LI-Paper

The Case Against "Tax Harmonisation": The OECD and EU Initiatives

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1. Introduction

The present paper is inspired by the current debate about tax competition, particularly in the OECD and EU. But let me also stress at the very beginning that the title is somewhat misleading since I do not intend to give a full account of this debate (for instance the administrative measures which are imagined to cope with the supposed problems caused by tax competition). Keeping in mind this debate and the present world environment, I prefer to focus on the analytical arguments which seem the most relevant ones in the debate. More specifically, the present paper can be considered as a pure exercise in logic about the problem of tax competition.

There is, to be sure, an apparent contradiction between, on the one hand, the fact that human activities are becoming more and more globalised, whereas, on the other hand, tax systems remain strictly national (or local). For many people such a discrepancy is not acceptable and they argue in favour of more "globalised" tax systems, which, in their opinion, means either harmonisation of taxes or even the creation of world taxes and, at least, some cooperation between national tax administrations. But such claims are based on a completely wrong interpretation of what is globalisation. In fact globalisation can be defined as competition at the world level. Now competition does not imply that activities become more and more similar all around the world, quite the contrary: As a process of discovery – according to the words of Friedrich Hayek – competition induces producers to differentiate one from the other. Therefore, from this very general point of view, if ever, in a globalised world, one would consider that tax systems also have to be "globalised", it would imply tax competition and tax differentiation and not tax harmonisation or world taxation.

Most often, those who are opposed to tax competition argue:

• Tax competition, by creating a "race to the bottom", oblige governments to reduce their total revenues and to abandon the production of certain desirable

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public goods. It is thus assumed that the level of expenditure was optimal and any decrease in revenues can only be harmful.

- It is unfair that some tax payers who benefit from public expenditures can avoid financing them because they have a mobile tax base and can be considered as free riders. In turn, this argument implicitly assumes that the given distribution of the tax burden is fair (“optimal”), so that any departure from this optimal distribution is undesirable. Implicitly it may be assumed that redistribution of resources is a public good, so that the production of this public good is disturbed whenever someone no more accepts the place to which he has been allocated by the state in the redistribution process.

Supporters of tax competition consider that competition is always desirable in any private market and that there is no a priori reason for it to be harmful whenever it exists in public activities. But the publication by the OECD of a pamphlet entitled *Harmful Tax Competition* (1998) may have given some official credibility to the idea that tax competition might be “harmful”. Thus, in the present paper we will try to determine to which extent and under which conditions tax competition can be considered as “harmful”. We first recall some facts (Section 2) and some basic principles of tax theory which we need for this evaluation of tax competition (Section 3). The role of tax competition is discussed in Section 4 and we conclude with some thoughts about the limits of tax competition (Section 5).

2. A Short Reminder about Present Facts

During the 1980s and the 1990s, technical improvements in transportation and telecommunications, as well as the elimination of many trade barriers and capital controls, reinforced worldwide competition. The increased mobility not only of goods and services but, also, of factors of production has been felt as a threat for countries with high tax rates, specially the “old” countries of Europe. They feared that activities and capital would flee away to countries with lower tax rates so that they would be obliged to decrease their own tax rates. Their important level of redistribution—assumed to be made possible by a high rate of taxes and social contributions—characteristic of the “European social model” was thus challenged. Therefore, it is not surprising if all efforts to limit or to prevent tax competition have been mainly inspired by those same European countries. The OECD and the European Union are the main instruments of the struggle against tax competition.

As we already stressed, it is feared that tax competition leads to diminished tax revenues because of the lower tax rates implied by the “race to the bottom”, but also that the decrease in tax rates is particularly important in the case of mobile production factors, such as capital. Thus low taxation countries may attract capital, and other countries hence be obliged to adopt tax rates on capital income close to zero.

However, it seems that the actual consequences of increased tax competition have not turned out to be consistent with what was expected. According to some economists, national tax policies have not been greatly affected by an increased economic integration and the mobile tax base has not been greatly eroded by tax competition. A detailed study of the evolution of tax systems in the context of global competition has been made by Philipp Genschel (who, by the way, is not particularly in favour of tax competition). According to him, "In recent years, the average OECD country has neither suffered a dramatic decrease in total tax revenues nor experienced a clear shift of the tax burden from mobile to immobile bases". In fact, in sixteen OECD countries, the share of tax revenues in GDP has risen by 8 per cent between 1970 and 1998. Philipp Genschel attributes these results to the fact that, to preserve the welfare state, governments had to maintain their revenues and, given the fact that they did not want to increase taxes on labour, they were obliged to maintain high rates of taxation on capital in spite of the pressure from competition (Genschel, 2002).

