Mythbusters

from **nef** and the Tax Justice Network

"A competitive tax system is a better tax system"

Nicholas Shaxson and Ellie Mae O'Hagan

Governments often make out that raising taxes on big business would be a terrible mistake. International corporations would take their investments elsewhere – to countries with a so-called 'competitive' tax systems – and our position in the global market would crumble.

This Mythbuster reveals just how unhealthy this emphasis on tax competition between countries is. It shows individual countries need not participate in what is essentially a global race to the bottom, and that tax 'competition' harms everyone but for a wealthy few.

The myth

Few slogans are as easy for a politician to pronounce as the cry "We must have a competitive tax system!"

It sounds so reasonable. Competition and competitiveness are good things, right?

Not in the context of tax. Such calls almost always rest on a giant economic fallacy. Here is the problem, at its simplest.

Competition between companies in a market is broadly a good thing. The competitive race, for all its warts and imperfections, makes the business world go round. It means that companies must constantly innovate to produce better products and services, at better prices. If they cannot compete they go bust and disappears. It sounds sad, but this 'creative destruction' is a source of the healthy dynamism of markets. Employees, customers and suppliers may well find equivalent opportunities elsewhere.

But the tax-cutters have hijacked this idea of healthy market competition to justify something completely and utterly different: the idea of 'competition'[1] between *countries on tax*. This is a totally different economic beast.

The theory

Theoretical arguments used to support tax 'competition' between countries are founded on a 1956 paper[2] by the economist Charles Tiebout. He wrote that when citizens can choose between

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many communities where to live, with each community offering different mixes of public goods and taxes, the resulting 'competition' forces jurisdictions to collect and spend their taxes efficiently.

This argument is repeated to the present day.[3] But unfortunately, there is no evidence, anywhere, to support it. Quite the opposite.[4]

Tiebout's argument rests on shaky assumptions – not least the idea that hordes of perfectly knowledgeable citizens flit from one jurisdiction to the next like shoals of fish, at the drop of a tax inspector's hat. That is clearly nonsense.

But although *people* rarely move in response to changes in the tax rate, there is something that is far more mobile: tides of financial capital, sluicing around the world in a constant hunt for better returns. And in the grip of tax 'competition' mania, governments try to make their tax systems more 'competitive' to lure this skittish capital by lowering tax rates on it.

But is this a good thing? In a word, no.

The reality

Tax 'competition' results in wealth being redistributed upwards

The first major consequence of tax 'competition' is to redistribute wealth upwards. As tax rates on capital fall in response to these 'competitive' pressures, governments make up shortfalls by levying higher taxes on other, less wealthy sections of society, or by cutting back on essential public services. So tax 'competition' boosts inequality and deprivation.

Tax havens are the sharpest edge of this 'competitive' axe. Owners of capital shift profits into tax havens, paying zero or very low taxes there, then tell politicians in the 'onshore' countries where the genuine wealth is being created that they will bring the money home into the tax net only if the politicians cut their home taxes on capital some more. Too often the politicians quail, and cut some more. Wealth shifts upwards.

All this has knock-on effects. Corporate tax cuts also lead governments to cut individual income tax rates on the wealthy. If they don't, rich individuals will find ways to reclassify their ordinary income as capital income, to enjoy the capital income tax rate that has been forced lower by tax 'competition'.[5] More wealth flows upwards.

Tax 'competition' hits developing countries particularly hard. Because collecting corporation tax is more simple and lucrative than trying to extract small sums of income tax from large numbers of poor people[6], developing country governments tend to rely heavily on it to make up their income. So, as one IMF report explains, the effects of tax 'competition' on developing countries may be "much more troubling" than to developed ones.[7]

But rich countries suffer greatly too. Inside the United States, for example, individual states engage in fierce cross-state tax 'competition', with the result, as one report puts it, that "All states have regressive tax systems that ask more from low- and middle-income families than from the wealthiest."[8]

The combination of international tax 'competition' forcing taxes on the wealthy lower, plus this regressive effect on state tax systems, add up to a tax system where rich, poor and middle class pay roughly the same effective tax rate.[9] Figure 1 illustrates a worldwide trend.

Falling corporate income tax contributions have accompanied a worldwide trend of rising corporate profits as a share of the economy.[10] The result of these two opposing trends has been flat corporate tax receipts in money-of-the-day terms, and falling receipts once inflation is taken into account.

