

Tax Competition

Much To Do About Very Little

Sinclair Davidson

Perspectives on Tax Reform (13)

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Foreword

This is the thirteenth in the ‘Perspectives on Tax Reform’ series of Policy Monographs published by the Centre for Independent Studies.

In this Monograph, Sinclair Davidson challenges the notion of ‘harmful’ international tax competition. He argues that in the sphere of taxation, as elsewhere, competition should be welcomed as a force for good, not stifled by international policy harmonisation.

As globalisation and international capital mobility have increased, tax policy-makers and revenue collectors—especially in the developed world—have become concerned about the revenue implications of tax competition among countries, and have pursued cooperation and harmonisation through the OECD.

The need for international cooperation to counter tax evasion is well understood. Less clear, and under challenge from Davidson in this Monograph, is the notion that tax policy coordination is needed to counter a tendency for international competition to lead to tax rates that are in some sense ‘too low’.

Davidson argues that the OECD has based its economic argument for tax policy coordination on unsubstantiated assertions that tax competition produces negative externalities and depresses tax revenue. To the contrary, Davidson cites evidence of international competition having forced tax rates down while tax revenue has remained buoyant.

In Davidson’s view, the debate surrounding tax competition is in fact inseparable from the familiar and much larger debate about the appropriate size and role of government. Those favouring more limited and less redistributive government are likely to welcome international tax competition as a discipline on government. Those who favour larger and more redistributive government see international tax policy cooperation as necessary to their objectives, especially in a world of greater capital mobility.

The thrust of Davidson’s case is that if Australian policy, rather than demonising international tax competition and trying to ‘manage’ it with other countries through the OECD, were to accept and adjust to it, then the Australian economy would benefit. This is relevant to the current Australian tax debate at a number of levels, particularly for personal and company income tax reform.

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Tax Competition: Much To Do About Very Little

Sinclair Davidson

Executive Summary

In this paper I argue that the criticism of tax competition is overblown. The whole notion of ‘harmful’ tax competition itself is ill-defined. The OECD began its campaign against tax competition on the basis of assumed harm and has failed to demonstrate any such harm from competition between nations. In addition, I argue that most of the debate surrounding tax competition is ideological. Differing views on the ability and role of government and markets to affect outcomes and to redistribute income feed into preferences for and against tax competition.

I investigate whether tax competition has actually had any impact on tax revenue raised by the OECD economies, or the mix of tax revenue within OECD economies. The data do not indicate that any ‘harmful’ tax competition has occurred. While corporate tax rates may have declined, there is no evidence to suggest that corporate tax revenue is especially at risk. Finally, I review the literature investigating the benefits from full scale cooperation and harmonisation of tax systems. The theoretical benefits are small—less than one per cent of GDP—and further these benefits are based on very restrictive assumptions. In other words, the benefits of tax harmonisation are very small and the costs of tax competition are small, too—indeed there is no evidence of any costs. The empirical literature, however, indicates economic benefits from tax competition. In other words, the whole tax competition debate has generated a lot of heat but very little light.

An earlier version of this paper was presented at the CIS Tax Forum on Tax Harmonisation in Melbourne (14 November 2005) and Wellington (21 November 2005). I would like to thank participants in those forums, Robert Carling, Daniel Mitchell, Alex Robson and Peter Saunders for valuable feedback.

Introduction

Tax competition has generated a huge, heated, public policy debate.¹ Tax competition theory holds the possibility that competition for capital, amongst countries, will lead to ‘inefficient’ low taxes on capital (that is, corporate income tax rates), and also ‘inefficient’ low levels of public expenditure and the under-provision of public goods. John Whitney, tax partner at PricewaterhouseCoopers, has said that ‘I believe that corporate tax is in near terminal decline. Over the next 10 years governments may have to deal with a lot less corporate revenue.’² In this view, tax competition is economically undesirable and tax harmonisation, or coordination, is required to improve economic behaviour. Alternatively, tax competition could lead to lower taxes, and appropriate levels of public intervention in the economy. In this latter view, tax competition leads to improved economic behaviour.

I investigate the tax competition/harmonisation debate and highlight three important considerations. First, there is a conflict of visions. Protagonists have differing perspectives on the value and role of markets and government. Protagonists also have differing expectations as to the role of fiscal policy. Second, the tax harmonisation arguments contain hidden assumptions that need further evaluation. Finally, I report some basic facts that undermine the standard tax harmonisation arguments. Overall, then, the basis for tax harmonisation relies on three foundations: a flawed vision of markets, false assumptions, and basic facts that do not support the arguments.

What is Tax Competition?

Richard Teather has defined tax competition as ‘the use by governments of low effective tax rates to attract capital and business activity to their country’.³ Daniel Mitchell defines a tax haven as ‘any jurisdiction, anywhere in the world, that has preferential rules for foreign investors’ – yet somehow the phrase has become a pejorative term.⁴ Tax havens and tax competition are intimately related to each other. It is important to dispel stereotypical views about what constitutes a tax haven. That view may relate to some tropical island paradise with poor banking practices that allows money laundering, and related criminal behaviour. To be sure, such places do exist – yet they are rarer than many think.⁵ Switzerland – the most famous tax haven – has none of those features. Neither does the United Kingdom, a tax-haven for wealthy foreign domiciled, but UK resident, individuals. Hong Kong has very low tax rates, yet is seldom, if ever, criticised for being a ‘tax haven’. New Zealand can be described as a foreign trust tax haven. New Zealand also does not tax the foreign income on new migrants for a period of four years.⁶ Ireland is a corporate tax haven. In his Budget Reply speech, Kevin Rudd proposed that Australia become a funds management tax haven by halving the ‘withholding tax on distributions from Australian managed funds to non-residents from 30 percent to 15 percent’.⁷ The federal government have hinted at a similar policy.⁸ Australia already qualifies as an inheritance tax haven. In other words, tax competition is common amongst countries, and at some level many, if not all, countries qualify as tax havens.