Thus, facts seem to be at odds with the conventional wisdom about tax competition. These results are comforting for those who fear it. For those who expected a decrease in tax rates due to tax competition, they are both regrettable and puzzling.

However, if, contrary to what was feared, total revenues have increased since the 1970s, public expenditures have increased even more. It may mean that governments did not dare to increase tax rates in a context of higher tax competition and that they shifted to deficits. But it may be true that the public debt has now reached unbearable levels in many countries, so that it cannot be increased any more and the pressure of tax competition on tax policies may become more visible in the near future. There is, in fact, a growing recognition in Europe that it is impossible to finance the European social model through taxation or debt so that deep reforms may be necessary both on the expenditure and the revenue sides.

Another interpretation of the observed facts could consist in assuming that cartels have been formed between the governments of high taxation countries. Such an assumption is interesting, since a great part of the literature about tax competition assumes that it is harmful because countries adopt a sort of beggar-my-neighbour policy behaviour: In a non-cooperative world each country tries to get a competitive advantage by decreasing its tax rates more than others. In this endless process, all governments would lose revenues without getting a definite competitive advantage. It would lead all of them to a situation of so-called sub-optimal level of production of public goods. Cartels would be the only possible answer for countries trapped in such a process of declining revenues.

However, for the time being, it is not quite obvious that such cartels do exist, even if some governments may have implicitly accepted the idea that they had to resist in common against this threat on their social and public model. But it seems more realistic, anyway, just to assume that high taxation governments have been blind and deaf to this threat of tax competition and, for the time being, each of them has independently tried to maintain, or even to increase, the level of taxation and social contributions, because they give a political priority to maintaining their model of a developed social welfare system and high public expenditures. Given the fact that the horizon of any government is rather short and that tax competition cannot erode the tax base very rapidly, it may be rational for any government to try to maintain the existing system, while expecting that future governments will have to enforce the necessary reforms. As far as most high taxation countries behave in such a way, the result is similar to what could be obtained by a formal cartel. In other words, each government tries to ignore the pressure from tax competition and to maintain high tax rates. As others do the same, the pressure of tax competition is very moderate, which gives a justification for keeping hig tax rates, however, as more and more countries adopt a policy of low taxation and as they are more and more competitive in comparison to high taxation countries, this conservative strategy may be less and less sustainable. To summarize, the fact that tax competition has been less efficient than expected in the past does not mean that it will not play its normal role in the future.

Under the pressure of high-tax countries which fear tax competition, the European Commission steadily tries to set up a European reporting system—so that a government may be able to tax capital incomes obtained in another country by one of its residents—or an harmonised system of withholding taxes. But it has not really succeeded for the time being, mainly because it meets the opposition from small countries—including countries from central Europe—which attract capital with preferential tax treatment.

Who could have imagined twenty years ago that countries which were suffering under a communist regime would now be model countries in promoting low taxation and tax competition? This is certainly one of the great and satisfactory irony of recent history, but it is frequently not accepted by the old EU members: Thus, in France, Nicolas Sarkozy, when he was minister of finance, proposed that European subsidies not be given to those countries engaging in "harmful tax competition". In some sense he was (unvoluntarily) right, since the countries which adopt low taxation have a better development strategy than just waiting for subsidies. But it is obvious that to him, not giving subsidies was to be considered as a sanction against governments which did not play by rules of the game.

In spite of the hostility of the old members of the EU, especially France and Germany, more and more countries decide to implement important tax reforms. More specifically, a flat tax has been introduced in several ones, for instance in Slovakia, Romana, in the three Baltic countries and, outside the EU, in Serbia, the Ukraine, Georgia and Russia (where a 13 per cent flat rate made possible an increase in real revenues by 28 per cent in 2001 over 2000). Last, but not least, in Poland an important tax reform has been adopted: In 2008, the flat tax will be implemented with a single rate of 18 per cent. The VAT will also be 18 per cent, as well as the corporate tax rate.