In summary, tax 'competition' compresses entire tax systems, so that the rich pay less and the poor pay more. Voters would never independently choose such an outcome; tax competition effectively forces them into it. This also weakens popular support for government itself and heightens social tensions.

Yet this is just part of the damage from tax 'competition'.

Tax 'competition' distorts markets

Countries attract tax-shy capital in four main ways:

- cutting tax rates
- offering tax loopholes and special incentives
- offering financial secrecy to facilitate tax evasion
- being deliberately lax about tax enforcement.

Countries race against each on all four. In each case the result is typically a reduction both in tax rates and in the tax base (that is, which items get taxed). All this distorts markets, potentially reducing efficiency and raising prices.

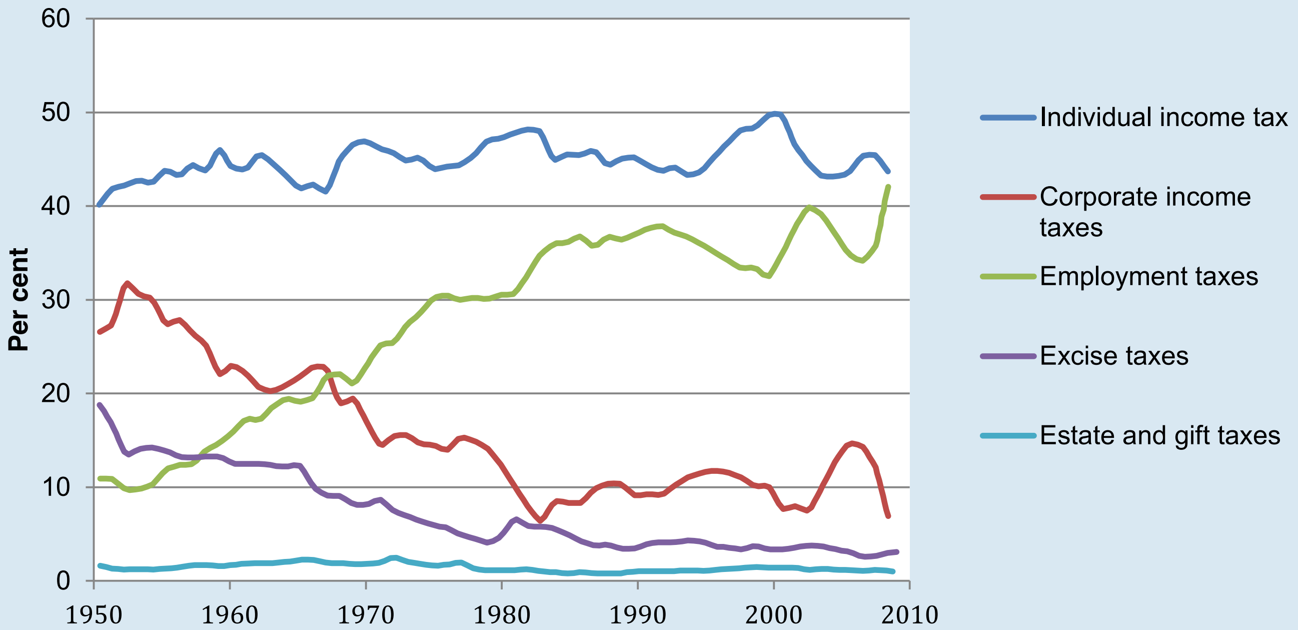
For example, multinational corporations can use tax haven loopholes to cut their tax bills. As with all tax avoidance, this is merely the unproductive extraction of taxpayer-funded tax subsidies by multinationals: it helps nobody, anywhere, produce a better product or service. It comes with high associated costs of expensive tax advice paid to lawyers, accountants and bankers.

Far worse, though, is the fact that multinationals can use these tax subsidies to out-compete smaller, locally-based competitors, which do not exploit the loopholes in the international tax system and are typically the true innovators and job creators. Multinationals kill them in markets using a weapon (tax) that has nothing to do with genuine business productivity or true innovation. It promotes the big at the expense of the small, and thus stifles true market competition. This leads to higher prices for everyone, and higher wealth concentrations too.