As Richard Teather describes, in the late 1990s a number of (European) high-tax economies began to fear that tax competition would undermine their own ability to raise tax revenue.⁹ Wouter Bos, the Dutch Minister of Finance, argued that tax competition was ‘not just a ‘race to the bottom’ but a ‘race to public poverty’, ... where total tax income of the countries becomes too low for governments to finance a sustainable and sufficient level of public services’.¹⁰ These high-tax economies began a campaign against tax competition and (some) tax havens using international organisations such as the European Union, the OECD and the United Nations Organisation. The Australian government has been a supporter of this campaign.

Tax competition, according to its critics, is a negative consequence of globalisation. Some countries deliberately establish their tax policies in order to erode the tax base of other countries, alter the tax structure of those countries, hamper the application of progressive tax regimes, and impede the redistribution of income or wealth. This decreases ‘global welfare’. All these undesirable outcomes can be avoided ‘through intensifying international co-operation’ – in other words, by establishing a tax cartel. Those taxpayers who take advantage of tax havens are free riders ‘who

benefit from public spending in their home country and yet avoid contributing to its financing'.¹¹ It is worth noting that this is not a legal argument, but rather a moral argument masquerading as economics.¹²

The OECD promotes the view that tax competition has the potential to create harm by distorting investment flows, undermining the integrity and fairness of existing tax structures, discouraging tax compliance, changing the 'desired' mix and level of taxation and government spending, causing the tax burden to shift to less mobile tax bases and increasing the costs of tax administration and compliance burdens. Enrique Mendoza and Linda Tesar have summarised all of these effects into three 'global externalities'.¹³ The first externality is an old-fashioned 'beggar-thy-neighbour effect', whereby governments reduce their taxes in order to attract investment from neighbouring countries. The second externality is a 'wealth-redistribution effect', which is caused by inefficient tax-driven investment choices. Finally, there is a 'tax externality' caused by the impact tax competition has on tax revenue.

In 1998 the OECD published a report, 'Harmful Tax Competition: An Emerging Global Issue', which makes a series of claims regarding international taxation. The OECD had been commissioned by member states to 'develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases'.¹⁴ The Report is a wordy affair. It contains some discussion of the 'definition' of 'harmful tax

The OECD promotes the view that tax competition has the potential to create harm ...

competition', and also some criteria for identifying those economies that may engage in harmful tax competition. It is worth pointing out that two OECD members dissented from the Report, but did not veto the project. Luxembourg argued that the Report 'gives the impression that its purpose is not so much to counter harmful tax competition where it exists as to abolish bank secrecy';¹⁵ while the Swiss claimed that the Report 'is partial and unbalanced'.¹⁶ The dissenters, however, were hardly being principled. They could have vetoed further OECD work on tax harmonisation; instead they

refused to participate further.

The 1998 Report doesn't provide a concise definition of harmful tax competition, but it does offer the following criterion: 'If the spillover effects of particular tax practices are so substantial that they are concluded to be poaching other countries tax bases, such practices would be doubtlessly labelled 'harmful tax competition'.¹⁷ So harmful tax competition is caused by 'spillovers'. This is a very convenient definition. Spillovers—which economists usually refer to as 'externalities'—are often invoked as a justification for government regulation. This is the first of our hidden assumptions. It seems that any, and every, externality calls for government intervention. Worse, simply alleging externality is grounds for intervention.¹⁸ A further quote from Wouter Bos highlights this point.¹⁹

From an economic perspective, tax competition therefore leads to efficient governments and the highest possible level of wealth for everybody.

There is only one very important side condition for this last statement to be true, and that is that the global markets are perfect and there are no market failures whatsoever. This is, I am afraid, not the case in real life.

When markets are imperfect, policy goals can not be achieved by market forces alone. The same is true for competing in the field of tax policies. Any competition needs some form of regulation, so does this one.

It is true that externalities are, in theory, a form of market failure. It is much harder to make that type of argument in practice. Tibor Scitovsky, more than 50 years ago, said that 'Definitions of external economies are few and unsatisfactory'.²⁰ That comment is as valid today as it was then. Economists differentiate between types of externalities. Pecuniary externalities are those that operate via the price mechanism, while technological externalities don't. Only technological externalities give rise to public policy responses. If they do exist, tax externalities are, at best, pecuniary externalities and wouldn't normally concern economists.

The tax-externality argument is the usual focus of popular discussion. The idea is that tax competition would trigger a ‘race to public poverty’, in which governments reduce tax on mobile bases (corporate income) and, in order to maintain government revenue, increase taxes on immobile tax bases. Alternatively, governments experience a loss of revenue, and either reduce expenditure or increase government debt, or inflate the economy. Spillovers, and allegations of ‘free riding’, have the advantage of being intuitively obvious to the layman, but technically difficult to prove. In essence, this definition, based on spillovers, is an appeal to populism and is empirically empty. Indeed the OECD admits this point on the very next page of the 1998 Report: ‘The available data do not permit a detailed comparative analysis of the economic and revenue costs involving low-tax jurisdictions’, and, further, ‘A regime can be harmful even where it is difficult to quantify the adverse economic impact it poses’.²¹ In other words, despite having no evidence to justify any policy intervention, the OECD had decided that tax competition was undesirable.