In order to limit capital outflows to these countries with lower tax rates, the EU introduced on July 1st, 2005, a directive which implements a system according to which capital incomes received by a non-resident in the EU are automatically declared in order to be taxed in the origin country. But Luxembourg, Austria and Belgium will not be obliged to implement this agreement as long as similar agreements will not have been made with Switzerland and other tax havens (specially Monaco, Liechtenstein, Andorra and San Marino). Swiss authorities have in principle accepted to impose a withholding tax on incomes from capital belonging to citizens of the EU and to pay back part of the revenues to these countries. But it is obvious that capital owners will shift their capital to other financial centres and the EU is trying to obtain similar agreements with countries such as Hong Kong or Singapore. It was expected that the US would accept to enter into such an agreement. Fortunately it was rejected in 2002 by the Bush administration which also rejected a UN project according to which an international tax organization would have levied and collected taxes across national borders.

3. Some Lessons from Tax History

In order to be able better to evaluate the precise role played by tax competition, it may be useful to recall some basic principles of tax theory. To simplify things, let us assume for the time being that we are in a closed economy. But our final target consists in addressing the following question: To which extent is it legitimate to speak of harmful competition, as OECD does? We already stressed in the introduction of the present paper that speaking of harmful competition implicitly assumes that a government had designed an optimal tax system in isolation and that international tax competition obliges it to modify it—for instance by decreasing tax rates—so that the system becomes sub-optimal.

Optimality of a tax system

But what is an optimal tax system? It is clear that it is impossible to evaluate it without referring to the over-all public sphere, i.e. both the expenditure and the revenue sides. Those who believe that the state is both benevolent and well-informed implicitly assume that it is producing only so-called public goods which are desired by the population. However, it is well known that such a vision is debatable. In fact, it would be possible to speak of an optimal system only in the case in which

• The public goods produced by the state were desired by all individuals without any exception;

• Their utility to each individual would be higher than the utility brought about by the private goods which could have been produced with the resources devoted to the production of these public goods;

• The distribution of the burden of the corresponding taxation is considered unanimously as the fairest possible one.

In other words, in such an hypothetical case, as no individual would prefer any change from the existing situation, it is optimal for every one and, therefore, for all. The tax system can be said to be optimal.

It is obvious that such an extreme assumption cannot correspond to any realistic situation. In reality what is called a public good is a good desired by a certain number of individuals who are ready to pay for it or who use public constraint to oblige others to pay totally or partially for it. Thus, the production of "public goods" and its financing are considered as "optimal" by some, but as non-desirable by others.

If one considers, on the contrary, that the state is neither benevolent nor well-informed—it is at the extreme a Leviathan-type state—the tax system cannot be said to be optimal: The state tries to extract a maximum of resources from citizens in order to finance what it has decided to produce. In such a case, if ever tax competition induces governments to reduce tax rates, it does not lead to a situation of "sub-optimality". Quite the contrary, it makes possible better to adapt the tax system to the very desires of the citizens.

The distribution of the tax burden

An important principle can be derived from tax theory, namely that the burden of taxation is not necessarily borne by those who explicitly pay the taxes (or social contributions) to the tax admin istration, because taxes can be shifted to other persons. Generally speaking, it can be said that there is only one tax base: the creation of wealth through exchange (except for a tax such as a lump-sum tax which is completely independent from economic activities). This has two important implications:

• As there are two traders in any exchange, the burden of taxation is distributed between them. For instance, whenever a wage contract is signed, part of the value created through it can be extracted by the state, but it does not matter whether it charges it to the wage-earner (who can shift part of the burden to his employer) or to the employer (who can shift part of the burden to the wage-earner). Now, the precise distribution of the burden is not known, since it is impossible to know the (ever-changing) elasticities of demand and supply curves for all sorts of goods and services. It means that, in reality, it is irrealistic to pretend that a government does know who is paying for the public goods it is producing. An "unfair" distribution of the burden of taxation between taxpayers may correspond to the apparently "fair" distribution of this burden. From this point of view it is fallacious to pretend that any government can design an "optimal" tax system, so that any tax competition would be "harmful".

• It follows from this that, for instance, a tax (or a social contribution) on wages or a tax on profits are equivalent: They are levied on the occasion of an exchange and they are shifted in one way or the other according to who has to pay them to the tax administration.

