Chapter 3: International Tax Competition

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Overview

Globalization is knitting separate national economies into a single world economy. This is occurring as a result of rising flows of trade and investment, greater labor mobility, and rapid transfers of technology. Deregulation of financial markets, reductions in trade and investment barriers, and reduced communications and transportation costs have spurred those trends.

High tax rates are more difficult to sustain in this new economic environment. As economic integration increases, individuals and businesses gain greater freedom to take advantage of foreign economic opportunities. That increases the sensitivity of decisions about investment and location to taxation. As a result, high tax rates cause large economic losses when borders are opened up, giving countries strong incentives to reduce rates. International "tax competition" is increasing as capital and labor mobility rises.

Most major countries have pursued tax reforms in recent years to ensure that their economies remain attractive for investment. The average top personal income tax rate in the industrial countries of the Organisation for Economic Cooperation and Development (OECD) has fallen 20 percentage points since 1980.[1] The average top corporate income tax rate has fallen 6 percentage points in just the past six years.[2]

Pressure to reduce tax rates stems from the direct loss of capital and skilled labor from countries that do not reform their tax systems and from the example of countries that are prospering under low-tax regimes. For example, Ireland's recent economic success has been much heralded. This small country of 3.8 million people has attracted more foreign direct investment than either Japan or Italy in recent years.[3] The main draw for foreign investors has been a 10% corporate tax rate on manufacturing and financial services.[4] As a result, Ireland has boomed and now has one of the highest standards of living in the world.[5]

Nonetheless, stories of such successful tax cuts concern some economists who view tax competition as distortionary. One concern is that, if differing tax rates cause capital and labor to migrate across borders, resources may not end up in the most productive uses. So Ireland is receiving "too much" investment because of its low tax rates, according to this view. But, this loses sight of a larger issue: high tax rates stunt economic growth. Thus, to the extent that tax competition creates pressure to reduce tax rates globally, all countries gain from increased growth and higher incomes.

Political concerns are behind much of the opposition to international tax competition. A high-profile 1998 report from the OECD argued that coordinated global action was needed to limit "harmful tax competition." One concern is that tax competition may reduce governments' ability to redistribute income. With greater international economic freedom, businesses and individuals that are heavily taxed will naturally look to better locations for working and investing. The OECD calls such tax avoidance "free riding" that "may hamper the application of progressive tax rates and the achievement of redistributive goals."[6] Redistribution, however, involves taxing some people at high rates and others at low rates, so it would seem that the latter group, who pay less than a proportionate share of their income in taxes, are the "free riders." Tax competition may indeed hamper income redistribution but this is a beneficial outcome because redistribution has advanced to an excessive degree in most countries.[7]

In addition to efforts by the OECD and others to reduce tax competition through coordinated global action, governments are taking numerous anti-competition measures on their own. For example, many countries have imposed complex layers of restrictive tax rules on the foreign operations of corporations. Anti-avoidance or "anti-deferral" rules are generally designed to prevent companies from enjoying low tax rates on certain types of foreign subsidiary earnings.

Such defensive responses to globalization are a threat to economic freedom because they counteract the tax-reducing pressures of tax competition. But, restricting tax competition through unilateral action or through an international cartel does nothing to spur economic growth or encourage reform of inefficient tax systems. Tax competition should be defended and encouraged as an important incentive for countries to adopt more efficient low-rate consumption-based tax systems.[8]

Growing Capital and Labor Mobility

Capital Mobility

World economies have become more tightly integrated in recent decades. Rapid growth in cross-border investment—spurred by technological advances and government deregulation—has been a key dimension of integration. Since the 1970s, most countries have reduced or eliminated controls on foreign currency exchange, the purchase of foreign securities, and the ability of foreigners to buy domestic securities and companies.[9] Hundreds of bilateral investment treaties have been signed to lower investment barriers. Financial markets have been deregulated in dozens of countries, making them more attractive to foreign investors.

Throughout the world, direct investment flows soared from $204 billion in 1990 to $1.3 trillion by 2000 (Figure 1) and portfolio investment flows increased from $219 billion in 1990 to $1.4 trillion by 2000 (Figure 2). In recent years, direct and portfolio investment, on net, has flowed out of Europe and Japan and into the United States and fast-growing developing countries.[10]

To attract foreign investment, countries must first get the economic fundamentals right, as documented in *Economic Freedom of the World*. They need to establish a stable currency, have trustworthy legal rules, and have liquid and transparent financial markets. Dozens of formerly socialist countries have begun to get the fundamentals right in the past decade and most industrial countries have made substantial market reforms. As a consequence, tax policy has risen in importance as a factor influencing global investment flows. That is, as other factors become more equalized among countries, investors become more sensitive to differing tax rates.