... one of the greatest benefits of mobile capital is that it disciplines government.

Conflicts of Vision²²

Attitudes towards tax competition will inevitably tempered by attitudes toward the legitimate role of government and markets. These attitudes can be seen with respect to views on both capital mobility and, more generally, fiscal policy and the trade-off between market and state. In one sense, the tax competition debate is simply a continuation of the exchange rate régime literature—should exchange rates be fixed or floating? One of the defining characteristics of the Bretton Woods exchange rate régime was that capital was meant to be relatively immobile. Policy makers have since come to accept that mobile capital is preferable to immobile capital. This, however, is a grudging acceptance; and schemes to fix exchange rates and control capital flows have died a slow and painful death. Reuven Avi-Yonah makes this link quite explicit. He argues that ‘Since the early 1980s, when exchange controls were relaxed, nominal tax rates have gone down sharply’.²³ The first vision is whether capital mobility can be considered to be ‘good’ or ‘bad’. The second vision is the view of government. The Nirvana view—the ‘standard model’—views governments as being benign, benevolent social-welfare maximisers. In contrast, the Leviathan model of government suggests that politicians and bureaucrats are self-seeking agents and are less likely to be benign.²⁴

Trust Politicians	Capital Mobility	
	Good	Bad
Yes	<ul style="list-style-type: none"> • Tax Harmonisation • Fixed Exchange Rates 	<ul style="list-style-type: none"> • Capital Controls
No	<ul style="list-style-type: none"> • Tax Competition 	<ul style="list-style-type: none"> • Dystopia

As policy-makers came to the view that capital mobility was preferable to immobility, so the preference for capital controls would change to a preference for tax harmonisation. In that sense, tax harmonisation is simply a sophisticated form of capital control. In this context tax harmonisation implies that different countries should have similar, if not identical, tax rates. Daniel Mitchell says ‘Harmonised tax rates eliminate fiscal competition, much as a price-fixing agreement among gas stations destroys competition for gasoline’.²⁵ As Wouter Bos tells us, ‘The OECD progress report describes standards and application notes with the aim of helping countries establish *a tax policy that is in line with the OECD standards*’ (emphasis added).²⁶ To be clear, no credible argument has been made for all countries to have identical tax rates. Indeed, the OECD argued, ‘there are no particular reasons why any two countries should have the same level and structure of taxation’, but then went on to say, ‘Countries should remain free to design their own tax systems *as long as they abide by internationally accepted standards* in doing so’ (emphasis added).²⁷ This begs the question, ‘What are the internationally accepted standards in setting domestic tax rates?’ While Bos has answered this question, the OECD itself is silent on this issue, yet it seems that so long as

different tax rates do not give rise to a behavioural response then harmful tax competition has not occurred. In other words, so long as the differences in taxes are too small to encourage a private sector response taxes can be said to have been harmonised. The OECD describes two sources of tax differential. First there may be a mismatch between two tax systems. This may be rectified by one or both of the countries changing their tax system, either by lowering or increasing the tax burden. The other source of tax differential is a deliberate decision taken by the government of one country to 'poach' economic activity from another – this apparently is harmful tax competition.

The Leviathan view is that government, not capital, should be controlled. Indeed, one of the greatest benefits of mobile capital is that it disciplines government. Even the OECD concedes, high-tax countries can reduce the impact of 'harmful' tax competition by modifying their own tax systems (i.e. lowering their tax rates). Proponents of free-markets should welcome tax competition, allegedly harmful or otherwise. Tax competition reduces the tax burden for everyone and increases economic activity for everyone. Indeed, Adam Smith recognised this in his *Wealth of Nations*²⁸

The proprietor of land is necessarily a citizen of the particular country in which his estate lies. The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could, either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country, would so far tend to dry up every source of revenue, both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour, would necessarily be more or less diminished by its removal.

In other words, governments have an incentive not to subject mobile capital to 'vexatious inquisition' lest that capital migrates. Leviathan is constrained in how much tax it raises. Richard Teather argues that an upper limit on revenue forces the state to be more efficient in providing public services. These arguments are true, yet given the phenomenal growth in government size it is clear that these constraints are somewhat weak. The benefits of tax competition are more likely to be observed in the private sector. High levels of taxation are known to create deadweight losses that have adverse economic effects. As Alex Robson has argued, 'There is little evidence to suggest that higher taxation increases GDP growth rates, and much evidence to suggest that the opposite is true'.²⁹ As Richard Teather argues, the opponents of tax competition motives 'are the same as those of all who protest against true global free markets: a tendency to worry more about risks than opportunities, a desire for the status quo, and a distrust of economic freedom'.³⁰

Opponents of tax competition are quite specific about the adverse consequences of that competition.