But one could also demonstrate that an income tax or a VAT are absolutely equivalent, which means that, contrary to the traditional accepted view, a VAT is not a consumption tax but a tax on the incomes of production factors. (Murray Rothbard (1994) was one of the rare economists who did emphasize this important point.) Just to make the demonstration short, let us assume that there are two countries in the world and that no state exists initially. Now, in both countries a state is created which has to absorb 10 per cent of the resources created every year. In one country the state imposes an income tax of 10 per cent on all incomes. In the other one, the state decides to create a VAT at a rate of 10 per cent. In the first case, all the added-value created in economic activities is distributed and it is later taxed. In the second case it is taxed before it is distributed, so that distributed incomes are inferior by 10 per cent to what they were before the creation of the tax. The result is exactly the same with both taxes.

Thus, let us assume a closed country in which the state provides an "optimal" quantity of public goods (if ever such a situation has any meaning). Let us also assume that added value in production is shared 50/50 between profits and wages; and that there is a tax on capital income at a rate of 20 per cent and a tax on wages at the same rate. The behaviour of the taxpayers would be affected exactly in the same way if ever there was a tax on profits at a rate of 40 per cent and no tax on wages. The tax wedge is exactly the same in both cases.

Tax distortions in present tax systems

There are a lot of discriminations in present-day tax systems. Some are voluntary, others are not (for instance those we just mentioned about the actual burden of taxation). But, given its importance for the current debate, there is one we would like to stress particularly, namely the discrimination against capital or, more precisely, the bias existing in most tax systems against the future and in favour of the present. For long it has been tempting for governments to over-tax capital because it was not very mobile internationally due to capital controls. Moreover, there is quite often an ideological bias against capital and it is politically easier to tax "capital" than wages. But the over-taxation of capital is still existing in most tax systems. This is the outcome of an accumulation of various taxes the base of which is either capital itself, or its transmission or its income: For instance in France there are a wealth tax, death-duties, a tax on windfall profits, a corporate tax and an income tax on the returns of capital, and some other ones. But the over- taxation of capital is also the consequence of the existence of the income tax. In fact, income is composed of two parts, one which is consumed, and another one which is saved. A taxpayer who has paid the income tax and who decides to consume will pay the tax only once (since the taxe base disappears through consumption). The one who decides to choose the future against the present and who saves will have to pay the income tax again on the returns of his savings. From this point of view, there is a double taxation of savings and capital. Moreover, as we recall, the VAT is nothing but an income tax with an other name; what is true for the income tax is also true for the VAT.

It is quite often suggested in the U. S. that the replacement of the income tax by a VAT would make possible to suppress the double taxation of savings by the income tax. This belief comes from the fact the VAT is interpreted as a tax on consumption, which it is not. In fact the name of the VAT is quite clear: It is a tax on value added and, therefore, on the incomes which are the counterpart of the value added. But the interpretation which is given is misleading. This wrong interpretation of the very nature of the VAT may come from the fact that governments have wrongly decided to reimburse the VAT on exports and to ask its payments on imports (whereas there is no reimbursement of the income tax paid by the production factors whose incomes are the counterpart of the exported value of goods and services).

4. The Role of Tax Competition in an Open Economy

As most taxes have more or less the same tax base, as we underlined, we have to care not about one specific tax but about the total amount of all taxes extracted from the same base. In other words, a potential investor in a country does not consider specificallyone tax or the other, but he is concerned about the final profit he can get after having paid all taxes directly (i.e when he is administratively the taxpayer) or indirectly (i.e. when those who are the taxpayers from an administrative point of view succeeded in shifting part of the burden of taxation upon him). From this point of view, all empirical studies of comparative taxation are useless, since they isolate one single tax and compare its rate in various countries in order to estimate to which extent these countries are more or less attractive. This method is meaningless both because it singles out one tax among all those which are paid on the same tax base, and because it does not take account of possible tax shifts between people. Therefore, instead of focusing on any empirical aspect of tax competition let us rather focus on the logical aspect of the debate about tax competition.

To this end, let us begin with one remark: From what we recalled in the previous section, most taxes (and social contributions) are paid by factors of production. They are never paid by consumers or by “firms”, but they are necessarily paid by individuals who contribute to the production of wealth through contracts. Therefore the main problem we have to consider to evaluate the role of tax competition consists in evaluating to which extent production factors react to taxation. From this point of view, the international mobility of production factors plays a crucial role.

