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Tax competition: A curse or a blessing?

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Fiscal competition is often presented as harmful and distortive. On the basis that low-tax jurisdictions are unfairly attracting capital from less fiscally benign jurisdictions, the European Union and other countries (including the US), as well as several international organizations (such as OECD and IMF), are promoting policies aimed at preventing, or discouraging, the free flow of capital. This paper shows that the theoretical basis for this claim is unsound. Fiscal competition, in fact, is a powerful constraint on governments' natural tendency to grow. In a world without "tax heavens", taxes and public spending in today's high-tax jurisdictions would likely be higher. To support this:

- all the available evidence is reviewed, which shows that, since jurisdictions set their taxes with reference to the choices of other jurisdictions, it should be expected that more fiscal competition contributes, all else being equal, to keeping the tax burden under control;
- a game-theoretic model is developed to illustrate the reasons for this, apparently counter-intuitive, behavior.

Then the policies fostered by, among others, the EU and OECD are discussed. In particular, we look at the series of OECD studies dedicated to curbing "harmful tax practices." The European Union has also dedicated considerable effort to limiting the extent to which tax competition occurs within the continent and this tendency is likely to be further fostered by the Lisbon Treaty. An important role in this process has been played by the European Court of Justice and its rulings, and we expect its role to grow in the years to come.

Finally, some arguments against tax competition are addressed:

- The first common argument proceeds by claiming that tax competition distorts the allocation of mobile factors of production across countries. This presupposes that the initial allocation of capital between the two countries was optimal and that tax competition is driving it away from the optimum.
- The second argument recurrent in the literature says that tax competition can reduce tax revenue and endanger the stability of public finances. It implicitly assumes that the initial amount raised in taxes corresponded to some well-defined social optimum and therefore that tax competition was driving revenue below that optimal level.
- Finally, tax competition cannot really be separated from a competitive process of learning by which individuals in different jurisdictions can attempt at improving their domestic institutions by observing and copying institutions in neighboring countries. An imposed harmonization would eliminate this mechanism of evolutionary learning and institutional change.

Dalibor Rohác is MPhil Candidate in Economics. St Antony's College, Oxford OX2 6JF. E-mail: dalibor.rohac@sant.ox.ac.uk. *This policy paper is an extension of our previous work on tax competition, published as Rohác (2005, 2006). In the process of investigating issues of tax competition, we have benefited from numerous conversations and comments from Petra Orogványiová, Pascal Salin, Ondrej Schneider, Pierre Garello, Pavol Hardoš, Carlo Stagnaro and countless other individuals. All remaining errors are our own.*

Prior to concluding, we briefly address the issue of financial privacy which has been linked – although without any compelling justification – to tax competition. While we remain agnostic about the overall utilitarian "benefits" of policies restricting banking secrecy, we confess to being very uncomfortable with the idea that it is the individual who ought to be transparent in the eyes of the government, and not the other way around. In our view, this move goes against the ideas of Western constitutionalism and accountable and limited government.

Executive Summary

This paper discusses the nature and significance of tax competition. Recent decades in Central and Eastern Europe have been marked by a widespread adoption of flat tax rates on both personal and corporate income. These fiscal reforms were in general viewed as beneficial since they have eliminated loopholes and have made tax systems more transparent. Paradoxically, at the same time the process that has led to these particular fiscal outcomes – tax competition – is often labeled as harmful and distorting. The aim of this paper is to show that this is a deep misunderstanding.

We start by outlining some of the essential characteristics of tax competition and provide arguments for why it has become a very significant phenomenon over the course of past decades. This is particularly because the mobility of both capital and labor has increased, which has led jurisdictions into a state of competition for mobile taxable bases. We also review some of the evidence suggesting that jurisdictions have been setting their tax rates in an interdependent way, which shows that tax competition exists and is significant. To illustrate our point, we present a simple game-theoretic model in which we show the effects of tax competition on the ability of governments to raise revenue. We work with the assumption of revenue-maximizing Leviathan governments. Under this assumption, no mobility leads to the governments' taxing away all income. Under capital mobility and no cooperation, governments' ability to raise taxes is limited. Finally, if a collusive agreement between governments is enforced, capital mobility does not alter the fact that governments are able to tax away all the income, just as under the no-mobility scenario.

We then discuss policies fostered by the OECD and the EU in order to curb tax competition and analyze their economic foundations. In particular, we look at the series of OECD studies dedicated to curbing "harmful tax practices." The European Union has also worked to limit the extent to which tax competition occurs within the continent and this tendency is likely to be further fostered by the Lisbon Treaty. An important role in this process has been played by the European Court of Justice and its rulings, and we expect its role to grow in the years to come.

Most importantly, we try to come to grips with some arguments proposed against tax competition. The first common argument is that tax competition distorts the allocation of mobile factors of production across countries. The second argument recurrent in the literature says that tax competition can reduce tax revenue and endanger the stability of public finances. The troublesome feature of both of these arguments is that they start from the assumption of government benevolence and omniscience. For instance, the first argument presupposes that the initial allocation of capital between the two countries was optimal and that tax competition is driving it away from the optimum. Likewise, the second argument implicitly assumes that the initial amount raised in taxes corresponded to some well-defined social optimum and therefore that tax competition drives revenue below that optimal level. Hence neither of these arguments holds in the light of basic public choice theory which convincingly demonstrates that governments do have a tendency to overspend and overtax. Finally, tax competition cannot really be separated from a competitive process of learning by which individuals in different jurisdictions can attempt at improving their domestic institutions by observing and copying institutions in neighboring countries. An imposed harmonization would eliminate this mechanism of evolutionary learning and institutional change.

Prior to concluding, we spend a brief time addressing the issue of financial privacy which has been linked – although without any compelling justification – to tax competition. While we remain agnostic about the overall utilitarian "benefits" of policies restricting banking secrecy, we confess to being uncomfortable with the idea that it is the individual who ought to be transparent in the eyes of the government, and not the other way around. In our view, this move goes against the ideas of Western constitutionalism and accountable and limited government.

