tax reforms will eventually produce winners and losers.

However, for a country, lowering tax rates or introducing preferential tax arrangements for foreigners to increase immigration involves benefits and costs, which governments will likely seek to balance. Potential benefits from the immigration of income and wealth-rich individuals include, first, an increase in the supply of capital and skilled labour, which may boost economic activity. Second, immigration may create knowledge spillovers which can spur innovation. Third, there are also fiscal gains in the form of higher tax revenues when income and wealth-rich individuals immigrate. However, allowing more people to immigrate involves costs as well. Fiscal costs arise because the demand for public services and infrastructure increases. Second, immigration may also cause negative externalities for domestic citizens due to a potential increase in labour market competition. Finally, the introduction of extensive preferential tax arrangements for foreigners may also raise fairness concerns and provoke resentment among the population because they imply a higher tax burden for domestic citizens than for foreigners.

In light of this trade-off, whether tax-induced mobility actually provokes a tax race to the bottom remains an open question. Clearly, reducing personal income and wealth tax rates to zero for both foreigners and domestic citizens cannot be an optimal strategy for governments as they would suffer significant tax revenue losses. It is hard to imagine a scenario in which potential gains from migration are large enough to compensate for this loss in tax revenue. Consequently, the more promising way for governments to attract income and wealth-rich immigrants is by granting preferential tax arrangements to foreigners. However, due to the costs they involve and political constraints, the scope may be limited.

Nevertheless, the unilateral, uncoordinated introduction of such preferential tax arrangements can indeed be considered harmful as they cause negative externalities for other countries. These externalities include, inter alia, a loss of tax revenue as well as skilled labour and capital. Flamant et al. (2021) assume that currently at least 200,000 individuals in the EU and UK are benefitting from preferential personal income tax arrangements for foreigners. The estimated loss in tax revenue for EU member states amounts to EUR 3.2 billion per year. Muñoz (2019), in contrast, estimates the tax revenue loss in the EU to be only EUR 1.2 billion per year. While even the larger figure of EUR 3.2 billion only represents 0.1 percent of total annual tax revenues collected by EU member states, it should be kept in mind that this figure does not reflect the economic costs countries losing skilled workers face. When a country decides to introduce a preferential tax arrangement, it will not consider the costs it imposes on other countries. The unilateral, uncoordinated adoption of preferential tax arrangements will thus lead to a deviation from the policy that would be socially optimal. At some point, we may end up in a world where preferential tax arrangements become widespread, but single country measures neutralize each other so that their adoption represents a zero-sum game.