A second conflict of visions can be imagined. The traditional theory of public finance has three functions for fiscal policy: to raise revenue, to redistribute wealth, and to maintain macroeconomic stability.³¹ In particular, the tax harmonisation debate has concentrated on the second of these, in the progressive aspects of income tax. John Kenneth Galbraith is worth quoting in this regard. 'The only effective design for diminishing the income inequality inherent in capitalism is the progressive income tax. Nothing in the age of contentment has contributed so strongly to income inequality as the reduction of taxes on the rich; nothing, as has been said, so contributes to social tranquillity as some screams of anguish from the very affluent'.³²

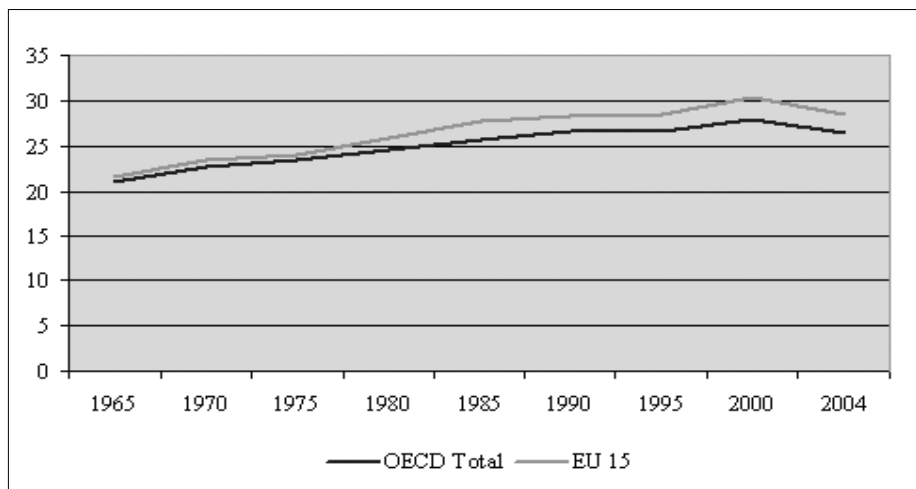
At best, fiscal policy can perform only one of these functions. It is not clear that fiscal policy is successful at redistributing wealth. Furthermore, arguments in favour of progressive taxation have been shown to be weak.³³ Nor has fiscal policy done very well in achieving macro-economic stability. These latter functions dovetail well when capital is immobile. Capital mobility is said to make macroeconomic stability harder to achieve, and redistribution impossible. Revenue is apparently reduced. In essence, much of the tax harmonisation debate is an argument about the

relative merits of the market versus the state, and the goals of fiscal policy. Those who believe markets work better than government, that international capital mobility is a good thing, and that fiscal policy should have narrow goals are more likely to support tax competition, while those who prefer government action and expansive roles for fiscal policy will prefer tax harmonisation.

Harm by Assertion

Opponents of tax competition are quite specific about the adverse consequences of that competition. The tax burden on (mobile) capital will fall and shift to (immobile) labour. The social safety net will be cut and the welfare state will experience a fiscal crisis. The OECD prepared a long list of consequences of tax competition, but nowhere in their report did they actually demonstrate that any of the potential harm had in fact occurred. The OECD, however, had good reason not to appeal to the facts. In this section, I review evidence that ‘harmful tax competition’ has actually occurred in the OECD, and also the EU-15. In Figure 1, I have plotted the Total Tax Revenue to GDP ratio for both the OECD and also the EU-15 over the period 1965–2004. This should provide some perspective on the extent of the fiscal crisis facing those economies.

Figure 1: Total Tax Revenue to GDP



Source: OECD Revenue Statistics 1965–2005; Table 4, p.72. Data exclude social security.

In 1965, total tax revenue (excluding social security) made up 21.0 per cent of GDP. By 2000 this figure had increased to 27.9 per cent. The EU-15 is in an even better position—tax to GDP (excluding social security) increased from 21.6 per cent to 30.3 per cent. On the basis of these data it is difficult to argue the welfare state is experiencing a fiscal crisis. Tax competition, however, is said to have a huge impact on capital taxes, and corporate tax in particular. A *Financial Times* editorial has argued, ‘Corporation tax is a dying tax ...’³⁴ John Braithwaite blames corporate tax competition on the Thatcher government, which lowered the corporate rate from 46 per cent to 34 per cent in 1984. Ireland has lowered its corporate tax rate to 12.5 per cent. Average corporate tax rates in Europe (and the world generally) have declined. So too, however, have personal tax rates. Chris Edwards and Veronique de Rugy have shown that personal tax rates had fallen on average by 20 per cent in the OECD over the period 1980–2000, while corporate tax rates have fallen by six per cent over the period 1996–2002.³⁵

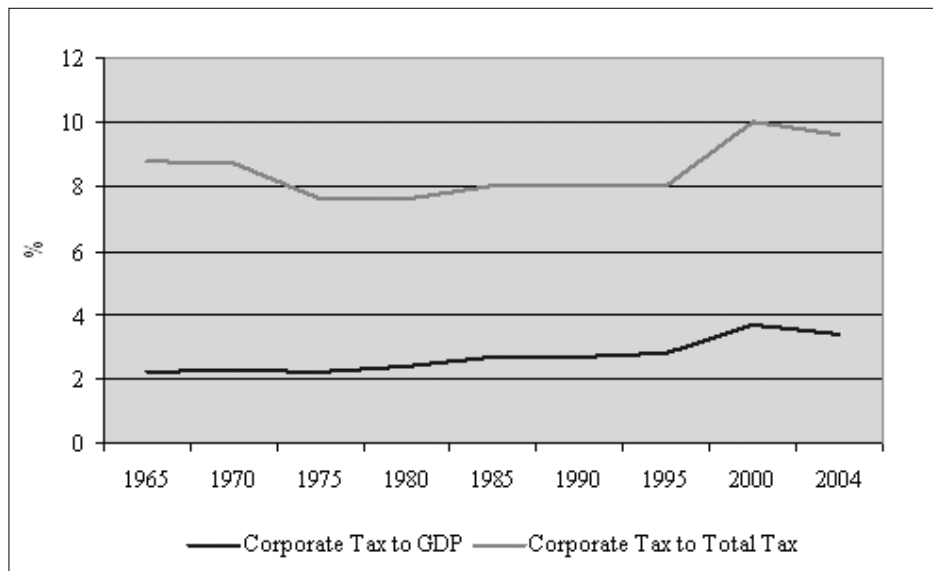
Revenue from corporate taxes increased—just as the OECD attempted to establish a tax cartel.