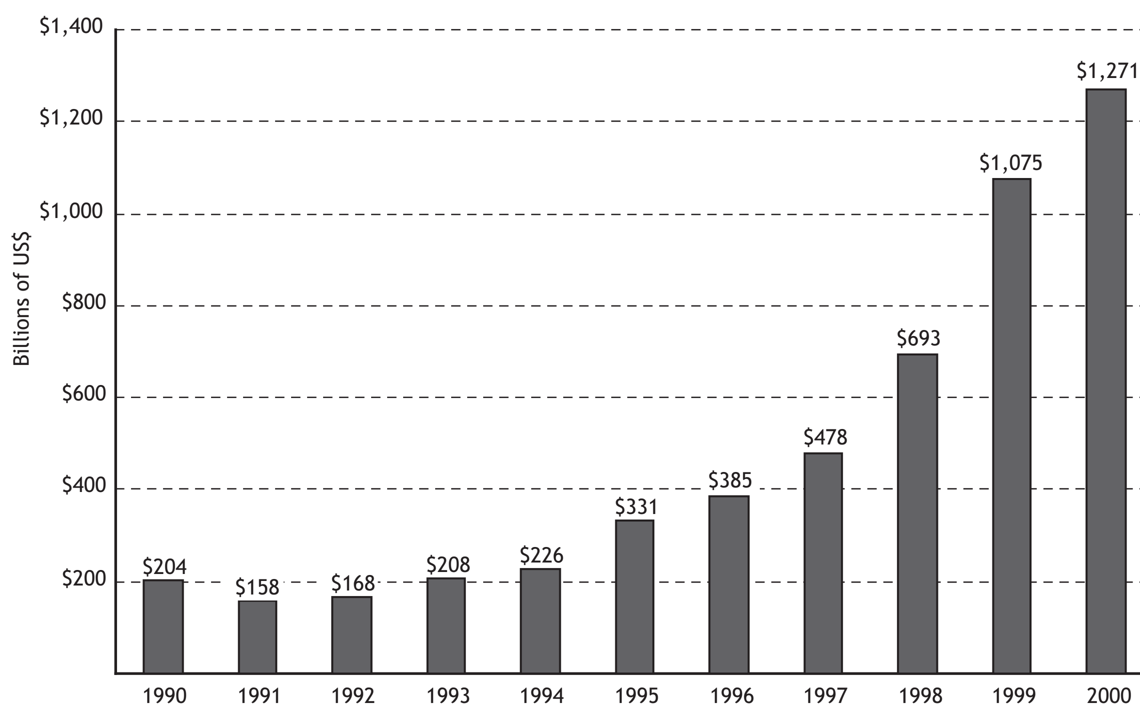
Decisions about the location of businesses have become more sensitive to tax factors. Traditionally, an important reason to invest abroad was to gain access to fixed resources, such as oil deposits. Today, more industries are foot-loose and can be located just about anywhere. Finance and services, for example, are the two fastest growing areas of American direct investment aboard.[11] Also, an increasing share of product value is in the form of intangibles such as knowledge, trademarks, and patents. The profits from intangibles may be easily moved to low-tax countries. Corporations have greater ability to move profits to low-tax locations than previously.

Empirical research confirms that foreign direct investment (FDI) is becoming more sensitive to taxes. In a new compilation of studies on the issue, James Hines of the University of Michigan Business School concludes that "recent evidence indicates that taxation significantly influences the location of foreign direct investment, corporate borrowing, transfer pricing, dividend and royalty payments, and research and development performance."[12] One study found that American multinationals became more sensitive to taxes on FDI between 1984 and 1992.[13] For 1992, the results of the study suggest that countries with 10% higher tax rates received 30% less American FDI (controlling for other factors).

Similarly, a recent study published by the International Monetary Fund (IMF) found "strong evidence" that FDI is affected by tax factors.[14] The study found that, of the countries examined, those with lower taxes had larger inflows of FDI than those with higher taxes. Another analysis found that four European countries with favorable tax regimes—Ireland, the Netherlands, Luxembourg, and Switzerland—accounted for 9% of European GDP but attracted 38% of American FDI in Europe between 1996 and 2000.[15]