By allowing multinationals to free-ride on the public goods paid for by others, it also further erodes democracy and a sense of trust in the system.

Worsening matters further, the outcome of tax 'competition' (ever lower tax rates, more tax loopholes, secrecy or lax enforcement) undermines David Ricardo's theory of comparative advantage which says that capital and production should gravitate to where it is most genuinely productive – cheap manufactures from China, say, or fine wines from France or Chile. Instead, companies relocate to zero-tax Bermuda, even though there is almost never any genuine economic value added there.

Figure 1: Federal receipts by source as share of total receipts



Source: Joint Committee on Taxation, 2011.[11]

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Tax 'competition' involves economic warfare, and a dangerous race to the bottom

Tax 'competition' is not just an impersonal force: it is often funded, networked and organised. Greg Leroy, a long-term analyst of what he calls "economic warfare" among U.S. states says:

> *"This system has a long history and many moving parts. It traces back to at least the 1930s and the Great Depression, and really matured by the 1970s. By then, most of the key actors were in place: secretive site location consultants who specialise in playing states and cities against each other; 'business climate' experts with their highly politicised interpretations of tax and jobs data; and an organised corporate network orchestrating attacks on state tax systems.*
>
> *Today this industry has spawned a more elaborate cast of characters: rented consultants packing rosy projections about job creation and tax revenue; subsidy-tracking consultants who help companies avoid leaving money on the table; and even an embryonic industry to help businesses buy and sell unused economic development tax credits."*[12]

An in-depth New York Times report provides an example of how virulent the problem has become:

> *"A recent bidding war for United Airlines […] drew more than 90 cities. The airline had set up negotiations in a hotel, and its representatives ran floor to floor comparing bids. Jim Edgar, then the governor of Illinois, called for a truce, but many states would not sign on, he said."*[13]

A January 2013 study found that the two U.S. States of Kansas and Missouri alone had spent at least $192 million in tax subsidies to poach jobs from one another – despite an "anti-poaching" agreement between the two. The net result appears to have been only a tiny net jobs migration of a few hundred jobs (in favour of Kansas[14]) at very high cost to both.

Again, this bears no relation at all to market 'competition'. It is an unseemly scramble for subsidies.

The sum of tax credits and non-tax subsidies can mean that state revenues from some corporations sometimes don't stop falling when they reach zero: they can turn *negative.* Oklahoma and West Virginia give up amounts equal to a third of their entire budgets to these incentives, the above New York Times story reported, far outstripping any corporate tax revenues paid. In one notorious case, Rhode Island provided a $75 million loan in 2009 to a video game company, 38 Studios, which soon went bankrupt leaving the loan unpaid, far more than wiping out any tiny taxes paid[15].

This race is ultimately self-defeating: as one country takes a step, others respond, and soon everyone is back to square one – yet with a more regressive and complex tax system. (Ireland, an old poster child for tax-cutters, is a good example[16].)

If individual countries are harmed by tax 'competition', this is doubly true when considered from a global perspective. Multilateral institutions, with responsibility for tackling global problems, have been particularly myopic here.