REFERENCES

- Agrawal, D. R., & Foremny, D. (2019). *Relocation of the Rich: Migration in Response to Top Tax Rate Changes from Spanish Reforms*. The Review of Economics and Statistics, 101(2), 214–232. https://doi.org/10.1162/rest_a_00764
- Agrawal, D. R., Foremny, D., & Martínez-Toledano, C. (2021). *Paraísos Fiscales, Wealth Taxation, and Mobility*. https://doi.org/10.2139/ssrn.3785906
- Akcigit, U., Baslandze, S., & Stantcheva, S. (2016). *Taxation and the international mobility of inventors*. American Economic Review, 106(10), 2930–2981. https://doi.org/10.1257/aer.20150237
- Akcigit, U., Grigsby, J., Nicholas, T., & Stantcheva, S. (2021). *Taxation and Innovation in the Twentieth Century*. The Quarterly Journal of Economics. https://doi.org/10.1093/qje/qjab022
- Alstadsæter, A., Johannesen, N., & Zucman, G. (2019). *Tax evasion and inequality*. American Economic Review, 109(6), 2073–2103. https://doi.org/10.1257/aer.20172043
- Bach, L., Bozio, A., Fabre, B., Guillouzouic, A., Leroy, C., & Malgouyres, C. (2021). *Follow the money ! Why dividends overreact to flat-tax reforms*.
- Blumkin, T., Margalioth, Y., & Strawczynski, M. (2021). *The effects of permanent income tax cuts on emigration from Israel*. CESifo Economic Studies, 66(1), 1–32. https://doi.org/10.1093/CESIFO/IFAA001
- Brülhart, M., Gruber, J., Krapf, M., & Schmidheiny, K. (2019). *Behavioral Responses to Wealth Taxes: Evidence from Switzerland*. Ssrn. https://doi.org/10.2139/ssrn.3477721
- Brülhart, M., & Parchet, R. (2014). *Alleged tax competition: The mysterious death of bequest taxes in Switzerland*. Journal of Public Economics, 111, 63–78. https://doi.org/10.1016/j.jpubeco.2013.12.009
- European Parliament (2021). *Reforming the EU policy on harmful tax practices (including the reform of the Code of Conduct Group)*. European Parliament resolution of 7 October 2021 on reforming the EU policy on harmful tax practices (including the reform of the Code of Conduct Group) (2020/2258(INI)).
- Flamant, E., Godar, S., & Richard, G. (2021). *New Forms of Tax Competition in the European Union: An Empirical Investigation*. EU Tax Observatory, Report No. 3.
- Glogowsky, U. (2021). *Behavioral responses to inheritance and gift taxation: Evidence from Germany*. Journal of Public Economics, 193, 104309. https://doi.org/https://doi.org/10.1016/j.jpubeco.2020.104309
- Goupille-Lebret, J., & Infante, J. (2018). *Behavioral responses to inheritance tax: Evidence from notches in France*. Journal of Public Economics, 168, 21–34. https://doi.org/10.1016/j.jpubeco.2018.09.016
- Jakobsen, K., Jakobsen, K., Kleven, H., & Zucman, G. (2020). *Wealth Taxation and Wealth Accumulation: Theory and Evidence from Denmark*. Quarterly Journal of Economics, 135(1), 329–388. https://doi.org/10.1093/qje/qjz032
- Jakobsen, K., Kleven, H., Kolsrud, J., & Landais, C. (2021). *Do the rich flee wealth taxes? Evidence from Scandinavia*. Paris–London Public Economics Conference.

- Kleven, H. J., Landais, C., Saez, E., & Schultz, E. (2014). *Migration and wage effects of taxing top earners: Evidence from the foreigners' tax scheme in Denmark*. Quarterly Journal of Economics, 129(1), 333–378. https://doi.org/10.1093/qje/qjt033
- Kleven, H., Landais, C., Muñoz, M., & Stantcheva, S. (2020). *Taxation and migration: Evidence and policy implications*. Journal of Economic Perspectives, 34(2), 119–142. https://doi.org/10.1257/JEP.34.2.119
- Martinez, I. Z. (2021). *Beggar-Thy-Neighbour Tax Cuts: Mobility after a Local Income and Wealth Tax Reform in Switzerland*. KOF Working Paper 490. https://doi.org/10.2139/ssrn.2979275
- Moretti, E., & Wilson, D. J. (2017). *The effect of state taxes on the geographical location of top earners: Evidence from star scientists*. American Economic Review, 107(7), 1858–1903. https://doi.org/10.1257/aer.20150508
- Muñoz, M. (2019). *Do European Top Earners React to Labour Taxation Through Migration?* September.
- Seim, D. (2017). *Behavioral responses to wealth taxes: Evidence from Sweden*. American Economic Journal: Economic Policy, 9(4), 395–421. https://doi.org/10.1257/pol.20150290
- Trautvetter, C., & Winkler, E. (2019). *Competing for the Rich. Tax Exemptions and Special Scheme for the Rich*. Brussels: The Greens/EFA Group in the European Parliament. Consultado a, 1, 2020.

Existing preferential tax arrangements also meet some of the criteria of harmful tax practices outlined by the EU and OECD. They can result in effective tax rates that are significantly lower than the statutory level of taxation and are reserved to foreigners. However, at the moment, these guidelines only apply to corporate income taxation, but not to personal income or wealth taxation. In light of the potential economic costs of these tax arrangements, it might be worth thinking about defining similar criteria to identify harmful tax practices in other areas of taxation. At the least, there should be some coordination mechanism or ground rules at the EU level to make sure that the adoption of such arrangements by single EU member states do not harm the collective interests of the EU.

This document was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the Economic and Monetary Affairs Subcommittee on tax matters (FISC).

PE 703.343
IP/A/FISC/2021-02

Print ISBN 978-92-846-8908-8 | doi: 10.2861/926447 | QA-05-22-017-EN-C
PDF ISBN 978-92-846-8909-5 | doi: 10.2861/50512 | QA-05-22-017-EN-N