1. Introduction: The flat tax revolution

The G-8 Summit in L'Aquila concluded on July 8, 2009 with a declaration stating that "[w]e cannot continue to tolerate large amounts of capital hidden to evade taxation."[1] The financial crisis, and massively expensive bailouts and fiscal stimuli which have accompanied it, have revived the themes of tax competition and financial privacy as major policy issues. Angel Gurria, the secretary-general of the OECD has said: "At a time when governments need every tax dollar legally due to combat the world recession, such practices [tax evasion, bank secrecy] can no longer be tolerated."[2]

This paper argues that the both the current attacks on tax competition and financial privacy, and the long-standing and persistent opposition to tax competition on the part of international organizations such as the OECD and high-tax countries, are unjustified and should be fought vigorously. In our view, tax competition is an important discipline on governments. And this is especially so in situations like the one which we are facing nowadays, when governments attempt – mostly in vain – to spend their way out of a recession. By increasing the costs of raising revenue through inefficient forms of taxation, tax competition curbs the tendency of governments to overspend and distort their economies with harmful tax instruments. We will show that being opposed to tax competition means adopting a very naïve view of government as a benevolent and omniscient entity that ought to be left free to act unconstrained. Needless to say, we do not subscribe to this view and there is no persuasive argument for it in the economic literature.

The past decade was marked by a widespread adoption of flat income taxes throughout Central and Eastern Europe. This has rightly been seen as a sign of tax competition. Indeed, most of the flat tax reforms were openly justified in terms of attracting foreign investment. Throughout the region, the decrease in tax rates has been associated with fairly high rates of economic growth, in some cases close to 10% yearly. Estonia was an early bird, with a 26% flat tax rate introduced in 1994. This has progressively decreased to 24% in 2005, 23% in 2006, 22% in 2007, 21% in 2008 and is planned to further fall to 18% by 2011. Lithuania, another Baltic country, decreased its corporate tax rate to 29% and its top rate on individual income to 33%. Now, it levies a flat tax rate of 24%. There is no evidence for a fall in Lithuanian public revenues, quite the contrary. By eliminating loopholes and arguably also by generating a Laffer effect, tax revenues have gone up in Lithuania, accompanied by an increase in real wages and employment. Since 1995, Latvia has reduced its top individual tax rate to 25%. The corporate rate was reduced to 15% in 2004. In 2001, the Russian government introduced a 13-percent flat tax on individual income and a 24% flat tax on corporate income. Three years later, Ukraine introduced a 13-percent individual flat tax rate and cut its corporate tax from 30 to 25%. Georgia has had a flat tax of 12% since 2005.

In 2004, Slovakia introduced a 19% flat tax on both individual and corporate income, followed by Romania with a 16% rate. Within a few years, the Slovak economy has taken off sharply, attaining impressive growth rates and certainly not eroding its public revenues. In the Balkans, Serbia has introduced a 14% flat income tax both on corporate and individual income. Bosnia and Herzegovina – with the exception of Republika Srpska – is now taxing individual and corporate income at a 10% rate. Since January 2008, Albania has also had a 10% flat tax.

Of course, tax systems in all of these countries differ drastically in terms of the definition of the tax base, the extent to which they allow for various forms of deductions and so on. Most of them are therefore not flat tax systems in the strict sense but are mildly progressive. But it is undeniable that there has been a massive move towards simpler and less progressive income tax schemes and that this move was simultaneous in a large segment of Central and Eastern Europe. Furthermore, it appears that the new tax systems are popular among the general public and that there is little willin-

1 G-8 Declaration: Meeting of Heads of Government. L'Aquila, Italy, July 8, 2009. Cited in Owens and Saint-Amans (2009, p. 16).

2 Cited in Bessard (2009, p. 6)

gness across the political spectrum to return to more progressive tax schemes.[3] Hence flat taxes appear to be a stable equilibrium. The reasons for the popularity of these policies are manifold. First, simpler tax codes have eliminated loopholes and a number of special regimes that were accorded to different groups of individuals and corporations under the old income tax schemes. By doing this, flat tax systems have been perceived by the population as more just and more transparent. There is little evidence that the flat tax revolution has eroded tax bases in countries that have adopted flat tax rates. In most countries, the opposite effect was observed: elimination of loopholes and growth driven by an inflow of foreign capital has in some countries increased the revenue from income taxation. In other cases, a decrease in income taxation was accompanied by an increase in consumption taxes, leaving the change revenue neutral overall. In any event, that the flat tax revolution has left Central and Eastern European countries with more transparent, more efficient and more functional tax systems is recognized even by those who had initially opposed the idea of the flat tax. And here comes a paradox: although these fiscal reforms have in general been hailed as beneficial, the process that had led to them is often labeled as 'harmful tax competition.' The aim of this paper is to account for that incongruity and to show that tax competition is an instrument empowering the taxpayer and constraining the government's ability to raise revenue in arbitrary ways. It creates a pressure towards more efficient, more transparent and, indeed, more just tax systems. As such, it should be celebrated, not feared.

The organization of this paper is as follows. We start by discussing some of the defining characteristics of tax competition and the factors that have made tax competition more visible and more focal in recent decades. We also present a simple game-theoretic model that shows how strategic interaction between revenue-maximizing governments constrains their ability to raise taxes. Finally, we will look at some of the international initiatives directed against tax competition and show that the arguments which have been used to justify them are unconvincing.

2. How does tax competition work?

A result of an increase in capital mobility is that governments have more difficulty taxing capital. The process of tax competition is thus a process of attracting mobile tax bases to jurisdictions by lowering tax rates. By its nature, the process of tax competition is a process of interdependent setting of tax rates and tax bases. The main requirement for tax competition is a high mobility of capital and/or labor. Mobility of capital can be increased for instance by technological changes that allow individuals to move their funds electronically across continents or by relaxation of exchange controls.

