

# EDITORIAL

## Tax Competition: Harmful or Beneficial?

Barry Bracewell-Milnes, Banstead

*Tax competition* was a phrase little heard a decade ago. It is often heard now, and for good reason. It represents a correct and important economic concept. Just as firms compete with each other, so do governments. In particular, governments may be more or less corrupt or more or less efficient, and they may have more or less oppressive tax regimes. An honest, efficient low-tax regime provides an attractive business environment and is likely to win custom from its rivals. Increasing interaction between economies makes this incentive more and more important.

The European Commission, the Member Governments of the European Union and the overlapping Member Governments of the Organisation for Economic Co-operation and Development are well seized of the significance of tax competition. The reaction so far has been defensive and hostile. In April 1996, the EU Single Market Commissioner, Mario Monti, submitted a discussion paper 'Taxation in the European Union' to a meeting of European Finance Ministers in Verona. A principal theme was 'unfair competition in the tax area', thus competition within the EU from Member States with relatively low-tax regimes. The EC document 'Towards Tax Co-ordination in the European Union: A Package to Tackle Harmful Tax Competition', submitted by Monti to European Finance Ministers in October 1997, contained a draft Code of Conduct for Business Taxation, with a coverage going far beyond corporate income taxes: low or zero taxes were considered to be 'harmful', not high taxes. In May 1998 the EC published a draft directive on taxation of interest payments in the EU and proposing *inter alia* a 20 per cent withholding tax on cross-border payments of interest to individuals. In May 1996 OECD Ministers called upon the OECD to 'develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases'. The Report on this subject was submitted to Ministers at the meeting on 27–28 April 1998 and published (and reprinted) in 1998 under the title 'Harmful Tax Competition' (with statements of reservation by Luxembourg and Switzerland, Annex II). This Report was the subject of an article by Jeffrey Owens in *Intertax* 1998/8–9.

The activities of the EU and the OECD in this area are a mixture of the tax-technical and the political. The OECD Report lists 19 recommendations, most of

which are sufficiently technical to lose the interest of the general reader. But there can hardly be a more political project than an endeavour to make levels of taxation permanently and substantially higher than they would otherwise be throughout the EU or throughout the industrialized world. The rationale for this endeavour rests on a number of assumptions that are treated as self-evident although they can be shown to be questionable or false.

### 1. Can commercial competition be harmful?

Generations of protectionists have argued for restrictions on trade on grounds that are now widely agreed to be spurious. Thus, the main effect of anti-dumping duties is to make poor foreign producers poorer and richer domestic producers richer. Anti-cartel and anti-price-fixing measures are rigorously enforced within a number of industrialized countries. More and more business and professional restrictive practices are coming under attack. Such practices are becoming more and more difficult to defend. If competition between firms and individuals is good, almost without exception or qualification, how can competition between governments be bad? Internal tax competition has helped rather than harmed Switzerland and the United States.

### 2. Do governments pursue their countries' interests or their own?

Much of the case for government economic intervention, through the tax system or otherwise, rests on the assumption that governments embody the public interest whereas individuals and firms merely follow their private interests. This assumption has not withstood the critical onslaught of writers like Professors Deepak Lal, Gordon Tullock and Nobel Prizewinner James Buchanan. The more realistic belief is that politicians and bureaucrats are self-seekers just like anyone else. That means that they are against competition for themselves. Everybody is. Nobody likes being ousted by a superior rival. Competition is always for the other man, not for oneself. The difference between private persons and governments is merely that governments can enforce their privileges through the armed might of the state.

### 3. When is tax competition harmful?

The OECD Report 'focuses on geographically mobile activities' (para. 6). The problem is 'harmful tax practices' which 'affect the location of financial and other service activities' (para. 4). But when a supermarket competes with a rival on price or otherwise, the purpose is precisely to attract 'geographically mobile' customers and to 'affect the location' of their activities (to move their purchases from a rival's premises to its own). The concessions absorbed by immobile customers, who would stay with the store through thick and thin, are a deadweight cost of promotions. How can the opposite be true of tax competition, namely that it is harmful to affect the location of activities?