Immobile production factors

Let us first assume that production factors are completely immobile internationally, following the traditional Ricardian model. Globalisation exists for goods, but not for production factors. Given the fact that taxes are paid by production factors, differences between tax systems and public expenditures systems are without any consequence: Production factors are trapped in a country and the state can extract from them whatever it wishes. If ever it is a Leviathan state, it will try to maximize its revenues without caring about the level of public goods it is providing. As is well known, even in such a case, different outcomes may exist: If the state is well informed and it knows, for instance, that there is some “Laffer effect”, it may prefer a lower tax rate than a higher one and taxpayers are in a better situation. If it looks for a long run maximization of its revenues, it may care about the effects of taxation on savings and investment and, for instance, it may avoid a double or multiple taxation of savings.

In such a case of complete factor immobility, one may be tempt ed to say that there is no tax competition as far as production factors cannot react to differences in tax systems by moving from one tax jurisdiction to the other. However, tax competition may play a role according to two different channels: one consists precisely in the reaction of production factors to differences in taxation—which is non-existent in this case—but the other consists in the information brought about to a country by what happens in another country. Thus, even with a Leviathan-type state which is in a position to extract a maximum of wealth from its citizens (or slaves), the government may learn from other countries that, for instance, there is something such as a “Laffer effect”. The “discovery process” of competition is at work.

Now, many people believe that tax competition exists under this assumption of factor immobility, just because they have not accepted the idea that all taxes are paid by production factors. Thus, the majority of people believe that the VAT is paid by consumers on their purchases of consumption goods. Therefore, if goods are internationally mobile, they consider that tax competition exists, at least as far as the VAT is not reimbursed on exports. In reality, even in such a case, prices are set by the international market so that, if the VAT rate is higher in one country than in another, it is shifted back to the returns of the production factors. From this point of view, a high VAT rate in a country does not mean that producers in this country suffer from a loss of “competitivity” and it cannot be said that tax competition is “harmful”, either for producers or for governments, which would be obliged to decrease their VAT rates in order to maintain the competitiveness of national goods, and, therefore, to abandon part of their production of public goods. Tax competition cannot be harmful in such a case simply because there is in fact no tax competition! Therefore, and contrary to what is usually believed, there is no need to harmonise VAT rates, i.e. to pretend to suppress tax competition. By the way, there is no more reason to harmonise VAT rates than to harmonise, for instance, income tax rates, since both taxes are equivalent.

For long the EU authorities mainly focused their efforts towards the harmonisation of VAT rates, since they considered that the single market implied to abandon the "destination principle" (paying the VAT where the good is consumed) and to shift to the origin principle, in which case—they believe—tax competition in VAT would exist. They have not abandoned this target, but they focus more and more on the problem of the taxation of capital, due to its increased international mobility. As far as they care about tax competition, they are right in caring about the taxation of capital. But they ought to abandon definitely any concern about the harmonisation of VAT. We now have to evaluate to which extent tax competition can be harmful in a context of factor mobility.

Mobile production factors

Let us now assume that all production factors are perfectly mobile. From a Ricardian point of view nations no more exist in such a case. But they do exist as institutional areas: In each of them there is a state levying taxes and providing "public goods". Tax competition exists, since the tax systems may be different in these different nations and production factors can move from one area to the other, possibly for tax reasons. But to which extent can tax competition be harmful and to whom?

Let us assume a world with two countries, A and B. In A, taxation makes possible to produce a "pure and perfect public good", defined as a good which can only be produced by the state (in order to avoid any free riding behaviour) and which makes possible for each citizen to obtain a higher level of utility than what he could obtain from any other (private) good or service. Let us also assume, for the time being, that the state is both benevolent and well-informed, which means that it produces exactly the desired amount of "public goods" and that it has implemented an "optimal" tax system. An optimal tax system could be defined as a tax system such that any slight departure from this system could not benefit any taxpayer but could be harmful for at least one of them. In turn this implies both that there is an "optimal" distribution of the tax burden—i.e a distribution which is unanimously desired by all taxpayers—and that the state knows perfectly the behaviour of taxpayers: Thus, it has a perfect knowledge of the "Laffer curve" and, being both benevolent and well-informed, it chooses the lowest possible tax rate which makes possible to finance the "optimal" provision of public goods. In B there is no state, i.e. there is no public good nor taxation. Let us assume that taxpayers can freely move from A to B (perfect mobility of persons). They may move for non-tax reasons, for instance because the productivity of labour is higher in B or the way of life is more pleasant, etc. But, in the present paper we are only concerned with the tax reasons for mobility. Here is a case of tax competition, since the tax rate is positive in A and equal to zero in B. Will individuals move from the high rate-country to the low-rate country to benefit from the zero tax rate in B? If they do move for this single reason, it just means that they do not consider that what they get from the state for what they pay is worthwhile. In other words, contrary to our initial assumption, the good provided by the state is not a “pure and perfect public good”. In such a case harmful tax competition cannot exist. Quite the contrary, tax competition is necessarily profitable since it makes possible for taxpayers to reveal to which extent they consider the good produced by the state as a “pure and perfect public good” for them.