Fiscal interactions between governments entered economics with Tiebout (1956) who presented a model of competition for mobile households, showing that – under certain assumptions including personal mobility – a diversity of competing jurisdictions can bring about an efficient output of public goods, with each jurisdiction offering a different bundle of both public goods and tax burden appealing to individuals with different tastes.

In the economic literature, tax competition is usually associated with taxation of mobile capital. Yet it should be stressed that the mobility of labor is a phenomenon that deserves our attention as well. Although evidence for increasing mobility of capital is ubiquitous,[4] we ought to recognize that mobility of labor has markedly increased over past decades as well. OECD (2001b) finds that there has been a substantial rise in migration for economic reasons. Some of these reasons are personal income taxes which vary between countries, in particular for the high-income individuals. One can also recall the persistent outflow of young Irish to the United Kingdom and United States. This trend seems to have been reversed by corporate tax cuts in 1981, followed by personal income tax cuts. Du-

3 E.g., the left-wing populist government coalition which has acceded to power after the 2006 election in Slovakia have made no attempt – in spite of the initial rhetoric – at modifying the tax system.

4 E.g. Leibfritz et al. (1997). Alfano (2001) extents their analysis to sensitivity to tax differentials.

ring the 1990s, Ireland has experienced a marked increase in immigration and a fall in emigration (Ireland Central Statistical Office 2001).

It is thus not entirely correct to distinguish between “mobile capital” and “immobile labor.” There are a number of factors of production with greater or lesser degrees of mobility, including various forms of capital and labor.

Avi-Yonah (2000) points out that the two fastest growing taxes in OECD countries in recent decades have been consumption taxes (from 12 per cent of total revenue in 1965 to 18 per cent in 1995) and payroll taxes (18 per cent to 25 per cent). Even though personal income taxes have not risen over that period (from 26 per cent of total revenue to 27), the total tax burden has grown from 28 per cent to almost 40 per cent, which is due mainly to the increase in consumption and payroll taxes, which seems to support our claims. Devereux, Griffith and Klemm (2002) observe data on tax revenue on corporate income as a proportion of GDP for the OECD countries during 1965-1999 and find that they have remained fairly stable, yet varied strongly across countries. In the same way, Carey and Tchilinguirian (2000) observe a small rise in the OECD average implicit tax rates on capital during the 1980s and 1990s. One explanation might be found in the Laffer curve – lower rates might have boosted profitable investment, increasing corporate income tax revenues as a portion of the GDP (or another variable, such as the operating surplus).

There has been a marked decrease in corporate tax revenues as a portion of total tax revenues. This suggests that governments are relying less on corporate taxation as a source of revenue and shifting the tax burden to other sources of revenue. Looking at measures based on tax legislation reveals that statutory tax rates in OECD countries were falling between 1982 and 2001, with the unweighted mean statutory rate going from around 48 per cent to around 35 per cent (Devereux, Griffith and Klemm (2002, p.11). Equally important, however, has been the development of corporate tax bases. Throughout 1980s and 1990s the weighted mean of rates of allowance fell from 83 per cent to 74 per cent, which means that the tax bases broadened during that period.

On the whole, one can conclude that there has been a decrease in corporate tax rates during the recent past. Governments do tax capital less than they did before. This does not mean that the overall tax burden has necessarily decreased over the past decades, only that the tax structure has changed, taxing labor and consumption more heavily than capital. What is more, empirical studies suggest that governments have been setting taxes interdependently. Since the pioneering study by Case, Rosen and Hines (1993) who estimate fiscal reaction functions for the US states, there has been a growing empirical literature on the subject, finding that the EU and the OECD nations have been setting taxes interdependently. Altshuler and Goodspeed (2002) investigate fiscal interdependencies among a subset of EU Countries and find that European countries interact strategically in setting their capital taxes. Devereux, Lockwood and Redoano (2002) study data from 21 OECD countries between 1983-1999 to conclude that countries actually compete not only over the statutory tax rates, but also over the effective rates. Redoano (2003) has confirmed previous findings concerning fiscal interaction within the EU. The evidence is aptly summarized by Altshuler and Grubert (2003): The evolution of country effective tax rates between 1992 and 1998 seems to be driven by tax competition. Countries that had lost shares of U.S. manufacturing affiliate real capital cut their rates the most over the period. Further, smaller countries and those with high initial average tax rates experienced larger declines in effective tax rates relative to the average.

2.1 A simple model

This model describes revenue maximizing governments competing for mobile capital which is the only source of tax revenue. There are two distinct countries indexed by *i*=1, 2. Each country uses a production function with decreasing returns to scale

$$Y_i = F_i(K_i), F_i' > 0, F_i'' < 0.$$

Different production functions for different countries reflect not so much differences in technology but differences in population. In the Cobb-Douglas case of $Y_i = A_i\sqrt{K_i}$, the constant A_i could stand for these differences. The total stock of capital is fixed and is distributed among the two countries so that

$$\overline{K} = K_1 + K_2.$$

where $\overline{K}$ is a constant. Government uses one tax instrument solely, a capital tax t_i defined by

$$r_i = (1 - t_i)F_i'(K_i)$$

where r_i is the after-tax return from capital and the price of output is normalized to unity. In other words, the tax puts a wedge between the real return from capital and the after tax return. The government is assumed to behave as revenue maximizer and faces the following problem:

$$\max_{t_i} t_i F_i(K_i), i = 1,2.$$

The revenue-maximizing assumption corresponds well to the Niskanen's (1971) characterization of public servants as budget maximizers. This assumption seems to be a good approximation of a Leviathan-like government without complicating matters by introducing a model of government decision-making processes or a model of voting as in Besley and Smart (2001) or in Janeba and Schjelderup (2004). However interesting their models might be, we find it advisable at this moment to introduce a more simple model showing uniquely the fundamental features of the process of tax competition.