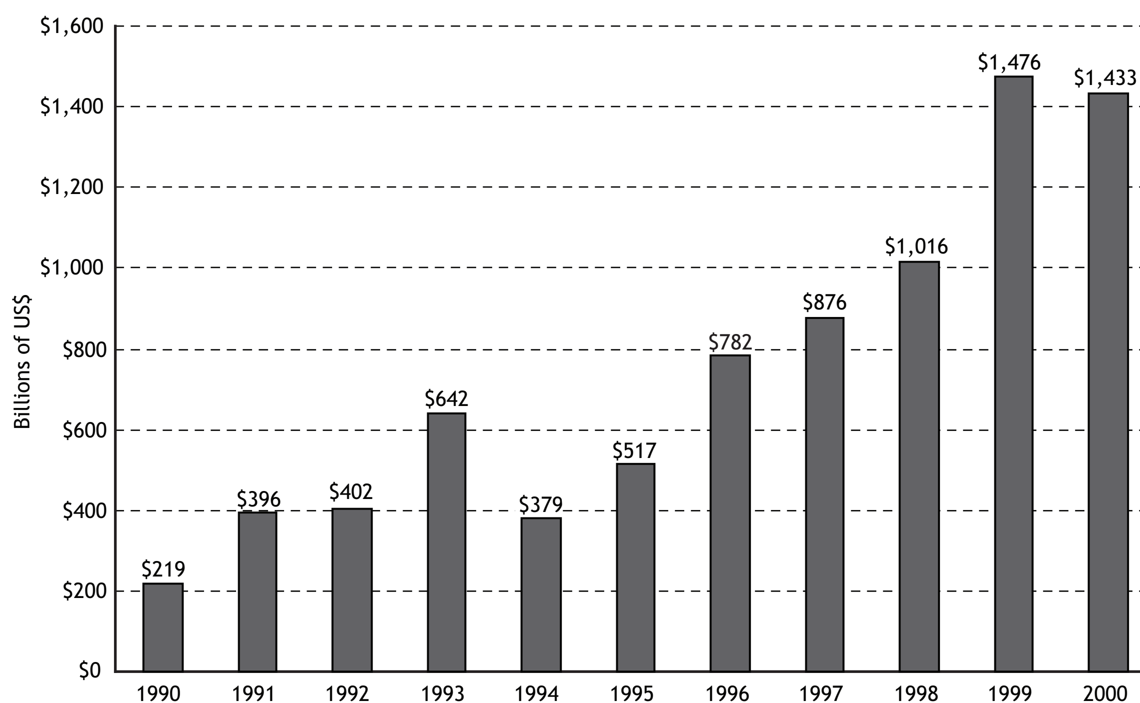
Portfolio investment flows have also become increasingly responsive. The IMF notes that "amid widespread capital account liberalization and increased reliance on securities markets, these investable funds became increasingly responsive to changing opportunities and risks in a widening set of regions and countries."[16] Some countries have eliminated taxation altogether on certain inflows of financial investment because of the increased sensitivity to taxation. For example, American bank deposit and portfolio interest paid to foreigners is exempt from American taxation.[17] Those rules have helped attract more than $1.1 trillion in foreign deposits to American banks and made Miami a banking center for Latin America.[18]

Figure 1: Foreign Direct Investment Flows throughout the World



Source: United Nations, World Investment Report, 1996 and 2001. Figures are FDI inflows.

Figure 2: Foreign Portfolio Investment Flows throughout the World



Note: these are private flows of financial securities (stocks and bonds). Figures are average of inflows and outflows
Source: International Monetary Fund, Balance of Payments Statistics, 2001.

The effect of tax competition on portfolio investment flows is being played out intensely in the European Union (EU). Countries with high taxes, such as Germany and Sweden, have had substantial unreported outflows of savings to EU countries with lower taxes.[19] A 10% German withholding tax on domestic interest payments was introduced in 1989 and "caused a massive movement of funds to Luxembourg."[20] The tax was abolished. The adoption of the euro has intensified tax competition because it eliminates currency risk and narrows interest-rate differentials for savers across Europe.

Labor Mobility

International tax competition is generated by mobile labor as well as mobile capital. This is particularly the case for highly skilled labor in industries such as technology and finance. Family reunification remains the key cause of international migration but there has been an increase in migration for employment and financial reasons.[21] One of those reasons is personal taxation, which varies substantially from country to country; this is a motivation particularly for those with high incomes because most countries have income taxes with progressive rate structures.

Numerous factors have increased the importance of taxes in international migration. First, the Internet has increased information about foreign opportunities and it has allowed firms to broaden international job searches. Second, falling travel and communication costs have made it easier for workers to take employment abroad and maintain close contact with relatives. Third, emigration restrictions in many formerly repressive countries have been eliminated. Fourth, technology has increased the ability to perform work in a foreign country while residing elsewhere. Fifth, regional trading pacts have allowed increased worker mobility.[22] And sixth, a number of countries have raised immigration limits for highly skilled workers.