To be somewhat more precise, within this general framework, we may consider two polar cases: Either the cost of producing the public good is proportional to the number of citizens to which it is provided or the production of this public good implies only a fixed cost. In the first case, whenever a citizen leaves country A and goes to B, the remaining citizens do not suffer from his decision, since they will still get the public good at the same individual cost. In the second case, the unit cost increases when the number of citizens decreases. However, it cannot be said that the free riding behaviour of some citizens imposes an additional cost to others who thus have to bear a negative externality. The departure of one citizen is certainly harmful for others, and those who argue against tax competition could be tempted to say that tax competition creates a sub-optimal situation. However, such a statement is incoherent. In fact, saying that the final situation (after the departure of one taxpayer from A) is sub-optimal implies that the initial situation was (socially) optimal. But the only case in which one could legitimately label a situation as socially optimal is one in which this situation is considered by all individuals as optimal for them. It would only be the case if the state was producing what we have labelled a “pure and perfect public good”. But, by definition, the good produced by the state in the initial situation in country A was not a pure and perfect public good since a citizen preferred to emigrate in order not to pay for this good. And the emigration of the citizen who did not agree with the tax and expenditure systems transforms those latter into “optimal” systems.

Thus, under the present assumptions (perfect factor mobility, perfectly benevolent and well-informed state), tax competition cannot be harmful: Either the tax system and the expenditure system are optimal and factors have no reason to move or, if ever production factors move from one country to the other, they reveal that the tax system and/or the expenditure system are not optimal. Thus, if production factors move for tax reasons, it means that the existing tax system in a country is harmful and tax competition cannot be harmful, since it makes possible for people to evade from a harmful system and to adopt a better system. Tax competition is profitable for citizens (at least those who were over-taxed). It is harmful for the state, but it has been revealed by the very mobility of production factors that it was more of the Leviathan-type than of the benevolent type. How could we say that a process which is preventing someone (the state) from being harmful to others be harmful?

We may also imagine that the state is benevolent but not well-informed. For instance, it does not know the existence of a “Laffer effect” and it is charging too high a tax rate, although it could be possible to adopt a much lower tax rate without reducing public revenues. In such a case, tax competition is certainly not harmful, since it makes possible for taxpayers to move to areas with lower tax rates. But it may also happen that the state lowers the tax rate either because it learns from the experience of other countries or because it tries to avoid the outflow of production factors.

Thus, there is no possibility for competition to be harmful under the assumption of perfect factor mobility, whatever is the assumption concerning the state (benevolent or not, well-informed or not). If governments fear tax competition, it cannot be because they fear that they would be obliged to adopt a non-optimal system, but because the system is not optimal and they fear that they would be obliged by tax competition to adopt a system which would be "better" for citizens.

Partial factor mobility

At first glance, it seems that tax competition have more consequences in cases which are in-between those we have just examined (complete immobility or perfect mobility). And it seems that both the OECD and the EU are particularly concerned with the case in which one factor is more mobile than others and it is usually assumed that this factor is capital. In that case, it is felt, capital owners can act as free riders, avoiding taxation by moving their capital to low-tax countries, but benefiting nevertheless by the production of public goods in high-tax countries. The relatively greater mobility of capital would imply lower revenues for the state and/or the necessity to shift part of the burden to the immobile factor (labour) with the risk of increasing unemployment. Therefore, it would be fair to harmonise tax rates and/or to exchange information in order to tax capital in origin countries.

In fact, as we have seen in the first section of the present paper, the facts do not correspond exactly with these assumptions. Moreover, it is not perfectly correct to describe capital as the only mobile factor. Highly educated labour is also very mobile and anyone does know that the immigration problems faced by many developed countries are a clear indication that less educated labour is also mobile (although probably less so than capital).

