Challenges of a new Europe:
In between local freeze and global dynamics

Tax Competition: Race to the Bottom or Race to the Top?

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Introduction

This paper is intended to analyze the phenomenon of tax competition and whether it ultimately has a negative or a positive impact on the well being of the general public, hence the question race to the bottom or race to the top. In order to do that, I make the assumption that the government is not a benevolent organization which functions with the main purpose of maximizing the welfare of the common citizen but an ever increasing bureaucracy made up by self – interested individuals which is inclined to pursue the welfare of various special interest groups (small but powerful lobby groups, different political factions in power, groups in the electorate of the ruling parties and so on).

The analysis will initiate with some general considerations meant to clarify the concept of tax competition. The next step is to put forward the reasons which render tax competition such a salient issue of nowadays European Union. Subsequently, I will present the arguments and parties which maintain that tax competition may have a large array of negative outcomes at the individual level and as well at a macro level. The following section will deal with the arguments put forth by those who favour tax competition and consider it to be an important driver of economic prosperity and higher standards of living. Within this section I will present some relevant empirical data which strongly support the arguments that tax competition is nothing but beneficial for the common citizen. In the last section I will present a series of conclusions that I have reached by inquiring into the complex phenomenon of tax competition.

What is tax competition?

The basic requirement needed in order to speak about tax competition is that capital, and to a lesser extent, work can move across borders. Generally speaking, the European integration process in itself (which has been taking place in the wider context of globalisation) has greatly influenced the mobility of capital and labour in the EU by removing the barriers which could hinder their free movement.

In what concerns capital, as Teather (2005) notes, the 1980's brought about a series of governmental measures aimed at removing the exchange controls established during the two world wars. This lead to the creation of a global capital market, in which people or institutions willing to invest their capitals could chose the best suited country for their purposes taking into account, among other factors, also the after tax returns. As a result, it became obvious for the political decision makers that lowering the effective tax rates could result in more consistent inflows of foreign investments. Foreign investments are beneficial for the domestic economy as they translate, largely speaking, into new jobs creation and technological and managerial know-how transfers.

It is important to keep in mind that capital still displays a higher degree of mobility than labour. However there are a series of factors, as de Edwards and Rugy (2002) point out, which positively impact workforce mobility. The Internet expands the horizons of the job seeker by allowing him to access information regarding possible foreign opportunities. Furthermore, technological progress and particularly Internet make it possible to reside in one jurisdiction while carrying out work related activities in another one. Apart from that, taking a job abroad is also facilitated by huge reductions in transportation and communication costs but also by the fact that many jurisdictions have reduced emigration restrictions. Of outmost importance in this respect is also the phenomenon of regional trading pacts, notably the EU but also NAFTA. Evidently, labour is not homogenously mobile: high skilled professionals seem to display the highest degree of mobility against the developments depicted above. Of course, one could argue that this particular group has also the greatest incentives to display a more significant degree of mobility as it supports a higher tax burden, especially if we consider progressive tax rate regimes which penalize the ones who gain the most.

Taking advantage of the opportunities created by international economic integration, both businesses and people, acting as rational economic agents, tend to prefer lower tax jurisdictions in order to maximize after tax income. In other words, they simply try to retain a larger share of the value they create by engaging in productive activities such as work and investment. Against these trends, states engage in designing fiscal systems which are meant to attract mobile tax bases by providing higher after tax rates of return or disposable income. So, tax competition refers to the interdependency which may appear in the process of setting up taxes and to the influence that different national fiscal systems exert on one another (Roháč, 2006:88).

Why is so important the issue of tax competition in the European context?

As the integration process within the EU deepens, there are a number of economic issues which make the object on an intense debate. One of those is the future shape of tax policies across Member States.

Fiscal policy and, in particular, taxation is a very important instrument that can be used to influence the performance of the domestic economy, that is, to speed up the pace of economic growth. It gains even more importance if we consider the fact that decisions related to monetary policy (other major tool for fine tuning the economy) have been transferred from the national level to the European Central Bank (at least for the Euro zone), resulting in an 'one size fits all' monetary policy.