The maximization problem is trivial if there is no capital mobility, that is, if K_1 and K_2 are constant. In this case, the function maximized is a monotonic transformation of t_i as the total output $F_i(K_i)$ is constant. In that case both governments will choose t_i equal to one and extract all output. Hence, in a world in which factors of production are immobile and in which taxation does not disincentivize people from pursuing productive activities, a revenue-maximizing government will choose to appropriate the whole output.

Let us focus our attention now on the polar opposite case – a situation in which there is perfect capital mobility across countries, although it is clear that most real world situations are somewhere in between. Under perfect capital mobility, capital moves from one country to another until the after-tax return is equalized:

$$(1-t_1)F_1'(K_1) = (1-t_2)F_2'(K_2).$$

Now, provided that

$$K_2 = \overline{K} - K_1.$$

the arbitrage condition can be restated as

$$(1-t_1)F_1'(K_1) = (1-t_2)F_2'(\overline{K} - K_1)$$

and K_i a function of t_1, t_2. It is easy to see that K_i is strictly decreasing in t_i and strictly increasing in $t_j, j \neq i.$

It is important for further analysis to say how governments perceive each other's tax rates. If each government considers the tax rate of its counterpart as a constant, then tax competition will be a Nash game of simultaneous tax rate setting and the outcome can be characterized as a Nash-Cournot equilibrium. This can be the case when the competing jurisdictions are of much the same size. In a Cournot game, both governments face the problem $\max_{t_i} t_i F_i(K_i(t_1, t_2)), i = 1,2.$.

The first order conditions are

$$F_1(K_1(t_1^*,t_2^*)) + F_1'(K_1(t_1^*,t_2^*))\frac{\partial K_1}{\partial t_1}(t_1^*,t_2^*) = 0$$

$$F_2(K_2(t_1^*,t_2^*)) + F_2'(K_2(t_1^*,t_2^*))\frac{\partial K_2}{\partial t_2}(t_1^*,t_2^*) = 0.$$

Solving these yields reaction functions for both governments $t_1^* = \varphi(t_2), t_2^* = \varphi(t_1)$. The uncooperative Cournot equilibrium tax rates t_1^*, t_2^* will be solutions to this equation.

Alternatively, one can imagine a situation when one of the countries behaves as a Stackelberg leader. This is the situation described by Altshuler and Goodspeed (2002) who noticed that European countries might be behaving as Stackelberg followers with respect to the United States, while behaving as Nash players with respect to each other.The situation when one of our governments is a Stackelberg leader could be formally described as follows.

Without loss of generality, the country 1 is the Stackelberg leader. Hence, his maximization problem is:

$$\max_{t_1} t_1 F_1(K_1(t_1, \varphi(t_1))),$$

as he would expect the follower to act according to its reaction function. The solution of this maximization problem yields the Stackelberg equilibrium tax rates $\tilde{t}_1, \tilde{t}_2$.

The third and perhaps the most telling situation is the one in which the governments cooperate in order to maximize the total of their revenues. The equilibrium tax rates would be

$$\arg\max_{t_1,t_2} \{t_1 F_1(K_1(t_1,t_2)) + t_2 F_2(K_2(t_1,t_2))\}$$

It is not straightforward to find the equilibrium tax rates through the maximization problem governments face when engaged in cooperation. Intuitively, it is clear that tells us that the governments will cooperate in order to drive tax rates up to one - just as in the no-mobility scenario. The model, however, ignores the transitional dynamics of collusion. Would the governments just jump from whatever tax rates and capital allocations they have at the moment to the revenue-maximizing collusive vector of taxes? This might be one possibility. The other, and perhaps more empirically palatable one is that the governments will increase their tax rates progressively towards one but will do so in a way as not to distort capital allocation between the two countries in an inefficient way. In the case of such cooperation it is possible for the governments to set $\frac{1-t_1}{1-t_2}$ to a constant maximizing the total value of output and then proceed by increasing both tax rates while keeping the above ratio constant. In terms of productive efficiency, such a tax cartel would of course be efficient insofar as it maximized the total value of output. However, from the perspective of the individual taxpayer, the outcome of the collusion is identical to a situation of total slavery since he will not be able to appropriate any part of the surplus for himself.

If we relax the assumption of fixed capital stock in favor of capital stock that results out of individuals decisions to save, it is not difficult to see that the above cartel would soon destroy individual incentives to accumulate capital and to engage in productive activities.

A possible objection would consist of saying that in a model in which capital stock evolves over time according to individual saving decisions the government's problem would be different from the one depicted above. The government would not maximize its current revenues but would rather maximize the discounted stream of tax revenue, including future revenue. However, the problem with this

argument is that, even if true, there are numerous reasons to believe that the government would discount heavily, if not myopically, future revenues and would focus most of its attention on current revenue. The simplest explanation for that lies in the nature of democratic politics. An executive politician is elected for only a limited period of time and hence does not derive strictly any benefit from the ability of his successor to raise public revenue. The myopic behavior of democratic politicians is obvious in the current era and the setup of our model would, on our view, be robust to a dynamic extension that would easily demonstrate the destructive potential of capital taxation.

3. The attack on tax competition and financial privacy

For some time, tax competition has been an issue that some believed ought to be tackled at the international level. There have been several initiatives by international bodies that aimed at subjecting tax competition to control and regulation. Our account of the development of tax systems would hardly be complete without mentioning at least two major international organizations that have attempted to deal with tax competition – the OECD and the EU. In this and in the following sections, we will review both their activities and the arguments used in the debates over the potentials problems with tax competition and their connection to economic theory.

