



TAX JUSTICE BRIEFING

TAX COMPETITION

What is Tax Competition?

Tax competition refers to the rivalry between countries which compete for investment by lowering the tax rates on business, or offering other tax advantages, in order to attract or keep companies located within them.

Countries may also offer a range of other inducements to attract investment, some of which are related to tax, such as investment subsidies or grants. Since business is now much more mobile, and countries want the employment, taxes, technology, management skills and other spin-off benefits from foreign investment, there is increased pressure to offer inducements. Richer countries have for many years tried to attract investment, especially to backward regions, by offering capital grants or loans and other special arrangements, which are often discretionary and secretive, and invite corruption.

Despite attempts to restrict this competition through the OECD, it still continues. More recently, however, attention has shifted to the design of the tax system itself in order to attract investment. This may be more tempting

for governments, since it does not entail up-front payments to companies, although the lost tax revenue must be recouped somehow.

Investment decisions of course depend on many factors, including the availability of good infrastructure, a workforce with relevant skills, and access to markets. Governments provide this enabling environment, for which they require revenue, hence taxes should be regarded as a distribution by the firm to its most important stakeholder. However, business is sensitive to any expenditure, especially those which do not directly produce a return, such as taxes. So firms may regard taxes as a cost, and one which can be reduced by the government, even if this means passing the burden to others; hence they may pressurise the government to reduce taxes on business.

Types of Tax Inducement

Countries have responded to this competition in a variety of ways. First, they have lowered their corporate tax rates while maintaining or even broadening the tax base (the definition of taxable profit). This can be beneficial, since it

can reduce the economic distortions resulting from special tax breaks and allowances which reduce taxable profit, while maintaining the effective tax rate and hence receipts from business taxation. This is because a lower tax rate can still produce the same revenue from taxation if taxable profit (the tax base) is defined widely, and not reduced by special allowances.

Too often, however, tax authorities have gone in the opposite direction, by designing special schemes which have the effect of narrowing the tax base, sometimes to zero. This can be done simply by offering tax 'holidays', or a complete exemption from taxes, for a certain number of years after the initial investment. While this may at first succeed, mobile business can simply move on to another location once the holiday is over. Nevertheless, this approach may be tempting to poorer countries which may not have the resources to be able to offer up-front investment grants, and which may consider that foregoing some revenue from exempting business profits from taxation is a necessary trade-off to attract investment.

Second, some have partitioned off parts of their territories into special commercial regions in which the burdens of taxation, as well as other regulatory requirements, are less than they would be in the rest of the country. These regions may be referred to as export production zones (EPZ), free trade zones, special economic regions or maquiladoras. According to the **Worldwatch Institute**, 43 million people are working in about 3,000 such regions in 116 countries. However, they are often deprived of protections such as the rights to join a trade union and to collective bargaining and hence exposed to poor conditions and low pay. Also, business in such

special zones is often simply assembling or processing imported components for re-export, hence creating few beneficial or long-term spread-effects on the local economy.

Third, countries may offer tax arrangements which allow firms to reduce their overall global tax liabilities, by offering low or zero tax rates for specific types of business, usually limited to those owned by non-residents, such as financial services, holding companies which own or manage assets such as intellectual property rights, headquarters operations, or shipping. Charges made for such services can reduce the taxable profits of the companies to which they are provided, which are often parts of the same firm or corporate group, yet the income from them may benefit from a low-tax or no-tax regime in the jurisdiction where they are supposedly based. Some of these activities can be located almost anywhere, so they are especially mobile. Indeed, their connection with the country in which they are supposedly carried out may be largely notional, especially in today's 'virtual world'.

This is especially the case for financial and corporate services, which may consist merely of book-keeping activities, which are now often electronic and can be handled remotely. This has led to the establishment of 'Offshore Financial Centres' in countries where financial services affiliates, corporate headquarters and other offices can be legally registered, but in which very little, if any, actual economic activity actually occurs. Transactions are nominally 'booked' within these countries for their tax advantages.

Is Tax Competition Good or Bad?

Some argue that tax competition is good, because it creates pressure on states to

become more efficient in how they raise and spend taxes, as well as giving investors a choice between locations according to the tax levels compared to the benefits provided. Others say that it is damaging, by putting pressure on countries to reduce taxes on business, and therefore either to cut public services or shift their cost by increasing taxation of less mobile factors such as employment income.

The argument in favour of tax competition, and indeed regulatory competition more generally, is often supported by referring to a theory originating in a paper written by the economist Charles Tiebout in 1956, suggesting that the optimum level of provision of 'public goods' by local communities can result if consumer-voters have a choice among a number of communities in which to reside which offer different levels of public goods and hence tax rates. However, Tiebout's model was highly simplified and unrealistic. First, it assumed that residents are all of the same type (people, not companies), are entirely free to move (they have income from investments, not employment), and can decide where to live purely on the basis of their tax-expenditure preferences. In reality, opportunities for mobility vary greatly between individuals and companies, and between different types of business. Hence, in practice, competition is likely to shift the tax burden towards the less mobile persons or firms.

Secondly, it assumes that all jurisdictions are entirely self-contained, and that residents are genuinely located within only one, which provides all the public services they consume. In practice, of course, they are interdependent - in economic terms there are external economies or diseconomies between communities. For example, if a community

chooses to have a low level of policing or a corrupt police force, it may attract residents who are criminals and who can prey on the residents of its neighbours. Tiebout himself conceded that inadequate law enforcement by one community may affect another, and accepted that in such cases 'some form of integration may be indicated'.

Supporters of tax competition argue that where there are such 'market failures', cooperation will emerge to deal with them. In practice, there are winners and losers, which vary in different contexts, so it can be very hard to develop effective cooperation, especially if there is no firm agreement on what is in the overall common good.