There are various voices that support a top to bottom process of tax harmonization within the EU as crucial for eliminating a series of distortions which could affect the single market. Tax harmonization refers to the coordination of tax systems across the EU with the purpose of avoiding 'non-concerted and competing changes in national fiscal policies'. Yet, it is extremely questionable that another 'one size fits all' EU policy, this time regarding taxation, would actually prove beneficial for the well being of Member States' quite diverse economies.

Although fiscal policies of EU member states are constrained to a certain extent by the Growth and Stability Pact, actual tax rates and the definitions of tax base are extremely diverse. There have been attempts on the part of the EU to harmonize certain areas of taxation, but decisions regarding direct taxation require unanimity in the Council and until now member states have found it difficult to reach a consensus. Harmonisation of indirect taxation has been more successful as member states have agreed to establish a minimum level of 15 percent for the value added tax.

The debate regarding the fiscal issue within the EU tends to be extremely heated. As people and businesses encounter fewer difficulties in voting with their feet, member states may be forced to lower tax levels so as to keep and attract capital and individuals. This scenario is particularly unpleasant for large EU welfare states which levy higher amounts of taxes in order to sustain a series of extremely costly social programmes.

Who and why is against tax competition?

There are a number of international bureaucracies like OECD, UN and EU which oppose tax competition and have taken various measures to curb it ranging from simple recommendations to actual legal measures. As a matter of fact, the position of these organizations is largely driven by those member states where the ruling parties favour high tax fiscal systems. Of course, the stance taken by these international bureaucracies is supported by a large number of persons pertaining to the academic circles who have put forward a large array of arguments against competition in the particular area of taxes.

The earliest scholarly argument against tax competition is that it will eventually lead to a race to the bottom: in their desire to attract more and more mobile tax base or even to prevent it from fleeing to lower tax jurisdictions, states will lower the level of taxation to the point where it will be almost impossible to provide an optimal level of public goods (such as education, healthcare, welfare programmes, transportation infrastructure, national defence, internal security, research and development and so on). This is believed to hold true especially in what concerns taxes on capital, namely taxes levied on corporate profits, dividends, investor's capital gains and savings. The situation translates into the impossibility of governments to perform their redistributive role, as the businesses and people (the ones most well off) who are taxed to support these measures, vote with their feet and move to lower tax jurisdictions. Subsequently, governments would have to face an ever decreasing tax base. To be able to maintain existing or desired levels of public expenditures, governments will be forced to impose higher taxes on less mobile tax bases. Namely, the tax burden on consumption for example (the VAT) will increase.

Closely related to the argument above, the OECD points out, in its 1998 report "Harmful tax competition: An Emerging Global Issue", that tax competition will spur behaviours like the so-called "free – riding": namely individuals in high tax jurisdictions, who benefit from a higher provision of public services, switch their income in lower tax jurisdictions, where they get to keep a larger slice of their income after taxation. So, they benefit from the advantages offered by welfare states but do not actually pay a fair amount of their revenues for that.

Some parties who do not favour tax competition base their opinions on a moral argument: only a small minority may have the means for moving their income generating assets across border and to lower tax regimes while a large majority is trapped in the high tax jurisdiction of their residence. This argument translates into the following point: only affluent groups, which already enjoy a more prosperous condition, may benefit from lower taxation abroad while less affluent groups can not afford the costs of doing so.

Another argument supporting the potential harmful effect of tax competition is brought up by a series of scholars who sustain that it leads to distortions in what concerns the international allocation of resources.

As Edwards and de Rugy (2002) point out, during the 1970s, governments across the world have realized the importance of foreign investments (and especially foreign direct investments - FDIs) in what concerns economic development. As a result, a large number of states have undertaken reforms meant at attracting the flows of FDIs, ranging from keeping stable currencies, enforcing efficient legal measures particularly regarding property rights and establishing transparent and liquid financial markets. In short, the degree of openness of national economies has substantially increased. Once the non-tax factors equalize between states, tax factors gain in importance in relation to resource allocation. Under these circumstances, some scholars fear that attracted by low tax regimes, resources may not be directed to their most efficient use. The issue is extremely salient as some Western European countries (like France and Germany) consider that the new EU member states from Eastern Europe, most of which being rather low tax regimes, are attracting an unfair share of the FDIs solely as a result of lower tax and without providing genuine business opportunities. So, the argument goes that taxes should not be the only reason taken into account when it comes to allocating capital.