One of the best known initiatives against tax competition was the one started by the OECD in 1998 after publishing OECD (1998). The report focuses on allegedly harmful tax practices in member states and in so-called tax havens. The report was followed by another one, OECD (2000) which monitors the progress achieved and somewhat elaborates the arguments against what it calls "harmful tax competition." The report divided harmful tax practices into two categories – "preferential tax regimes in member countries" and practices used by jurisdictions outside the OECD, deemed to be "tax havens."

Both categories were defined by roughly the same criteria – by corporate taxes that allowed a significantly lower effective level of taxation than those that applied in member states and lack of transparency and exchange of information (otherwise known as financial privacy). To qualify as a tax haven, the OECD used the criterion of a "lack of substantial activities" on the part of companies incorporated in the jurisdiction. However, this criterion turned out to be quite impossible to interpret and was eliminated later on.[5] OECD (2000) contained a list of 47 "harmful" practices within member states and 34 jurisdictions meeting the criteria of "tax havens." Those considered uncooperative – not agreeing to abandon the aspects of their tax systems that were considered harmful – were threatened with "defensive measures." It is important to note that they were not limited to simple enforcement of existing tax regimes, but went beyond that, introducing penalties for dealing with such jurisdictions.[6]

The report recommended that member states deemed to have harmful tax regimes should eliminate features considered harmful, which basically meant to raising tax rates and/or restraining financial privacy. Similar advice was given to non-member jurisdictions deemed to behave as tax havens.

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5 OECD (2001, p.10).

6 According to OECD (2000), member states should:

- Disallow deductions, exemptions and credits that would have otherwise been applied to transactions with uncooperative tax havens.
- Adopt controlled foreign corporation legislation and/or apply them in a consistent manner
- Deny any exceptions to the application of regular penalties in the case of transactions involving entities operating in uncooperative tax havens.
- Impose withholding taxes on certain payments to residents of uncooperative tax havens.
- Enhance audit and enforcement activities with respect to transactions with uncooperative tax havens.
- Not enter into tax conventions with uncooperative tax havens and consider terminating such conventions.
- Impose charges or levies on certain transactions involving uncooperative tax havens.

By 2001, 5 jurisdictions had pledged to eliminate their "harmful tax practices." They were Aruba, Bahrain, the Isle of Man, the Netherlands Antilles and the Seychelles.[7] According to OECD (2004b), all of the 47 "harmful" tax practices within member states, which were mentioned in the 2000 report, have been either abolished or amended so as not to be "harmful" any more. Likewise, the overwhelming majority of non-member jurisdictions identified in 2000 as "tax havens" are now "committed to transparency and effective exchange of information." Until recently, the remaining uncooperative tax havens were Andorra, the Principality of Liechtenstein and the Principality of Monaco but they have now adopted the OECD standards and signaled their willingness to cooperate. With the intention of having competition based on economic rather than on fiscal considerations, the OECD has introduced the concept of "global level playing field." The campaign aims at stopping business migration to jurisdictions where transparency and effective exchange of information is not at OECD-required level, that is, where financial privacy is respected.[8]

Particularly in times of the crisis, the OECD has been successful in pushing forward its agenda. Hong Kong, Macao and Singapore have announced that they would adopt the legislation needed to comply with the Global Forum on Transparency and Exchange of Information standards in 2009. Since November 2008, more than 120 tax information exchange treaties have been signed and many more have been initiated. Tax evasion and financial secrecy have been discussed extensively at recent G-20 and G-8 summits, where the governments have reached a consensus over the alleged need to combat these phenomena.[9]

The G-8/G-20 and OECD initiatives have been somewhat ambiguous in their content. On the one hand, they aim at "leveling the field" of capital taxation in order to minimize the alleged distortions related to tax-motivated capital moves. On the other hand – and unrelatedly – they try to restrict financial privacy to facilitate exchange of information between governments, which would then allow governments to keep a better eye on their citizens and their revenue.

In a similar manner, there have been several initiatives at the EU level to regulate tax competition, although the issue of direct taxation is not covered by the powers given to EU bodies. Furthermore, any decisions the EU might take in the area of direct taxation must be taken with unanimous support. Nevertheless, member states are constrained to some degree by provisions of existing treaties that define properties of the single market. According to the Community Law, member states must not:

- Hamper the freedom of movement of persons, businesses and capital and the freedom to provide the cross-border services.
- Distort conditions of competition through the provision of tax breaks and relief in the form of state aid.
- Discriminate on grounds of nationality in areas falling within the scope of the EC Treaty.[10]

The first attempt to deal with issues of corporate taxation can be found in the Neumark report of 1962 which concluded that a harmonization of tax bases was desirable in order to simplify existing European tax systems. The proposal was repeated in the European Commission memorandum of 26 June 1967. More recent attempts to harmonize tax bases include the European Commission (2001).

More interestingly, in March 1969 the European Commission published a memorandum demanding harmonization not only of tax bases, but also of tax rates, followed by the 1975 Action Program, which received little attention from the Council. Raising the problem again, a 1992 review for the European Commission suggested a harmonization of corporate tax rates at a minimum of 30 per cent, which was perceived as relatively acceptable at the time, but would hardly be conceivable nowa-

7 OECD (2001, p. 9).

8 OECD (2004a).

9 See Owens and Saint-Amans (2009) for a review of the OECD's work on tax evasion and financial secrecy.

10 See Checutti (2001).

days.[11]

In 1997, the Council of the EU adopted a code of conduct on corporate taxation, which was marked by a new, voluntary approach. The member states were called to avoid behavior considered harmful. By harmful it meant "those business tax measures which affect, in a significant way, the location of business activity within the Community."[12] That is, the code banned tax measures that were giving preferential treatment to a group of firms and offering a significantly lower tax rates than those usually applied in the Community. On 1st December 1998 a joint statement by France and Germany called for "a rapid progress towards tax harmonization in Europe."