Taxes on the wealthy and on corporations don't stifle economic performance

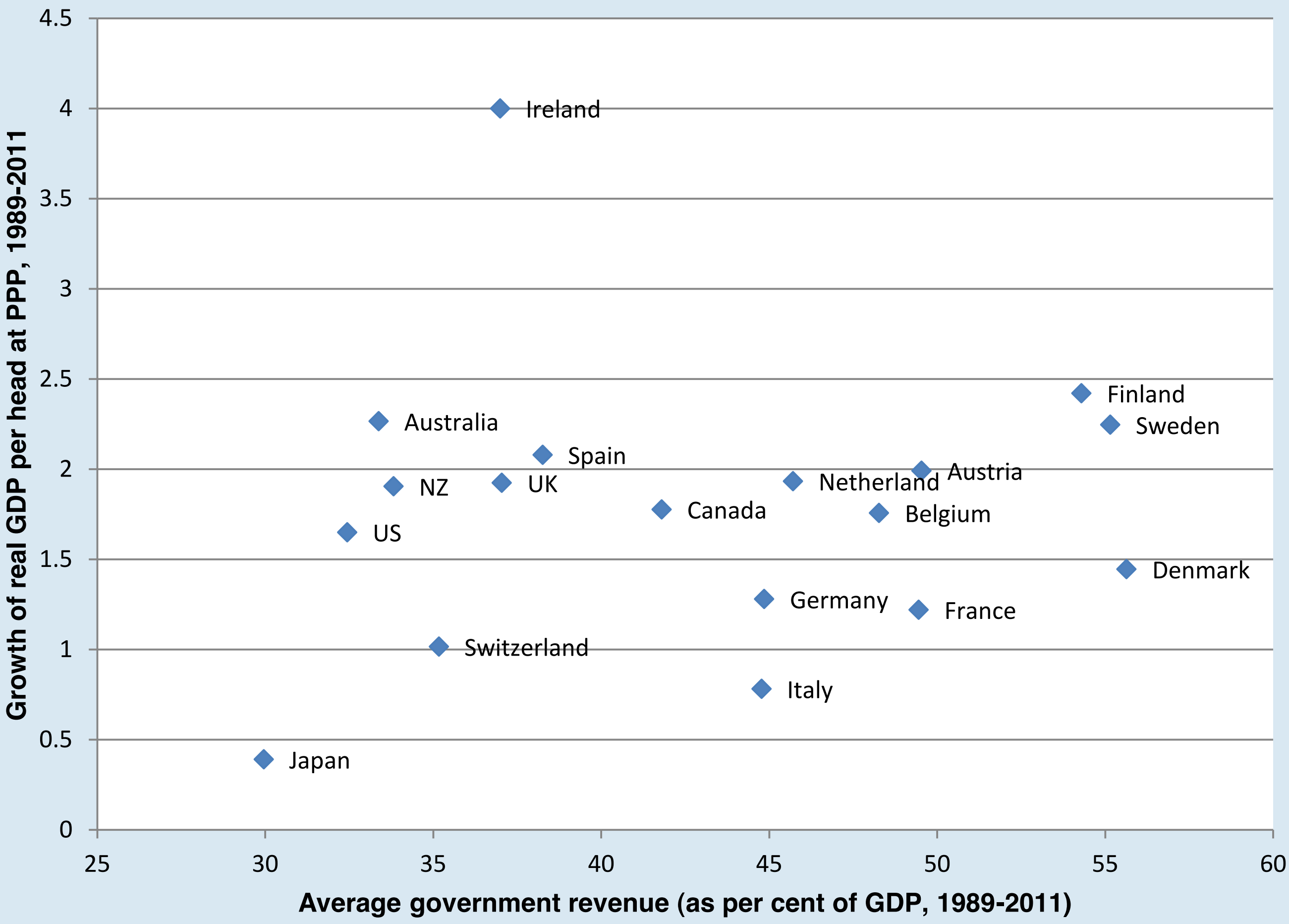
What is the evidence from the real world? Do higher taxes make countries 'uncompetitive'? And even if the effects are globally harmful, can individual states really afford not to keep up in this arms race?

The chart overleaf from the *Financial Times* illustrates one reason why states need not participate.

Astonishing differences in taxes as a share of the economy – from 29 percent in Japan to over 55 percent in Denmark - seem to have had no impact on growth rates.[17] The FT's Martin Wolf concludes from this graph:

> *"Such a spread seems to have no effect on economic performance."*[18]

Figure 2: Taxation and growth of real GDP per head in advanced democracies



Source: IMF, World Economic Outlook database and Conference Board

(That is the GDP *growth* picture; a similar story can be told with respect to the per-capita *absolute size* of GDP. And it should be noted that by plotting only *average* GDP per capita, these graphs mask inequality, which tends to be worse in low-tax states than in high-tax ones.)

A September 2012 report by the nonpartisan U.S. Congressional Research Services (CRS) concluded that tax fluctuations did not seem to affect US economic growth, but did affect inequality:

> *"Changes over the past 65 years in the top marginal tax rate and the top capital gains tax rate do not appear correlated with economic growth. The reduction in the top tax rates appears to be uncorrelated with saving, investment, and productivity growth. The top tax rates appear to have little or no relation to the size of the economic pie […] However, the top tax rate reductions appear to be associated with the increasing concentration of income at the top of the income distribution.*[19]*"*

Other studies, focusing on items other than economic growth, find stronger results. A report by Canada's Center for Policy Alternatives found that:

> *"High-tax countries have been more successful in achieving their social objectives than low-tax countries. They have done so with no economic penalty."*

Another study examining state-level taxes among individual U.S. States found:

> *"Residents of 'high rate' income tax states are actually experiencing economic conditions at least as good, if not better,*

than those living in states lacking a personal income tax[20]."