Before I move on to presenting the arguments in favour of tax competition I must insist on an aspect which has a paramount importance for the debate as already stated within the introduction. In judging if tax competition is good or bad for the economic development and in particular for the well being of the citizens one must clarify which assumptions are the most efficient in what concerns the behaviour of governments. If we were to assume that governments as bureaucracies act for the sole benefit of the tax payer and for maximizing their welfare, than the whole debate would lose its importance: it would emerge as very clear that competition in the area of taxes would not be necessary to ensure the exact amount of public goods desired by the tax payers. If, on the contrary, we take into account for example the opinions put forward by from the public choice school, who believe that the efficiency and the benevolence of governments should not be implicitly assumed, than we gain a whole different perspective on the role of tax competition. Public choice scholars emphasize the fact that public servants and politicians display strong budget maximizing behaviours pursuing their self-interest: larger budgets and thereby greater power, larger salaries and why not, more people hierarchically subordinated. As a result they will most probably seek to satisfy their own needs than the needs of the regular citizens and the general public. Democratic regimes are characterized by periodical changes of the ruling party. As a result, the party in power will be inclined to manipulate the redistributive processes in order to attract as many votes as possible. Furthermore, an increasingly large amount of public resources are channelled towards sustaining the sole functioning of the bureaucracy in power and not towards the provision of public goods. That translates into a wasteful allocation of resources.

Who favours tax competition and why?

The outcome of tax competition, namely the fact that taxes reach a more efficient lower level which is nonetheless beneficial for the common citizen of any state, generates a series of arguments which in my opinion make a strong case for supporting the phenomenon.

The strongest argument in favour of tax competition resides in the fact that it provides incentives for the governments to promote more efficient tax policies which will have a positive impact on economic growth. Lowering taxes as pointed out by the supply side economist Arthur Laffer (2004) stimulate such productive activities as work and investment which translate into increases in output and employment. Furthermore, as growth of domestic economy speeds up, individuals benefit from higher incomes and more workplaces which curbs the need for extensive social welfare programmes. Thus, governments may be able to cut some of their expenditures, particularly in what concerns redistributive measures.

Lower taxes though may not equal less revenue for the public budget. There are two reasons which strongly support this statement. In the first place, lower taxes make work, saving and investing more attractive as they enable people to gain more consistent rewards by engaging in these type of productive activities. When people work, save and invest more then more wealth is going to be created and even if actual tax rates decline, the tax base increases. Thus budget revenues may be kept at roughly the same level by levying lower taxes on a larger tax base. There is even the possibility that public budget revenues tend to grow. Some strong empirical evidence to support this point is offered in the 2007 Eurostat report 'Taxation Trends in the European Union' (2007:7, 9): despite the fact that corporate income tax rates in the EU have been 'forcefully cut' since the 1990's, public revenues collected from this type of tax have not declined, but on the contrary, have displayed a slight growth tendency since 2003.

In the reverse situation, individuals lose their motivation to engage in productive economic activities if they are left with declining amounts of disposable income after taxes are levied. Secondly, lower tax rates (coupled with simpler and more transparent fiscal systems) provide fewer incentives to engage in tax evasion as the costs and risks of using various means to hide revenues become more significant than the costs incurred with taxation as such.

David Mitchell (2006) emphasizes the fact that lower tax rates represent important stimuli for economic growth as they reward work, saving, investment and entrepreneurship. As these productive activities expand, the general public will enjoy higher levels of prosperity and, as a result, the benefits of higher living standards. It is common knowledge that citizens of more prosperous countries tend to live longer and enjoy better quality of life.