Gammie (2003) points out that the European Court of Justice (ECJ) played an important role in forming national tax policies, basically by ruling against certain practices, considered unacceptable under European law, particularly under the European Community Treaty. It is questionable, however, to what degree the ECJ decisions are relevant for the purposes of the present work. The ECJ has only rarely tackled a lawsuit concerning tax rate differentials as such, it is more common for corporations to take member states to court for limiting how they can report profits.[13] In Hurd v Jones the ECJ ruled that a member state was justified in levying a tax on remuneration paid to its own nationals where remuneration paid to nationals of other member states were exempt of tax, provided that the situation was wholly internal to the member state. The same reasoning has been used by the ECJ in situation where nationals of a member state were subject to higher rate because they did not reside in that state yet kept most of their assets or worked there. Nevertheless, this does not mean that member states are free in discriminating against their own nationals if they are seeking to exercise one of the freedoms guaranteed by the EC Treaty. To complicate matters, the ECJ position on this particular point has not been entirely clear – in Bachmann v Belgian State it ruled that a business may be required to be established in the host state, if this is deemed to be necessary for attainment of an objective of public interest. On the other hand, in Asscher v Staatssecretaris van Financien, the ECJ held that it was unjustifiable for Netherlands tax authorities to apply a higher rate to a non-resident on the basis that no social security contributions had been levied on the income of the non-resident in Netherlands.

There are important political pressures from high-tax nations such as France or Germany to curb the flat tax revolution in Central and Eastern Europe. It comes as no surprise that the Lisbon Treaty provides subtle hints at tax harmonization.[14] So although the ECJ is not a prime mover in the process of tax harmonization, it is likely to play an important role in future attempts. While the Lisbon Treaty does not allow for an explicit harmonization of tax rates, the "and to avoid distortion of competition" clause is likely to empower not only the Council but also the ECJ to produce rulings that tax rate x in country z is distorting competition and should be increased. From this perspective, the Lisbon Treaty represents a move towards less, not more tax competition.

11 European Commission (1992).

12 Council of the EU (1998).

13 Most national tax systems discriminate against transactions with foreign countries by using transfer pricing legislation or controlled foreign corporation regimes. All these should be, strictly interpreting the EC Treaty, considered illegal.

14 See Article 2.79 of the Lisbon Treaty. The amended Article 93 of the Treaty on Functioning of the European Union reads now: „The Council shall , acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition." (emphasis added to mark the amendment)

4. The crux of the debate

Given the concerns tax competition raises worldwide – and given the wide range of policies that are being put in place in order to curb it - it is only appropriate to ask whether it is something that should be feared, or whether it is something to be embraced. From the outset, one should clearly say that the alternative to tax competition is tax harmonization and abolition of preferential regimes. This raises the question whether - once tax competition is abolished - governments would not compete in different, markedly less efficient manners, such as subsidizing foreign investments from the public purse etc.[15]

There are essentially two categories of arguments that opponents of tax competition have articulated. First, it is argued that tax competition changes international allocation of capital in an inefficient manner, with capital as a mobile factor flowing to areas where it is taxed less, regardless of genuine economic considerations. Second, it is asserted that tax competition leads to a deterioration of tax bases, ultimately causing an underprovision of public goods.

The first argument can be found in a number of publications. The OECD (2000) says:

> [T]he project (the OECD Project on Harmful Tax Practices) is about ensuring that the burden of taxation is fairly shared and that *tax should not be the dominant factor in making capital allocation decisisions*. (OECD 2000, p.5, emphasis added)

The same argument is developed in OECD (2004a). It is claimed that when investment decision are influenced by tax considerations, this results into an inefficient allocation of capital across countries. Peggy Musgrave makes this point this way:

> Resources and capital in particular will flow to locations where taxes (or more precisely, net fiscal residuals) are lower, thereby distorting the regional allocation of factor use and thereby impairing the efficiency of the private sector.
>
> (...)
>
> Each jurisdiction taxing on a source basis will tax income accruing to foreigners so as to maximize the advantages it can derive therefrom. Lower rates of tax rates will attract foreign capital and raise the base, while higher rates will increase revenue from a given level of foreign capital. The outcome will depend on the elasticities of capital inflow responses, but there is no reason to expect that they will match the domestic share called for by the rules of internation equity. (Musgrave 1991, p.286)

One is compelled to admit that, if capital taxation was coordinated so as to equalize EMTR and EATR across countries, mobile factors would be allocated geographically in an efficient manner. Hence, a coordinated action might seem to be needed to harmonise capital taxes and to bring about that outcome. As the European Commission states,

> [S]ome harmonization of business taxation (both corporation tax and the personal taxation of dividends) may be required to prevent distortions of competition, particularly of investment decisions. Where tax systems are non-neutral – i.e. where relative post-tax rates of return do not correspond to relative pre-tax rates of return – resources will be misallocated. (European Commission, cited in: Mitchell (2004, p.14))

The argument follows a perfect internal logic. It sees the core of the problem in the existence of tax differentials and it proposes tax rate harmonization as the remedy. Furthermore, the harmonization is to be achieved by introducing a minimal rate, as in European Commission (1992). But if the problem of capital misallocation is caused by differences in tax rates among countries, than introducing

15 Janeba (1998) combines competition over strategic trade policies with tax competition and shows – perhaps surprisingly - that competition leads to elimination of wasteful subsidies. Likewise, Janeba and Smart (2002) finds that a restriction on tax preferences can induce governments to behavior leading to inefficient outcomes.

a maximal rate is a solution that would be equally appropriate. Yet we are not aware that anyone who subscribes to the argument against tax competition presented above would ever propose such maximal tax rate. It is also important to note that distortions in capital allocation are caused not only by capital tax differentials, but also by the absolute value of tax rates. Capital taxation in itself discourages investment by taxing away corporate profits and individual capital gains, as for instance Alesina et al. (1999) demonstrate in their model. In the same manner, capital taxes distort intertemporal allocation of resources by taxing deferred consumption more heavily. As a result, one should underline that in order to reduce distortions caused by capital taxation, it is crucial above all to decrease capital tax rates and not to equalize them at an arbitrary level.