Others have argued that even if high *overall* taxes don't matter, countries should cut *corporate* or *capital* tax rates to promote growth. The idea is that capital income taxes discourage savings and investment and hinder economic growth. Indeed, there are many studies out there that purport to show that low corporate taxes benefit growth. Yet every one we've seen has fatal flaws[21]. As one recent review of the academic evidence puts it:

"The growth argument has no real basis. […] when the negative growth effects of offsetting increases in labor income taxes or government borrowing are also taken into account, uncertainty begins to shade into doubt. Attempting to spur economic growth with tax preferences for capital income may be like trying to repair one side of the roof with shingles from the other.[22]"

The long historical picture tells us still more. In the 'Golden Age of Capitalism' lasting roughly a quarter century from World War II, economic growth was high and broad-based in many developed and developing countries – at a time when tax rates were generally very high by modern standards. Top marginal income tax rates in the U.S., for example, were around 90 per cent for much of that time, and capital income tax rates that are high by modern standards. The tax-cutting era that followed has been a period of lower growth.

Correlation is not causation, but the numbers certainly show that good economic performance can be compatible with high taxes on the wealthy and on corporations.

Genuine investors are not put off by taxes

So much for the broad national and international trends. How do individual actors respond to tax 'competition' and associated tax incentives?

Corporate interests and wealthy individuals routinely say "Don't tax us too much or your tax system will be uncompetitive and we'll go off to Switzerland." But talk is cheap: how often do those making these threats really relocate?

Politicians the world over need to understand that all the evidence shows that time and again: when their bluff is called, their threats are nearly always empty.[23]

Warren Buffett explains this from the perspective of an individual investor:

"I have worked with investors for 60 years and I have yet to see anyone — not even when capital gains rates were 39.9 percent in 1976-77 — shy away from a sensible investment because of the tax rate on the potential gain."

Paul O'Neill, former head of the aluminium giant Alcoa and former U.S. Treasury Secretary under George W. Bush, adds:

"As a businessman I never made an investment decision based on the tax code […] if you are giving money away I will take it. If you want to give me inducements for something I am going to do anyway, I will take it. But good business people do not do things because of inducements."[24]

Which is common sense. For genuine foreign direct investment, tax is typically a fourth- or fifth- (or lower) order consideration for the investor, after political stability and strong institutions, infrastructure, access to markets and inputs, a healthy, educated and skilled workforce, and the like. These benefits are heavily tax-financed. Nobody would site a semiconductor factory in Equatorial Guinea just because it offers a more generous tax break than South Korea does.

Research on the effect of tax policies on investment flows has produced many different results, but the Organisation for Economic Co-operation and Development (OECD) summarises:

"There is a consensus in the literature about the main factors affecting (foreign) investment location decisions. The most important ones are market size and real income levels, skill levels in the host economy, the availability of infrastructure and other resource that facilitates efficient specialisation of production, trade policies,

> *and political and macroeconomic stability of the host country.*
>
> *Survey analysis shows that host country taxation and international investment incentives generally play only a limited role in determining the international pattern of FDI.[25]"*

Tax is often mistakenly viewed from the perspective of an *individual investor*: if the tax rate in one jurisdiction rises, that investor may, just possibly, flit elsewhere. But from the perspective of the *country* involved, the picture changes completely.

Consider an international tender inviting companies to bid for rights to exploit an oilfield, say, or to win a valuable telecommunications licence. If the country suddenly boosts the headline or effective tax rates facing investors, one or two suitors may look elsewhere, but if a good net after-tax opportunity is available, others will replace them: the oil is still there in the ground and if it's profitable to extract it, someone will exploit it. After all, corporation tax is a tax on profits not on turnover: so tax only kicks in if profits exist.

There may or may not be a difference at the margin, and perhaps a slightly smaller pool of interested investors. But the cost of such incentives in terms of foregone tax revenues is likely to far outweigh the marginal changes in investment quality or quantity that might ensue: these tax breaks typically end up feeding many corporations that were never going to move away[26].