But the problem is in fact much more complex than it seems to be due to the existence of tax shifts. Ignoring such possibilities, those who care about tax competition focus their attention on taxes such as corporate taxes. They fear that capital moves to countries where corporate taxes are lower or even nil. And, therefore, they make a plea for the harmonisation of these taxes or for a mutual surveillance of capital flows. But we know—as we recall from Section 3—that part of corporate taxes are shifted to wage-earners and interest-income earners and that, on the other hand, part of the taxes which are supposed to be paid by wage-earners (or interest-income earners) is in fact paid by capital owners.

Let us imagine an initial situation in which both capital and wages are taxed (possibly at the same rate) and in which neither capital nor labour are mobile. As we have seen, it does not matter much whether public revenues are obtained by a corporate tax or a tax on wages (income tax). What matters is the total value of the “tax wedge” which creates a gap between the supply and demand for labour. The relative burden of each production factor depends on the relative elasticities of both curves.

Let us assume now that capital becomes mobile suddenly (for instance due to the suppression of capital controls). It means that the demand for labour by capital owners becomes more elastic, so that a greater part of the tax burden (of the “tax wedge”) has to be borne by wage-earners. However, it is wrong to believe that harmonising corporate tax rates will be sufficient to avoid this change in the relative distribution of the tax burden. Even if corporate tax rates were the same all over the world, the increased mobility of capital would make possible for capital owners to get rid of a part of the tax burden they previously had to bear, for instance due to the existence of a tax on wages. In other words, capital mobility does make possible for capital owners not only to avoid high tax rates on capital in the origin country, but, more generally, to avoid over-taxation coming from any sort of tax.

Thus, tax competition certainly has consequences, but not exactly those which are usually considered (when ignoring the possibility of tax shifts). But can we say in that case that tax competition is harmful? The answer we can give to this question is very similar to the one we gave previously, namely that it cannot be harmful. One reason is that we have to consider both the tax side and the expenditure side. If capital owners benefited, as capital owners, in the high-tax country, from very valuable public services, they would prefer to keep their capital inside, in spite of the high tax rates. The outflow of capital is a sign that capital owners consider that they pay too much for what they get. It is, however, true that, in spite of the fact they do not pay taxes in the origin country when exporting their capital, they may benefit from some public goods in the origin country.

But the choice is between suppressing capital mobility, suppressing the production of public goods or modifying tax systems in order better to meet the desires of the taxpayers. From this latter point of view, the priority ought to be the suppression of discriminations which are the most unfair and the most harmful (if ever one can accept some hierarchy in the “harmfulness” of various taxes).

Two discriminations which exist in many tax systems seem to be particularly harmful, the discrimination against the future, which we have already underlined, and the discrimination against high-income earners (progressive income taxes or wealth taxes). Both of them ought to be suppressed independently from the existence of any tax competition. But tax competition can help inducing governments to suppress them.

Regarding the former—the discrimination against the future—the outflow of capital from high-tax countries to low-tax countries can be considered as a normal, and even desirable, reaction of taxpayers in a situation of over-taxation, and not as an evasion from an optimal tax system. Therefore tax competition is not harmful, quite the contrary. The solution to the apparent problem does not consist in harmonising taxes on capital, in controlling capital flows, or in organising a system of multilateral reporting. It consists in suppressing the over-taxation of capital. Let us give an example. For long we have favoured the creation of a system of “general expenditure tax” in which the taxpayer would declare his income, as he does presently for the income tax, but he would be allowed to deduct the amount of his periodic savings from the tax base. He would pay the tax in the future only as long as the returns from his accumulated savings would be consumed and not saved. Thus, the double taxation of savings by the income tax would disappear. Under such a system, taxpayers would be induced to declare the amount of savings they are exporting into other countries, since they could thus deduct the exported savings from their tax base (but they would be obliged to declare the returns obtained from these investments in the future as long as they will not be saved). In such a case governments would have to care less about tax competition.

Regarding the progressivity of the income tax, it presently induces those who have the highest incomes to emigrate to relative tax havens. Here again it cannot be said that tax competition is harmful, since it makes possible for some taxpayers to avoid what they rightly consider as an unfair over-taxation of their income. It does not induce any departure from some optimum, quite the contrary.