In our eyes, tax competition might well offer a solution to the alleged problem of misallocation of capital caused by tax differentials. If tax competition was a "race to the bottom," then the final outcome would actually be a tax rate harmonized across countries and harmonized at a rate of zero per cent, thus eliminating capital tax distortions altogether.

This brings us to the second argument used in favor of tax harmonization: the idea of a "race to the bottom." It is argued that if tax competition is unconstrained, competing nations would set lower and lower rates on mobile factors, endangering their own tax revenues and ultimately supplying an inefficiently low level of public goods. Furthermore, if public goods manifest positive externalities across borders, inhabitants of low tax jurisdiction areas bordering with high tax jurisdictions will tend to behave as free riders and elect representatives that will supply them a lower amount of public goods, as they will benefit from cross-border spill-overs. This argument has been pervasive in the literature on tax competition since Oates (1972) and the pioneering article by Zodrow and Mieszkowski (1986). In this spirit, Avi-Yonah (2000) states:

> Tax competition, in turn, threatens to undermine the individual and corporate income taxes, which traditionally have been the main source of revenue (in terms of percentage of total revenue collected) for modern welfare states. The response of developed countries has been first, to shift the tax burden from (mobile) capital to (less mobile) labor, and second, when further increased taxation of labor becomes politically and economically difficult, to cut the social safety net. (Avi-Yonah 2000, p.1)

It is true that competition forces government to increasingly switch from taxation of capital to taxation of labor income and to consumption taxes. But is it something that should be denounced? We do not think so. Capital income taxes are especially harmful for intertemporal allocation of resources and affect growth rates significantly. A standard result of public finance literature is that taxing capital income should be avoided if less distortionary tax instruments are available. A transfer of tax burden from taxation of capital for instance to generalized consumption taxation would then be most welcome. But what if tax competition truly endangers the amount of social security services, or public goods in general? Razin and Sadka (1989) find in their model:

> If (. . .) there is not sufficient coordination with the rest of the world to allow each country to tax its residents on their income from capital in the rest of the world, then tax competition leads to no tax whatsoever on capital income (. . .) Naturally (*sic*) the outcome of tax competition in the case in which the countries cannot their residents on capital income from the rest of the world is welfare-inferior to the case where they can. Thus there are gains for competing countries from tax coordination. (Razin and Sadka 1989, p.4)

Peggy Musgrave (1991) puts it this way:

> Movement, in particular of capital, to low-tax locations permits the owner who resides in a high tax location to act a free rider enjoying a high level of public services without contributing to their cost. As a result, voting patterns will be distorted, burdens will be shifted, and an inefficient level of public provision will result. (Musgrave 1991, p.286)

Regardless of whether other tax instruments are available or not, to arrive at these conclusions, the

above-mentioned authors must make a number of heroic assumptions concerning the motivations of the policymakers. They must presume that governments behave as benevolent welfare maximizing-agents which were initially supplying the efficient amount of public goods. If this was the case, then tax competition would really lead to a welfare-deficient situation. Yet these assumptions are completely detached from reality. First of all, it should be clear that the vast majority of government activities have little to do with providing public goods and that we are witnessing an important expansion of government spending, which is due mainly to inefficiencies inherent in government operation. These may include a lack of knowledge on the part of the voters and government officials and lack of incentives to acquire relevant knowledge (rational ignorance).[16] In addition, voting procedures are unstable and competition in political markets is imperfect (public goods are "sold" in bundles). Furthermore, one should mention the existence of rents and their effects on discretionary behavior of public servants, politicians and interest groups[17]. The judiciary and public servants represent extremely powerful interest groups themselves.[18] Their activities can often be described as the behavior of budget maximizing bureaus –not benevolent planners aiming at maximizing society's welfare. Moreover, government behavior through time is yet another source of inefficiency. Governments change periodically, which induces a myopic behavior such as deliberate redistributive manipulations in order to acquire votes and so forth.[19]

Block (2003) provides evidence for this – admittedly not very sanguine – model of government behavior, using data for a large number for developing countries. In the same spirit, Drazen and Eslava (2005) offer both a model of the Political Budget Cycle and evidence using data from Colombian municipalities. It is for all of these reasons that democratic governments tend to grow, often resembling the well-known Leviathan. At the current point in time, no plausible reduction in the scope of their activities can possibly affect the quantity of public goods provided and, indeed, each and every reform aiming at this reduction is badly needed. Thus, if tax competition restricts governments in their taxing powers, it is something that should be hailed and not feared.

Another set of arguments raised against fiscal competition is of normative nature. It is unfair, it is alleged, for one group of individuals to be able to switch their income-earning assets to low tax jurisdictions, while the majority of the general public has to pay high taxes in the jurisdiction of residence. It is difficult to refute an argument based on normative assumptions concerning distribution of wealth in a society, for it often boils down to an argument about what one believes to be morally right and wrong. Nevertheless, several remarks deserve to be made about the normative position presented above.

First, with increased mobility of capital, it is not that difficult even for the general public to invest abroad and to avoid paying taxes in high-tax jurisdictions. What once was privilege of a few is now a common practice, and thus this argument loses much of its initial appeal.

Second, if we assume that tax avoidance is practiced mainly by a high-income minority, it is still difficult to say that it is something morally unacceptable. High income individuals pay a lot more in taxes than low income people do though they consume basically the same public goods. Is this fair? One might respond affirmatively by pointing at a need of solidarity within a society, yet this response would be completely arbitrary.

It is equally defensible to say that everyone should pay exactly the same amount in taxes and that a higher taxation of rich people is morally wrong; the latter being the normative position to which

16 Caplan (2007) makes a convincing case that the situation might be even worse than that. He shows that not only voters are ignorant, they are willingly biased and "rationally irrational" as voting behavior is a case of public goods production in which it is individually optimal to yield to passion and prejudice instead of following rational arguments.