Having a 'competitive' tax system in this context typically means making unnecessary donations of tax revenues to foreign owners of capital.

So what does make a country competitive?

There are meaningful ways to talk about 'competitiveness' among countries.

The World Economic Forum produces an annual 'Competitiveness Index' for 144 countries built on 12 'pillars' of competitiveness: institutions, infrastructure, the macroeconomic environment, health and primary education; higher education and training; labour market efficiency; financial market development; technological readiness; market size; business sophistication; and innovation

Not everyone would agree with all these choices[27] but the Index's goal of measuring "the *set* of institutions, policies, and factors that determine the level of productivity of a country" seems reasonable.

Most of the 12 'pillars' depend heavily on public investment – which means tax. So it's not obvious, even in theory, that tax cuts will make countries more competitive, as many people believe. After all, taxes raised don't go up in smoke! They are not a 'cost' in any meaningful sense of the word, but a transfer, from one (private) sector to another (public) sector: shingles taken from one side of the roof to put on the other.

In the World Economic Forum's Competitiveness Index for 2012-13, two of the top four most 'competitive' countries in the world are Finland and Sweden, two of the world's highest-taxed countries. Although some lower-tax countries such as Singapore also rank highly, there is no evidence that lower taxes make countries more competitive.

And the end of the day, tax 'competition' has *nothing whatsoever* to do with competition between firms in a market. It is always harmful: a beggar-thy-neighbour race to the bottom, worse than a zero-sum game.

Endnotes

[1] We recommend that anyone writing about tax 'competition' between countries must always put the words 'competition' or 'competitive' in inverted commas, to show they understood the issues!

[2] A pure theory of local expenditures, Charles Tiebout, 1956

[3] See, for instance, Diversity, Competition and 'Resilient Dynamism', Address by President Ueli Maurer at the World Economic Forum Annual Meeting 2013, 23 January 2013 in Davos.

[4] See the section on U.S. states, for example, below. One useful study that has looked at this is Millionaire Migration and State Taxation of Top Incomes: Evidence from a Natural Experiment, Cristobal Young and Charles Varner, National Tax Journal, June 2011. The study examined the introduction of a new tax bracket in New Jersey in 2005 resulting in an effective 41% jump in the top marginal state tax rate (to 8.97%) for incomes above $500,000. The researchers found "a minimal effect" overall, though some groups like wealthy retirees were a little more susceptible to the changes. See also Evidence Continues to Mount: State Taxes don't Cause the Rich to Flee, Citizens for Tax Justice, Oct 25, 2012, which links to several other studies.

[5] There are other effects too. Particular dynamics concerning corporate taxes make matters worse. As governments cut corporate tax rates in response to 'competitive' pressures from other jurisdictions, they have tried to shore up corporate tax revenues by broadening the tax base (in other words, expanding the range of economic activities that are taxed.) Again, the choice they make here, in order to stay 'competitive' with other jurisdictions, redistributes the tax charge away from large multinational enterprises and towards smaller enterprises. All this is exacerbated by the fact that although few people move in response to tax changes, the very wealthiest section are somewhat more mobile or at least perceived by governments to be so; this can add further to the pressure to tax these wealthy individuals less.

[6] See, for example, Justice and International Tax Competition, by Thomas Rixen and Peter Dietsch, Academia.edu, 2010

[7] See Is Tax Competition Harming Developing Countries more than Developed?, Tax Notes International, June 28, 2004, by Michael Keen and Alejandro Simone.

[8] Who Pays? Institute for Taxation and Economic Policy, Jan 2013.

[9] See Who Pays Taxes in America in 2013? Citizens for Tax Justice, April 2013

[10] In the U.S., for instance, corporate profits hit 12 percent of GDP in 2012, nearly twice the average rate over the past half century. See Graph: Corporate Profits After Tax (CP)/Gross Domestic Product, 1 Decimal (GDP), St Louis Fed, 2012

[11] Testimony Of The Staff Of The Joint Committee On Taxation Before The Joint Select Committee On Deficit Reduction, Sept 22, 2011

[12] See The Great American Jobs and Tax Scam, Greg Leroy, Tax Justice Focus, Q4 2006. The books Barely Legal and Free Lunch, by the Pulitzer-winning journalist David Cay Johnston, provide a wealth of further detail on this.