It is of outmost importance to restate the fact that high tax levels on investment returns seriously endanger the economic perspectives of a nation by providing disincentives in what concerns savings. Saving money represents postponing present consumption to a certain point in the future. People will overcome their natural propensity towards present spending only if they expect that by saving and investing their money now they will be able to consume more in the future. What higher taxes do at this point is that they curb the benefits one could derive from postponing consumption. Less saving equals less investment which in turn, equals slower economic growth. The same holds true if work is overtaxed.

As early as 1956, Charles Tiebout concluded that fiscal competition among jurisdictions can translate into a more efficient bundle of public goods provided by the governments. Supposing that citizens have the liberty to vote with their feet and that a certain number of jurisdictions compete for attracting these citizens as a potential tax base, governments will be forced to offer a more carefully tailored choice of public goods in order to attain their goal. Eventually, each individual or household will chose that jurisdiction to locate their residence in which offers them roughly the precise combination of public goods and tax burden they prefer. It follows that tax competition among governments will not necessarily lead to an under-provision of public goods, but to the provision of the exact amount of public goods that tax payers wish for and, as a consequence, are willing to pay for. This point of view is supported by the Nobel Prize winner, Milton Friedman (2005), when he makes the following statement:

> ‘Competition among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or enterprises in the goods and services they offer for sale and the prices at which they offer them’

In the end, it is a matter of keeping your clients (or attracting new ones) by serving them in a better way than your competitors. This can only be done by offering them goods and services which accurately respond to their needs and wants.

Within the private sector, it is each individual’s freedom of choice which forces suppliers to efficiently allocate their resources so as to produce goods and services which will be valued by the consumers. If they do not succeed in bringing the desired levels of utility to the consumers, then competition will most probably force them out of business.

In the case of the government, the circumstances differ substantially and not to the benefit of the ‘consumer’, that is, of the common citizen. As Teather (2005:34, 35) notes, governments are within the national territory, the 'ultimate monopoly suppliers' of public services. Not only are the governments the sole supplier of public goods, but they also have the monopoly over the coercive power. So, they are able to impose upon their citizens whatever levels of taxes needed to finance the provision of public services irrespective of what the citizens may actually want to pay for. Not being subjected to any form of competition, governments tend to behave in a rather inefficient manner: costs grow and so the need to acquire additional resources, but not necessarily with any improvement in terms of quality of the services they provide. The situation is very similar to monopolies in the private sector which, in the absence of competition, display a strong tendency to provide lower quality goods and services associated with a substantial waste of resources. Besides this, if we keep in mind the fact that governments may not act for the sole benefit of the general public, then increases in their operating costs may well be caused, to a certain extent, by the public servants' self interest. Under those circumstances, tax competition may prove extremely beneficial for the common public as it caps governments' ability to levy higher taxes. This in turn will limit the resources (public budget revenues) available for the public sector. So governments will be forced to operate more efficiently and avoid wasteful allocation of their limited resources. Furthermore, limited public funds will leave smaller room for pursuing the objectives of various special interest groups to the detriment of the population at large. It is easy to note why high tax jurisdictions with expensive and not always efficient welfare systems resent tax competition: in the context of an unhindered flow of capitals and work across national borders, their ability to overtax would be seriously endangered.

Closely related to the aspects pointed out above, is the fact that tax competition protects such invaluable 'goods' like personal freedom. If governments are able to levy increasing amount of taxes, thus benefiting from increasing resources at their disposal, their tendency to grow will most probably intensify. As a result, common citizens will have to face an ever growing bureaucracy with an ever stronger inclination to intervene even in those areas where personal freedom should prevail. The reverse of tax competition is tax harmonization whether it be direct (states agree to impose certain minimum levels of taxes) or indirect (states tax revenues obtained by their residents abroad – the principle of worldwide taxation). In order to achieve tax harmonization, and particularly its indirect form, governments would need to share a wide array of personal information regarding each taxpayer. This is not a very pleasant perspective for those who strongly support the freedom of each individual to hold personal matters for themselves.

As a result of tax competition and realising the positive impact that lower tax rates can have on economic development, many governments across the world have decided to implement a series of tax reforms in order to increase the welfare of their citizens.