At this point, however, we encounter an important source of confusion in the tax competition debate. Tax rates and tax levels are not the same thing. The literature assumes existing tax rates are ‘optimal’. It is not clear what ‘optimal’ implies, but the implication is always that government revenue declines due to a decline in tax rates. This assumes that tax rates are always on the upward sloping side of their respective Laffer curves. Furthermore, the literature suffers from a ‘fatal conceit’ and the ‘pretence of knowledge’.³⁶ Nowhere is it ever conceded that tax changes may occur as a consequence of greater understanding of tax policy, or experience, or changing circumstances.

These ‘errors’, of course, are due in large part to the conflict of visions that permeate the debate.

The OECD Ministers first commissioned the OECD to investigate Harmful Tax Competition in 1996. To the extent that tax competition caused any harm, we might expect to observe declining tax revenue prior to 1996. In Figure 2, I plot the corporate tax revenue as a percentage of total tax and also GDP for the OECD over the period 1965–2004. Tax competition is said to have a huge impact on corporate tax in particular. Between 1975 and 1995 corporate tax increased from 2.2 per cent of GDP to 2.8 per cent, while it grew from 7.6 per cent to 8 per cent of tax revenue. There is no evidence of a decline in tax revenue from the source most vulnerable to tax competition.

Figure 2: Corporate Tax: OECD Total



Source: OECD Revenue Statistics 1965–2005; Table 13, p.76.

The post-1995 situation is very interesting. Revenue from corporate taxes increased—just as the OECD attempted to establish a tax cartel. It could well be argued that the dot.com bubble was responsible for the increased tax revenues in 2000. To some extent, tax revenues have decreased since then, yet are still well above the 1995 levels. The increase in corporate tax revenue since 1980 is particularly interesting, since many OECD economies have reduced their corporate tax rates since 1980. Eurostat calculates an implicit tax rate on capital income for the EU.³⁷ This measure adjusts for the fact that different EU members have different corporate tax bases, and the like.

Eurostat³⁸ describes the measure as ‘the average effective tax burden on the economic activities of private sector investment and saving by dividing tax revenues on capital by a measure of potentially taxable capital and business income in the economy.’ Over the period 1995–2001, the implicit tax on capital income increased by 4.8 per cent³⁹—that is, the tax burden increased at a time when ‘harmful competition’ was said to be driving it down.

It may well be the case that ‘harmful tax competition’ has put downward pressure on tax rates, yet it is difficult to conclude that governments have suffered any harm when tax revenues have increased. Indeed, given the increased share, corporate tax revenue has increased faster than both general tax revenue and GDP. The tax burden on individuals also increased over that period (from 7 per cent to 10 per cent of GDP for the OECD and for the EU-15 from 7.2 per cent to 10.9 per cent of GDP). In short, there is no evidence to support the notion that the OECD is experiencing reductions in tax revenue due to tax competition.

There is another point worth highlighting from the data on corporate tax revenue. For many nations in the OECD this source of revenue makes up a small proportion of total tax revenue, and a tiny proportion of GDP. Yet the authorities attempting to track down this revenue spend

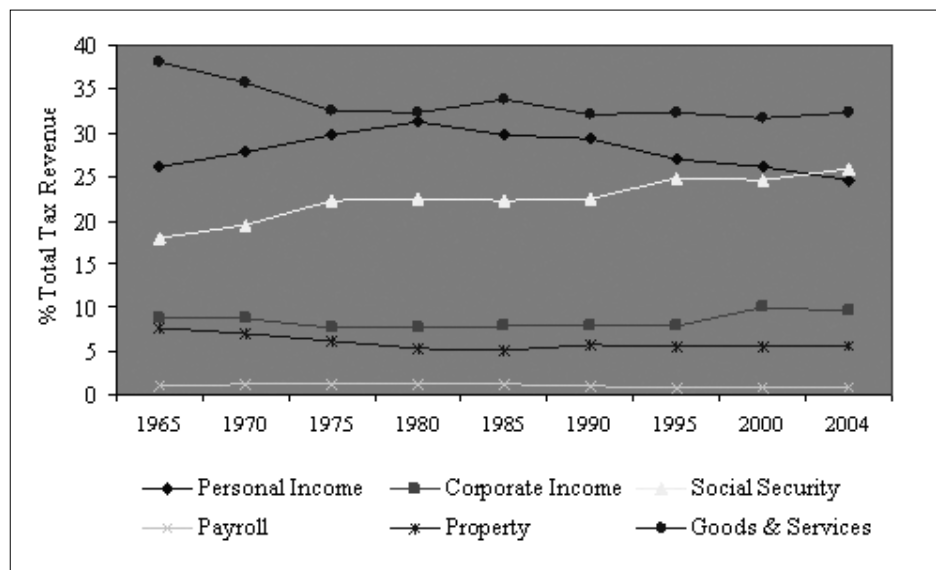
The OECD evidence is not consistent with ‘harmful tax competition’.

a lot of time and effort, and corporations complying with corporate tax legislation spend even more time and effort. This brings us to another problematic assumption in the tax competition literature. Corporations provide benefits beyond simply paying tax. While the tax authorities, and tax-economists, might assume that taxpayers exist simply to pay tax, shareholders, employees, consumers and governments may take a broader perspective. For example, a government may choose to lower taxation in order to boost domestic private investment, or reduce unemployment, and the like. Yet, the tax competition literature explicitly assumes that taxation exists for redistributive purposes and to provide revenue for public goods. The data show that governments and economists have had a huge debate over a threat to a very small portion of their overall revenue. Indeed, the figures show that this threat has not yet materialised.