17 Tullock (1967), Krueger (1974).

18 Tullock (1980), Niskanen (1971).

19 Rogoff (1990) describes in detail systematic distortions in public expenditures as a function of elections.

we adhere. In that case, tax avoidance is a justifiable act. What is of interest to us is that in the real world, tax competition emerges as a means of subjecting governments to more discipline and allows individuals to escape the burden of prohibitively high taxation. That is the commonsense argument that we try to put forward in this work. The idea emerges from a particular vision of the government, notably the one presented in Buchanan and Brennan (2000). This vision does not take the benevolence and the efficiency of government for granted and attempts to provide economic insights into the political process. An economic theory of tax competition which overlooks the role of political processes misses what is crucial in the whole issue. There have been several attempts to model effects of tax competition on welfare, taking into consideration the existence and nature of politics. Besley and Smart (2001) for instance consider both yardstick competition and tax competition in the strict sense. The latter is modelled as an increase in marginal costs of public goods. The authors represent the political process as a game with imperfect information from the part of voters, who cannot a priori distinguish "bad" (those maximizing their own rents) from "good" (those maximizing voters' welfare) politicians. They find that tax competition may enhance welfare if it leads to an increase in the ability of voters to detect bad political incumbents. Yet if there are other means available to discipline officials, tax-competition can conceivably decrease welfare.[20]

It is important to emphasize that yardstick competition in fiscal matters, i.e. competition among jurisdictions, which is based on imitation and learning, is in reality inseparable from tax competition, although it represents an analytically distinct category. In the strict sense, tax competition is only about attracting mobile tax bases while yardstick competition is a more complex process of learning and improving institutions by observing institutions in neighbouring jurisdictions and adopting their best practices. Clearly, these two phenomena go together in the real world. The flat tax revolution was not only a situation in which various Central and Eastern European have been setting taxes strategically so that investors locate in this or that particular country. It was also a process of various countries noticing that neighboring countries had adopted tax policies with favorable effects on growth and deciding to imitate them. Hence, competition is a necessary feature of institutional learning and a prerequisite to discovering the best policies. In a world without tax competition, no one can empirically verify that this or that fiscal institution or tax instrument is harmful and distorting since there is no space for experimentation. With tax competition – whatever its motives or exact strategic character – governments and voters can learn and imitate those who have tried policies that have been successful.

Finally, we ought to touch – however briefly – the issue of financial privacy, banking secrecy and tax evasion, since much of the more recent efforts of G-8/20 governments and of the OECD was not directed that much at harmonizing tax rates per se, but rather at introducing "transparency" into financial transactions and ensuring that no one can easily avoid paying taxes by moving his or her income to a low-tax jurisdiction. To quote the London G-20 Communiqué, "[t]he era of banking secrecy is over."[21] The motivations behind the pressure to eliminate financial privacy are manifold. They range from perhaps legitimate concerns about sources of terrorist funding and laundering income coming from criminal activities to an explicit attempt to make legal tax avoidance more difficult and more costly. Now, from an economist's perspective, it is difficult to comment on whether this move is desirable by some utilitarian benchmark. Clearly, the imposition of transparency in these matters will mean that governments will be more able to detect sources income that would have otherwise re-

20 Among other attempts to represent tax competition within a more general framework of a model of political processes, Janeba and Schjelderup (2004) deserve mentioning. Their paper present a comparative public finance model of both European-style parliamentary democracies and US-like presidential-congressional systems and show that increasing tax competition is likely to improve voter welfare. The main merit of their work is that they speak in the language of standard tax competition theoreticians, uniting in their models both the distorting effects of tax competition and distorting effects of political process itself and they show that increased competition can indeed improve utility.

21 Cited in Owens and Saint-Amans (2009, p. 17-18)

mained hidden to them and will thus be in a better position to prevent individuals and corporation from rearranging their assets in ways that minimize their overall tax burden. From this perspective, all of the arguments that we have pushed forward throughout this paper apply and coordination appears rather undesirable. But at the same time, it might well be the case these measures will help to prevent some great mischiefs that would have otherwise been orchestrated by various terrorist groups if only they had access to financial resources. Perhaps this effect outweighs the costs that are produced by limiting the extent of competitive pressures imposed on governments in levying taxes. In spite of any such hypothesizing one has to remain agnostic about the expected net effects of policies limiting financial privacy – or eliminating it altogether. But these policies force one to ask the question of what kind of society we want to be. Do we really want to live in a world in which the government can oversee all of our activities and in which the totality of our financial transactions has to be "transparent" to the government? Should we all be accountable to the government and should the burden of proof be on us to show that this or that transaction was legal? Or do we rather want to live in a world in which the government is accountable to us and in which we have the right ask any questions about government conduct but not vice versa? For someone who sees individual freedom as the most important social value, it is clear that it is the latter, not the former, that we ought to be striving for. And although economics alone cannot answer this question – and therefore it is rarely asked in policy debates – it still is a question that should not be forgotten.

5. Concluding remarks

Our main claim throughout this paper is that competitive forces – which are recognized as beneficial in the case of production of private goods – are equally beneficial in matters related to institutions, public affairs and taxation. This is particularly so if one realizes that the state is not an abstract welfare-maximizing agent – as imagined by some streams of public economics – but that it is a collection of individuals faced with a particular set of incentives and knowledge limitations. Under these constraints, tax competition has the potential to curb wasteful government spending and impose fiscal discipline. It is also inseparable from the process of institutional learning and change, which is likely to play an important role in promoting institutions and rules conducive to economic order. The example of countries in Central and Eastern Europe and their remarkable flat tax reforms make that clear. Hence, we maintain that tax competition is a phenomenon that should be embraced, rather than fought.

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