### 4. Elastic and inelastic demand

The traditional theory of public finance recognizes that tax imposes distortion on economic activity; the higher the tax, the worse the distortion; untaxed alternatives, such as leisure, retirement, emigration and the black economy become correspondingly more attractive. Ramsay and others have further argued that the distortionary effect of taxation is minimized if taxation is charged at higher rates on goods and services for which the price elasticity of demand is low and at lower rates on those for which it is high. The OECD Report turns both these principles on their heads. It ignores the distortionary effect of taxation as such (although in an economy in which taxation is taking 40 to 50 per cent of gross domestic product and thus more than 50 per cent of national income it would be difficult to argue that the distortionary effect of taxation is negligible or even small). And its criticism of tax concessions that affect location implies a preference for concessions that do not affect it and thus a preference for taxes on goods and services with a high price elasticity, like financial services. If the OECD has its reasons for believing that some hundred years of academic tradition on the subject of public finance are mistaken, it would be interesting to know what these reasons are.

### 5. Does tax avoidance cost the government money?

This is yet another elephant trap. The question might seem to answer itself: of course avoidance reduces taxable activity and thus reduces tax revenue. This answer is doubly wrong. First, it takes no account of the Dupuit curve (recently appropriated by Laffer as the Laffer curve), which indicates that the maximum

revenue rate of tax is not 100 per cent (100 per cent gross or infinity net) but some lower rate. In other words, governments can be too greedy for their own good. If tax rates are high, they may raise revenue by reducing them instead of losing revenue by increasing them. In the United Kingdom, the thought has in recent years at last sunk into policy-makers that the duties on whisky and other spirits were so high that they were more likely to increase tax revenue with a reduction or a standstill than with an increase. That assessment is for single transactions. When second-round and third-round effects are taken into account, the argument is even stronger. An example is the Inheritance Tax (IHT) on business property in the United Kingdom. Before the introduction of 100 per cent business property relief from IHT, IHT was yielding positive but negligible amounts of tax revenue (some £5 million a year, which was within the margin of error, since all published figures in the government's accounts were rounded to the nearest £5 million). After IHT on business property was effectively abolished by the increase of business property relief to 100 per cent, there is little doubt that tax revenue increased overall as a result of increases in corporation tax, income tax on employees, social security contributions, value added tax and other taxes paid by family businesses that would otherwise have been weakened or destroyed by the requirement to fund IHT.<sup>1</sup>

### 6. Empirical evidence

Concluding a substantial empirical and analytical study,<sup>2</sup> Keith Marsden, formerly with the World Bank, says:

'The empirical evidence is clear. Tax competition is not harmful. Analysis of data for two groups of countries, covering a twenty-year period, shows that incomes rose more rapidly in countries that chose to compete by extracting less tax revenue from their enterprises and citizens. Lower taxes were associated with higher rates of growth of investment, employment, productivity and private consumption. Countries that chose big government, and more public services financed by higher taxes, experienced slower economic growth'. (Page 51).

Within the last 20 years, many state enterprises have been privatized in dozens of countries. In the early stages of this process there were many critics who regarded it as impracticable or undesirable. There are few now who would seek to renationalize the industries that were privatized then.

Perhaps the most interesting single political question of the next few decades is whether the state

#### Notes

<sup>1</sup> This argument is spelt out in Barry Bracewell-Milnes, *Tax Avoidance and Evasion: The Individual and Society* (Panopticum Press, 1979/80), Appendix III.

<sup>2</sup> *Is Tax Competition Harmful?*, European Policy Forum, November 1998.

provision of health, education, pensions and other welfare services should be privatized as nationalized business concerns were privatized earlier. Opinion is divided. There are many opponents of privatization, just as there were many opponents of the privatization of state industries 20 years ago. But there are also supporters gaining in strength and self-confidence.

This is a question whose outcome should be determined by traditional domestic political processes. It should not be pre-empted by a supranational process of harmonizing taxes upwards. But a successful campaign against tax competition could substantially increase tax levels in countries where they are already among the highest in the world. Further tax revenues would be poured into activities which their critics believe to be already overfunded. The task of reforming the welfare state, already difficult, could become impossible.

Although a great company of governments is

engaged in the present campaign against tax competition, philosophically the enterprise is solipsistic. It ignores the analogy with commercial competition, the common-sense assessment that governments pursue their selfish interests as much as private persons, the established doctrine in the theory of public finance that higher tax levels create worse distortions and that mobile activities should be taxed less heavily than immobile, the concept of the Dupuit/Laffer curve that governments can gain revenue by reducing taxes, the concept of second-round effects (increasing tax revenue resulting from increasing prosperity) and the empirical evidence that lower taxes make a major contribution to higher economic growth. In so far as the campaign against 'harmful' tax competition succeeds, the losers will not merely be the peoples of the countries concerned: lower economic growth and prosperity will ultimately have their effect on tax revenues.