... the debate over tax harmonisation has generated substantial heat, but little light.

Finally, I investigate the tax-mix across the OECD. To the extent that harmful tax competition occurs; tax burdens should rise for immobile resources, and fall for mobile resources. It is immediately obvious from Figure 3 that the central prediction of ‘harmful tax competition’ is not supported by the evidence. The personal income tax burden has fallen relative to other forms of taxation. The Social Security burden and the corporate tax burden have increased, while the property tax (predicted to increase) has been quite stable. In short, the evidence from the tax mix does not support any adverse effects from tax competition.

Figure 3: OECD Tax Mix



Source: OECD Revenue Statistics 1965–2005; various tables.

The OECD evidence is not consistent with ‘harmful tax competition’. The overall tax revenue of these economies has increased over time, and there is no evidence to support a shift of taxation from mobile to immobile factors of production.

Comparing the Gains

An important question—glossed over by the OECD—is surely this: how large are the potential distortions created by tax competition, or the lack thereof? Wallace Oates argued as recently as 2001 that ‘we have precious little evidence on this.’⁴⁰ Two recent papers have attempted to estimate, at an international level, the relative costs and benefits of tax competition and coordination. Ian Parry estimates that the welfare costs from tax externalities are generally less than 5 per cent of capital tax revenue.⁴¹ He concludes that his results ‘cast some doubt on the economic case for harmonising capital taxes across a bloc of regions such as the European Union.’

Peter Sorensen presents a far more comprehensive analysis of tax competition and coordination.⁴² He develops a plausible and realistic model providing a synthesis of existing knowledge of the

competition–coordination trade-off, and he also estimates (by calibration) the magnitude of gains from coordination. Importantly, for our purposes, he employs an egalitarian welfare function to evaluate welfare under the alternative tax regimes. In layman terms, that means that the government attempts to maximise the ‘satisfaction’ of the median voter. In this instance the median voter’s satisfaction increases with their own-after tax income and consumption and decreases if the distribution of income in the country becomes more unequal. The *best-case* scenario is shown in Table 1.

Table 1: Best-Case Scenario of Tax Competition and Coordination.

	Competition	Coordination
Policy Variables		
Capital Tax Rates	12.7	42.3
Labour Tax Rates	44.4	44.4
Transfers	100.0	177.0
Infrastructure Spending	100.0	95.0
Other Variables		
Capital Stock	100.0	88.0
Employment	100.0	99.0
Profits	100.0	95.0
GDP	100.0	95.0
Average Real Wage Rate	100.0	96.0
Real Interest Rate	100.0	109.0
Welfare Gain %GDP		0.94

Source: adapted from Peter Sorensen, 2004, Table 1, p.1201.

In the model, tax competition has no impact on labour income taxes. Further, in the Sorensen model, the largest impact of tax competition is not under-provision of public goods, but rather too little income and wealth redistribution. In particular, relative to full-blown tax competition, tax coordination would lead to higher capital taxes (of course), and higher redistribution—but lower infrastructure spending, lower capital stocks, lower profits, lower real wages, lower GDP, and higher real interest rates. All these changes would result in an increase in social welfare of less

than one per cent of GDP, but only if taxpayers have egalitarian objectives. What happens in the model that GDP falls but inequality falls by a greater amount *with the net effect* being an increase in the median voter’s level of satisfaction.⁴³ It is not clear that voters (or taxpayers) would have egalitarian welfare functions.⁴⁴ In short, taxpayers would be ‘happier’ because they would all be equally poorer. The egalitarianism assumption is very restrictive. Egalitarianism has a specific meaning in the social sciences that is not shared by the general population. Peter Saunders has investigated popular opinion and found that only 5 percent of Australians can be said to have solely egalitarian principles.⁴⁵ He concludes his investigation by saying,

The egalitarian definition of fairness, which is taken for granted by the social policy intelligentsia as the *only* relevant definition, does not therefore do justice to what most Australians mean by a ‘fair go’ in the contemporary period. Indeed, if our social affairs intellectuals and pressure groups ever got their way, and taxes and welfare benefits were both raised even higher than they are at present in order to narrow what they call the ‘income gap,’ the result would be the very opposite of what most Australians think a ‘fair go’ entails.

It is unlikely that Australians are uniquely non-egalitarian. In other words, Sorensen has a model of human behaviour that generally does not describe humans at all. But as Harold Demsetz has argued, one of the Nirvana fallacies is that ‘people could be different’.⁴⁶

... tax haven governments do not appear to be smaller than the governments of non-tax haven countries.

Table 1 shows results for the best theoretical case for tax harmonisation. When Sorensen estimates more realistic scenarios, he finds welfare gains would be highest in the Nordic economies (0.95 per cent) and lowest in Continental Europe (0.03 per cent). The increased welfare gains for the UK (0.63 per cent) and the US (0.13 per cent) are also quite low. In other words, the debate over tax harmonisation has generated substantial heat, but little light. In fact, under the most favourable conditions, the most light that tax harmonisation would ever produce is less than one per cent of GDP.