From both these examples, one cannot deduct some general principle according to which tax competition will always have the consequence of suppressing or decreasing some over-taxation, although it seems to be the case in the present world. And we have to admit that the difference of mobility between different production factors may be a subject of concern. However, beyond these practical consequences of tax competition, there is no doubt that tax competition must be preserved at any rate and without restriction, just because it means freedom of choice for taxpayers.

Moreover, one ought to reverse the usual reasoning. According to it, whenever one factor is internationally mobile, the other factors suffer from an additional burden for two reasons:

• The marginal productivity of the immobile factors is lowered since they are associated with less of the mobile factor (capital or highly-educated individuals);

• Immobile factors may have to pay more in order for the government to provide the public goods it wants to provide.

Once more, such a line of reasoning implicitly assumes that the government is benevolent. But if we assume that it is more or less close to a Leviathan-type state—which may be a realistic assumption—such a state may be tempted to over-tax immobile factors who can thus be considered as “tax slaves”. It has been the case for long in many countries regarding capital and the temptation of governments to over-tax capital-owners was reinforced by the fact that they are less numerous than the owners of a human capital, i.e. they have less electoral weight. Now, if ever the mobility of this factor is increased, it can escape from its situation of tax slavery.

It is certainly a pity that the owners of the other factors have not the same opportunity (for instance low income wage-earners), but no principle could justify any measure designed to prevent a mobile factor to benefit from its position under the pretext that others have not the same opportunity.

5. The Limits of Tax Competition

From what we just said, it seems that competition plays its role in the field of taxation as it does on private markets: It transmits information and induces people better to satisfy the needs of others.

However, speaking of competition in the case of taxation is somewhat misleading for the following reason. Regarding the production of private goods, competition implies both that producers are free to enter into a market and to supply whatever they want and that consumers are free to choose the goods supplied by any producer. Obviously, competition does not imply perfect knowledge by producers and consumers so that a consumer, for instance, does not necessarily choose at any time the good which would be best fitted to his needs. However, the costs of shifting from one producer to another is rather low in most cases, particularly in our time, as trade barriers have more or less disappeared and information is spread all over the world rapidly and at a negligible cost. Thus, individuals can use their freedom of choice without having to care significantly about their own location.

As taxpayers and recipients of public goods, they are not in the same situation. They necessarily have to be located in some place where some authority benefits from a monopoly power to tax and to distribute public goods. In order to carry on their potential freedom of choice, individuals have to move from one jurisdiction to another, which is very costly (and even quite often prohibited). Meanwhile, given the limited number of jurisdictions (countries) in the world, individuals do not benefit from a great diversity of tax systems and public goods.

On the other hand, there is no freedom of entry on the “market” for public goods and taxation. For instance, the Icelandic government cannot propose to a Parisian to pay taxes to it and to get public goods from it, instead of being a customer of the French government. Taxation is always an act of constraint implemented by some institution which benefits from a monopoly, the monopoly of legal constraint. Therefore, tax competition would mean “fredom to enter on the market for legal constraint” which is somewhat contradictory and which, by the way, does not exist.

As we already said, tax competition plays its role through two channels: One is the information a government may get from observing tax reforms and experiments in other countries, the other consists of the possible reaction of taxing autorities who observe that their “consumers”, the taxpayers, escape from their jurisdiction (either by emigrating, by shifting their wealth or by using tax evasion), which means that the systems they are providing are not considered as optimal by those concerned. But neither channel works perfectly, far from it.

In fact, the causal relations between tax rates and tax systems, on the one hand, and economic activity and public revenues on the other hand are complex, so that the information brought about by tax competition cannot be easily interpreted, contrary to what occurs on a private market where the consumer can more easily evaluate to which extent the good he has purchased does correspond to his needs. The reactions of a government to tax competition also depend on its desire to be more or less benevolent and its capacity to be well-informed. Thus, a Leviathan-type government will be less harmful to citizens if it is well informed and if tax competition is a way for it to learn about the existence of a “Laffer effect”. It may thus adopt tax cuts because it knows from foreign experiences that they may be profitable not only for taxpayers, but also for itself.

However, in spite of these shortcomings, tax competition is a powerful instrument to prevent excessive taxation. It is therefore important to fight without any restriction all efforts made by OECD, EU, or any other international organisation, to limit tax competition.

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