[13] As Companies Seek Tax Deals, Governments Pay High Price, New York Times, Dec 1, 2012. This quote has been slightly shortened from the original.

[14] See The Jobs Creation Shell Game, Good Jobs First, January 2013, and subsequent follow-up blog.

[15] See The Job Creation Shell Game, Good Jobs First, Jan 2013, p37

[16] See, for example, The dangerous game of tax competition, Sheila Killian, University of Limerick, with more detail here.

[17] The big outlier here is Ireland, whose growth record stems partly from catch-up amid European integration, and partly from an boom which eventually turned out to be unsustainable.

[18] See Martin Wolf's exchange, Taxation, productivity and prosperity, Financial Times Blogs, May 31, 2012

[19] See Nonpartisan Tax Report Withdrawn After G.O.P. Protest, New York Times, November 1, 2012. The story provides a link to the report itself. That report, which came near the end of a

hard-fought presidential election campaign, was withdrawn under heavy political pressure from Republicans.

20 See "High Rate" Income Tax States Are Outperforming No-Tax States: Don't Be Fooled by Junk Economics, Institute on Taxation and Economic Policy, February 2012

21 First, corporate tax cuts often happen as part of government stimulus packages, when economies are doing poorly, at or near low points in the economic cycle – which is just when subsequent growth is likely to be greater than average. Second, tax-financed public goods such as education or railways often bear fruit over the medium, long, and very long-term: these studies exclude a good fraction of such benefits. Third, capital gains taxes throw a large spanner in the calculations. Unlike wages, interest, dividends and rent, which are taxed when earned, capital gains are only realised when the underlying asset is sold, and remain untaxed until that happens – which may be years in the future. So the stock of potentially taxable capital gains is much larger than the amount of gains that may arise in any given year. Cutting capital gains taxes may unlock some of these gains, which may have arisen over decades, leading to a temporary surge in revenue. But this revenue surges is likely substantially to reflect tax payments being shuffled through time, not genuine growth. (This last analysis is drawn from "Dynamic Scoring Once again", Bruce Bartlett, New York Times Economix blog, April 2, 2013. That article contains many other points pertinent to this analysis.

22 Do Capital Income Taxes Hinder Growth? By Prof. Chris William Sanchirico, University of Pennsylvania/Wharton, Feb 22, 2013

23 See, for instance, Financial Times finds evidence of huge flight of rich after French tax hikes, Tax Justice Blog, March 13, 2013

24 O'Neill speaking at his confirmation hearing to be President George W. Bush's first Secretary of the Treasury, January 17, 2001

25 See Tax Incentives for Investment: a Global Perspective, Experiences in Mena and Non-Mena countries, OECD, 2008. Also see, for instance, Tax incentives and exemptions not necessary to attract investment, Institute for Development Studies, December 20 2012. Also see Is Tax Competition Harming Developing Countries More Than Developed? Tax Analysts, June 2004, by the IMF's Michael Keen and Alejandro Simone. See also Selling Snake Oil to the States, Good Jobs First, Nov 2012

26 Richard Brooks' book The Great Tax Robbery provides a good example. The UK in 2011 announced tax changes making it easier for UK-based to multinationals use tax havens, in a shift expected to cut their taxes by £7bn over four years. Tax haven finance companies would be taxed at 0 - 5.25 percent: a rate chosen, according to tax chief Edward Troup, because "the Dutch have a rate of 5%" - an overt case of tax 'competition.' Martin Sorrell, head of the multinational WPP, led a blaze of publicity to sell the move to a skeptical public, promising to relocate WPP's HQ to the UK, (while paying little extra tax.) A tax writer noted: "Every other multinational with no intention of leaving the UK is ecstatic." Accountancy Age added: "The chancellor is paying a lot of money for very good PR."

27 Several recommendations focus on tax-cutting and on removing 'burdensome' regulations. For example, Pillar Six emphasises "competitiveness is hindered by distortionary or burdensome taxes…" So the WEF index penalises countries for high taxes, distorting the picture. Even so, a graph plotting countries' ranking against their GDP per capita slopes mildly upwards, indicating some positive correlation between higher WEF competitiveness and higher taxes. If the index' inherent anti-tax bias were removed, the line would be steeper.

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