There is empirical evidence consistent with Sorensen's theoretical predictions. Mihir Desai, Fritz Foley and James Hines have reported that tax haven activity increases economic activity in nearby non-tax haven economies.⁴⁷ Due to the higher after-tax returns that multinational firms are able to enjoy as a consequence of tax havens, they are able to maintain higher levels of foreign investment than otherwise. This empirical result is entirely consistent with the Sorensen theory. In other words, far from having a negative impact on their neighbours, tax havens have a positive impact on economic activity; and there is no evidence that governments suffer any adverse revenue effects from tax competition either. What is particularly damning for the harmful tax competition argument is the fact that tax haven governments do not appear to be smaller than the governments of non-tax haven countries.⁴⁸

Gebhard Kirchgassner and Werner Pommerehne provide an empirical analysis of tax competition and harmonisation within a single economy.⁴⁹ Switzerland has a unique constitutional framework. It has a federal structure with a weak federal government vis-à-vis the cantons (states) and local government. The Federal government relies on consumption taxes, while the cantons levy progressive income taxes. Cantons levy income taxes at differing rates and there are no legal impediments to taxpayers moving from high tax cantons to low tax cantons (i.e., the Tiebout hypothesis appears to work). Kirchgassner and Pommerehne report that some tax competition does occur; high-income earners do appear to choose their residence on the basis of tax burdens. In contrast, however, they also report tax competition has not led to an undersupply of public goods. 'Thus, the negative consequences of competition with respect to direct taxes as feared, ... have not—at least until now—occurred'.⁵⁰

It is possible to speculate about tax harmonisation within Australia. Unlike Switzerland, Australia has a strong central government and weak state governments. The central government levies a progressive income tax equally across the entire federation and a flat consumption tax equally across the entire federation. The bulk of tax revenue, from all sources, is raised by the central government in what can be described as a fully coordinated harmonised tax regime. In terms of Sorensen's predictions of such a tax regime we might then expect tax rates to be too high, and the like. A full discussion of the benefits and costs of the Australian federation, however, are beyond the scope of this paper.

Conclusion

The debate over tax harmonisation has been heated, and extensive. To some extent, this has been a European debate. Of course, this is due, in part, to the political desire to harmonise economic activity within the EU itself. This, however, is only a small part of the issue. High-taxing economies within Europe have attempted to establish a tax cartel beyond Europe. The OECD has run a campaign of vilification against a number of its own members and also non-members. There is, however, no evidence that tax competition is eroding the tax base of OECD economies. As *The Economist* has indicated, 'governments have raised the alarm about globalisation so often that their credibility is in doubt. For all the talk of footloose capital heading for low-tax countries, starting a 'race to the bottom' in which governments slash taxes and services to lure global business, the taxman's cut of world income is larger today than it has ever been'.⁵¹ Furthermore, there is evidence that full-blown tax cooperation would reduce GDP, increase unemployment and real interest rates. If cooperation could work as economic theory indicates, and people had egalitarian preferences, then the best-case scenario would see a welfare gain of less than one per cent. As Charles McLure indicated, nearly twenty years ago, 'I have been quite surprised—not to say flabbergasted—by much of the formal literature that presumes to examine the supposed adverse effects of tax competition'.⁵²

Endnotes

- ¹ Surveys include John Wilson, 1999, 'Theories of Tax Competition', *National Tax Journal*, 52, pp.269–303; and Wallace Oates, 2001, 'Fiscal competition and European Union: contrasting perspectives', *Regional Science and Urban Economics*, 31, pp.133–145. The Institute of Economic Affairs has a 91-page monograph that spells out many of the arguments and debates—see Richard Teather, 2005, *The benefits of tax competition*, IEA and Profile Books.
- ² Quoted in John Braithwaite, 2005, *Markets in vice: Markets in virtue*, The Federation Press, p. 20.
- ³ Richard Teather, 2005, *The benefits of tax competition*, London, The Institute of Economic Affairs, pg. 25.
- ⁴ Daniel J. Mitchell, 2006, 'The moral defense of tax havens', *Notes from FEE*, www.fee.org.
- ⁵ Mitchell, *ibid*.
- ⁶ <http://www.ird.govt.nz/technical-tax/legislation/2006/2006-3/leg-2006-3-temp-exempt-tax-migrants.html>
- ⁷ Kevin Rudd, Budget Reply Speech, pg. 10, May 10, 2007, http://www.alp.org.au/download/now/address_in_reply_pdf.pdf
- ⁸ Fleur Anderson, 'PM pitches business tax reform', *The Australian Financial Review*, 27 September 2007, p. 1.
- ⁹ Teather, *ibid*. pg. 23.
- ¹⁰ http://www.minfin.nl/nl/actueel/kamerstukken_en_besluiten,2000/06/v00_390.html
- ¹¹ OECD, 1998, *Harmful Tax Competition: An Emerging Global Issue*, OECD Publications pp.14.
- ¹² As an economic argument it is very weak. It assumes that these individuals pay no tax in their home country but consume public services. At best these individuals have paid less for their public services than their government may have wished them to pay. Alternatively, the OECD needs to demonstrate that those individuals making use of tax havens also consume public services. It also fails as a moral argument; see Mitchell 2006, *ibid*, for arguments that show tax competition creates value for non-tax haven economies. In this latter view it is those who do not invest via tax havens who free-ride upon those who do.
- ¹³ Enrique Mendoza and Linda Tesar, 2003, 'A quantitative analysis of tax competition v. tax coordination under perfect capital mobility', NBER Working Paper 9746, www.nber.org/papers/w9746.
- ¹⁴ OECD, p.3.
- ¹⁵ OECD, p.74.
- ¹⁶ OECD, p.76.
- ¹⁷ OECD, p.16.
- ¹⁸ This is nonsense – the costs and benefits of intervention need to be evaluate before any government action is taken to alleviate so-called externalities. See also Arthur Seldon, 1990, *Capitalism*, Reproduced as *The virtues of capitalism*, Indianapolis, Liberty Fund, p. 235.
- ¹⁹ Bos, *ibid*.
- ²⁰ Tibor Scitovsky, 1954, 'Two concepts of external economies', *Journal of Political Economy*, 62, pp.143–151.
- ²¹ OECD, p.17.
- ²² Thomas Sowell has argued for two types of world vision, constrained and unconstrained (Thomas Sowell, 1987, *A conflict of visions: Ideological origins of political struggles*, New York: Quill). Here I offer a less philosophical treatment.
- ²³ Reuven S Avi-Yonah, 2000, 'Globalization, tax competition, and the fiscal crisis of the welfare state', *Harvard Law Review*, 113, pp.1575 – 1676, p.1577.
- ²⁴ This view of government is associated with Geoffrey Brennan and James Buchanan, 1980, *The power to tax: Analytical foundations of a fiscal constitution*, Indianapolis, Liberty Fund. For a similar view of government, see Andrei Shleifer and Robert Vishny, 1998, *The grabbing hand: Government pathologies and their cures*, Cambridge, Mass., Harvard University Press.
- ²⁵ Dan Mitchell, 2004, 'Tax competition and fiscal reform: Rewarding pro-growth tax policy', available for download, <http://www.cato.org/events/russianconf2004/papers/mitchell.pdf>.
- ²⁶ Bos, *ibid*.
- ²⁷ OECD, *ibid*. p. 15.
- ²⁸ Adam Smith, 1776, *An inquiry into the nature and causes of the wealth of nations*, University of Chicago Press, p. 375.