The worldwide movement of reducing tax rates began in the United Kingdom and the United States during the 1980s Margaret Thatcher and Ronald Reagan regimes. Corporate tax rates were cut in the UK from 52 percent to 35 percent and in the US from 46 percent to 34 percent (Edwards and de Rugy: 13). In their 2004 article 'What has been the tax competition experience of the last 20 years?' Griffith and Klemm (2004: 7) emphasize the fact that the fiscal systems of all the OECD countries have undergone major changes since the 1980's: tax rates have been declining, tax bases on the contrary have the object of broadening measures and tax revenues generated by corporate income have been displaying roughly the same proportion of GDP since 1965.

Perhaps one of the most popular success stories in what concerns lowering the level of taxation as a result of tax competition is the case of Ireland as depicted by Mitchell (2004: 30). In the 1980's Ireland was confronted with a series of severe economic problems ranging from high unemployment to a relative weak economic growth. As a result, the country faced at that time substantial immigration. Partly to blame for this dismal state of the domestic economy were high level of taxes: top personal income tax rate - 65%, corporate tax rate – 50% and a maximum of 60 % levied on capital gains. In the following 10 years the government engaged in a series of tax rate cuts, bringing down the corporate tax to 12,5 percent, the capital gain tax to 20 percent and the personal income tax from 20 percent to 41 percent. The result: economic growth of an average of 7.7 percent in the 1990s and at the moment, the second highest standard of living in the EU. Not surprisingly at all, budget revenues as predicted by the Laffer model, not only did not decline but actually augmented. However, in 2002, the EU decided to take action against the fiscal policy conducted by Ireland though at that time, the country had the largest budget surplus in the EU, lowest total tax burden, second lowest amount of debt and the lowest level of government spending. Could it have been that other governments in the EU felt threatened in their ability to sustain large welfare systems through heavy taxation?

As shown by the 2007 Eurostat report 'Taxation Trends in the European Union' a more recent example of beneficial reforms at the level of tax policies is represented by a number of states from Eastern Europe. Estonia was the state who pioneered the flat-rate income tax in the region during 1991. Moreover, the government plans to cut income tax (personal and corporate) even further, from 26% to 20% between 2004 and 2009. Despite these tax cuts, Estonian authorities reported a 20.3 percents increase in 2006 tax revenues compared to the previous year. Besides this, the Estonian economy displayed real GDP growth of more than 7 percents for every year starting with 2000 (Eurostat 2007:145, 146). During 1995, the Estonian example was followed by Latvia which introduced a flat tax on personal income of 25 percents and began reducing the corporate tax rate from 25% in 2001 to 22% in 2002, 19% in 2003 and 15% in 2004 (Eurostat 2007:178). Lithuania too has chosen to reduce taxes on corporate income from 29% in 1995 to 24% in 2000 and 15% in 2002 (Eurostat 2007:182).

Conclusion

Is tax competition a race to the bottom or a race to the top? From my point of view, the correct answer can be found only if we consider how tax competition affects the general public and not the governments as bureaucracies or certain special interests groups such as public servants.

As empirical researches point out, tax competition provides national governments with incentives to reduce the level of taxation. As a result individuals as well as businesses get to keep a higher proportion of the income generated by the productive activities they engage in. So, lower taxes mean greater wealth for the general public.

Furthermore, it should be noted that higher taxes, and as a result higher public revenues, do not necessarily translate into an increased level of public welfare. Public choice school points out that governments are composed by individuals whose interest is to increase the power and scope of their bureaucracy so they in turn may become more affluent. Under these circumstances, the question arises if all public expenditure is made solely for the provision of public goods and the maximisation of public welfare. If not, tax competition is just what is needed to keep governments from acting in a wasteful manner.

In my opinion, the stake of the debate around tax competition is, in the end, personal freedom. If we accept and even consider necessary that parent-like governments should intervene in most of the areas of our socio-economic life then tax competition is to be rejected as it limits the power of the government to do so. If, on the contrary, we value our personal freedom and we believe that each of us has the right to seek personal fulfilment in whatever way he may think appropriate than tax competition is a valuable guarantee that governments will never have access to the resources needed in order to expand indeterminately their size and scope.

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