Attempts to Combat Tax Competition

The main issue regarding tax competition is agreeing on a distinction between legitimate competitive techniques from illegitimate ones. While this in itself may seem difficult to achieve, it goes deeper into the heart of contemporary politics as it effectively means agreeing on some basic principles of tax policy. Since taxation, along with defence, is considered an essential attribute of national sovereignty, this is hard to achieve.

However, the threat to tax revenues from international tax avoidance, which is made easier by tax competition, has led to some attempts at cooperation in recent years. This has taken place mainly through the **Organisation for Economic Cooperation and Development (OECD)**, a club of the 30 richest states. Since they are the home states of the world's largest corporations, and tend to have quite high tax revenues overall, they have most to lose from unrestrained tax

competition. This led to publication of a Report in 1998 on *Harmful Tax Competition*, which outlined a programme for coordinated action. However, this has been weakened by the refusal of Switzerland and Luxembourg, both important financial centres, to support the initiative, while others such as Belgium and Portugal have abstained from some of the follow-up. Furthermore, opposition in the US led to a further substantial watering-down, and a renaming of the topic to Harmful Tax Practices, on the grounds that tax competition can be beneficial.

It may be legitimate, as we have already seen above, for jurisdictions to take different views about the optimal rate of tax, as long as there is broad agreement among them on how to define the tax base. Instead, the OECD approach was to try to agree on criteria for unacceptable features of a tax regime. Two types of harmful regimes were identified, tax havens and preferential tax regimes. These were based on four main criteria. The threshold test is the existence of a zero or low tax rate for all or specific types of business. The next two criteria are lack of effective exchange of information with other tax authorities, and lack of transparency in the tax regime generally. The key test for tax havens is that the company or entity has 'no substantial activities' within that jurisdiction. A 'preferential' tax regime also is one that applies to activities which are considered 'mobile', in that they do not entail significant physical investments, if it is available only for some types of company which are 'ring-fenced' from others, in that resident taxpayers are excluded from the benefits of the regime, or the companies do not have access to the internal market. However, as already pointed out above, it is very hard to define whether

some types of activity are 'substantial', in particular financial services.

Nor surprisingly, the OECD initiative has increasingly focused on the issues of transparency and exchange of information. The application of the substantive criteria of 'harmfulness', a low or zero tax rate for companies carrying on specific types of business with no substantial activities within the jurisdiction, have only led to modest or cosmetic changes in tax regimes. Special treatment for companies in some specific types of business were generally found not harmful, such as holding companies and shipping. Special 'ring-fenced' regimes for some other activities have been phased out. However, this has created an incentive to reduce overall company tax rates, so that Ireland for example has moved to a 10 per cent rate. Also, it does not prevent preferential treatment for specific types of business income, provided it applies to all companies. So in some ways it has encouraged states to compete in devising special allowances, which have the effect of reducing the tax base. Other states may apply counter-acting measures, so the game of cat-and-mouse continues.

If the OECD countries have found it hard to establish effective coordination, the prospects for a more general global arrangement are even more remote. There is very little incentive for small developing nations to agree to this type of approach to limiting competition, as they do not have large populations or resource bases to offer the international economy. Their most valuable asset with which to compete with developed nations is their sovereignty. Sovereignty is bestowed by the international state system on each country and this allows any of them to

design their own tax system, even if it is essentially predatory on others.

Developed nations could offer payments to the developing nations so that it would be worth the while of small and poor developing nations to agree to the multilateral rules. However, a comprehensive multilateral agreement of this sort is extremely ambitious. Nevertheless, it could be developed if the vast majority of states could agree to a more coordinated approach for taxation of business or corporate income on a basis that could be accepted as fair, rather than trying to define each state's right to tax on the territorial basis of residence or location of transactions.

Alternative Approaches

The basic problem is that it is increasingly difficult to tax companies on the basis of where they are resident or where their activities take place, especially in these days of electronic transactions and the internet. An alternative solution may be to focus on the large corporations who stand to benefit the most from global tax competition. These companies have strong incentives to present to their investors consolidated financial statements with high profits at the securities exchanges where they are listed for the benefit of those investors. This is in contrast to their relationship toward tax authorities, since they are only required to submit tax returns for those subsidiaries resident or doing business within each jurisdiction, and have incentives to organize this to reduce their overall tax exposure. As a result, corporations are taking advantage of a global market failure.

Corporations are dispersing their financial and productive activities into an optimal jurisdictional network according to the global regulatory opportunities that are available to them. The result is that they are 'free riding' on the high regulatory jurisdictions established for the benefit of investors via securities exchanges, but they are able for tax purposes to assign a substantial proportion of their economic activities to low-tax jurisdictions. This global regulatory divide is exploited by the sprawling multinational corporation for the benefit of investors but to the detriment of international society as a whole.

This could be reversed by two types of regulatory changes. One is to introduce a requirement for corporations to declare in their financial statements how much tax they pay in each jurisdiction, together with the basic information on business done in that jurisdiction. Since there is only a handful of countries with major global securities exchanges, cooperation would be more likely as there is a greater chance that they could agree. The Publish What You Pay coalition is already campaigning for this objective, in relation to global corporations in the oil and minerals extraction industries (see: www.publishwhatyoupay.org/english/)

The second would entail a major shift in the principles of international taxation, moving away from jurisdictional allocation and towards unitary taxation, which is covered under a separate Tax Justice Network briefing.

This Briefing is based on a manuscript prepared by Ian Goldman of Vancouver, Canada, and was revised and edited following comments from other members of the Panel of Experts responsible for the series.