- ²⁹ Alex Robson, 2006, 'How high taxation makes us poorer', In Peter Saunders (ed), *Taxploitation: The case for income tax reform*, Sydney, Centre for Independent Studies, p. 38.
- ³⁰ Teather, *ibid.* p. 24.
- ³¹ Richard Musgrave, 1959, *The theory of public finance: A study in public economy*, New York: McGraw-Hill, p.5.
- ³² John Kenneth Galbraith, 1992, *The culture of contentment*, Boston, Houghton Mifflin, p.179.
- ³³ Walter J Blum and Harry Kalven, 1953, *The uneasy case for progressive taxation*, Chicago: University of Chicago Press.
- ³⁴ 'Ripe for rejection: Tax harmonization plans reflect Franco-German weaknesses', *Financial Times*, 14 May 2004, p.18.
- ³⁵ Chris Edwards and Veronique de Rugy, 2002, 'International tax competition', in James Gwartney and Robert Lawson (eds.), *Economic Freedom of the World: 2002 Report*, Vancouver, The Fraser Institute.
- ³⁶ FA Hayek coined these terms. See FA Hayek, 1988, *The fatal conceit: The errors of socialism*, Chicago: University of Chicago Press; and FA Hayek, 1974, 'The pretence of knowledge', in *New studies in philosophy, politics, economics and the history of ideas*, London, Routledge, 1978.
- ³⁷ Eurostat, 2003, *Structures of the taxation systems in the European Union: Data 1995–2001*, Luxembourg, Office for Official Publications of the European Communities.
- ³⁸ Eurostat, p.92.
- ³⁹ Eurostat, p.97.
- ⁴⁰ Oates, 2001, p.137.
- ⁴¹ Ian Parry, 2003, 'How large are the welfare costs of tax competition?', *Journal of Urban Economics*, 54, pp.39–60.
- ⁴² Peter Sorensen, 2004, 'International tax coordination: regionalism versus globalism', *Journal of Public Economics*, 88, pp.1187–1214.
- ⁴³ Sorensen, *ibid.* p. 14.
- ⁴⁴ See Peter Saunders, 2004, 'What is fair about a fair go?', *Policy*, Autumn, pp.3–10. Available for download at <http://www.cis.org.au/policy/autumn04/polaut04-1.pdf>.
- ⁴⁵ Saunders, *ibid.* p. 9.
- ⁴⁶ Harold Demsetz, 1969, 'Information and efficiency: Another viewpoint', *Journal of Law and Economics*. Reproduced in Harold Demsetz, 1989, *Efficiency, Competition and Policy*, Oxford, Basil Blackwell.
- ⁴⁷ Mihir Desai, Fritz Foley and James Hines, 2006, 'Do tax havens divert economic activity?' *Economics Letters*, 90, pp.219–224.
- ⁴⁸ James Hines, 2005, 'Do tax havens flourish?', *NBER Tax Policy & the Economy*, 19, pp.65–99.
- ⁴⁹ Gebhard Kirchgassner and Werner Pommerehne, 1996, 'Tax harmonization and tax competition in the European Union: Lessons from Switzerland', *Journal of Public Economics*, 60, pp.351–371.
- ⁵⁰ Kirchgassner and Pommerehne, p.366.
- ⁵¹ 'The mystery of the vanishing taxpayer', *The Economist*, January 2000; reproduced in *Globalisation*, 2001, London: Profile Books.
- ⁵² Charles E McLure Jr, 1986, 'Tax competition: Is what's good for the private goose also good for the public gander?', *National Tax Journal*, 39, pp.341–348.



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