Citizens dissatisfied with government benefits received compared to taxes paid can vote with their feet and move to more favorable economic climates. Countries sharing a common language and culture, such as Canada and the United States, may feel the strongest tax competition pressure. The Canadian "brain drain" to its lower-tax neighbor has been an important concern of Canadian policy makers.[23] John Roth, the former head of Canada's top high-tech firm, Nortel, routinely warned the Canadian government that tax rates needed to be cut because his best employees were moving to the United States.[24] The North American Free Trade Agreement (NAFTA) intensified labor mobility with a new work visa for skilled professionals called "TN." For each American who has moved to Canada under this category, six Canadians have moved to the United States.[25]

With the removal of restrictions on internal migration within the European Union in 1992, Europeans have also become more sensitive to tax differences between countries. While there are still large linguistic and cultural barriers to migration within Europe, there has been an influx of young, skilled workers to cities, such as London, with lower taxes and more opportunities, particularly in fields such as technology and finance. London's workforce is about 23% foreign and many are from countries with higher taxes on the Continent.[26]

Ireland is another interesting case study of taxes and migration. For years, many young Irish sought a better life in the United States and elsewhere. But corporate tax cuts, followed by individual tax cuts, reversed the Irish migration pattern. Ireland now has record net immigration of more than 20,000 annually, caused by a marked increase in immigration and a fall in emigration during the past decade.[27]

International tax competition with respect to labor is highly visible among highly paid celebrities. For example, many top French soccer and tennis players, artists, and models have moved to Switzerland, Britain, the United States, and elsewhere.[28] Tax avoidance by wealthy celebrities has long been a popular game in Europe. Luciano Pavarotti moved to Monaco and was chased down by the Italian government.[29] Tennis star, Boris Becker, who claimed residence in Monaco and later Switzerland, has been in trouble with the German tax authorities.[30] The message policy makers should receive from such developments is that by maximizing economic freedom with low tax rates, countries can retain those who are wealthy and highly skilled and attract the best immigrants from abroad.

Global Reduction in Tax Rates

The great majority of industrial nations have reduced their personal and corporate income tax rates since the 1980s. The average top individual income tax rate for national governments in the OECD fell from 55% in 1986 to 41% by 2000.[31] Figures in *Economic Freedom*

of the World, which include both national and subnational taxes, show that the average top individual tax rate in the OECD fell from 67% in 1980 to 47% by 2000 (Table 1).[32] Some Nordic countries have adopted dual income tax systems in response to rising tax competition. These systems feature a low flat rate on capital income (interest, dividends, and capital gains) while retaining progressive rates on labor income. Denmark, Finland, Norway, and Sweden implemented such reforms a decade ago and the Netherlands and Austria have recently enacted similar reforms.[33] The OECD notes that such "moves toward a lower and flat tax on capital income has often reflected the need to remain competitive on the international capital markets."[34] The average top corporate tax rate for national governments in the OECD fell from 41% in 1986 to 32% by 2000.[35] A survey by KPMG, which takes into account both national and subnational taxes, found that the average corporate rate fell from 37.6% in 1996 to 31.4% by 2002 (Table 2).[36]

Note that the statutory rate is just one factor determining the attractiveness of a business tax climate. The *effective* marginal tax rate must take into account depreciation deductions, investment credits, and other provisions. Effective corporate tax rates have fallen in the OECD in recent years, although not by as much

Table 1: Top Personal Income tax Rates (%), 1980–2000

(Includes national and state or provincial taxes)

	1980	1985	1990	1995	2000	Change 1980–2000
Australia	62	60	49	47	47	−15
Austria	62	62	50	50	50	−12
Belgium	76	76	55	58	58	−18
Canada	60	50	44	44	44	−16
Denmark	66	73	68	64	59	−7
Finland	65	64	63	55	52	−13
France	60	65	53	51	54	−6
Germany	65	65	65	66	59	−6
Greece	60	63	50	45	43	−17
Iceland	63	56	40	47	45	−18
Ireland	60	65	58	48	42	−18
Italy	72	81	66	67	51	−21
Japan	75	70	65	65	50	−25
Korea	89	65	60	48	44	−45
Luxembourg	57	57	56	50	49	−8
Mexico	55	55	40	35	40	−15
Netherlands	72	72	72	60	52	−20
New Zealand	62	66	33	33	39	−23
Norway	75	64	54	42	48	−27
Portugal	84	69	40	40	40	−44
Spain	66	66	56	56	48	−18
Sweden	87	80	72	58	51	−36
Switzerland	31	33	33	35	31	0
Turkey	75	63	50	55	45	−30
United Kingdom	83	60	40	40	40	−43
United States	70	50	33	42	42	−28
Average for 26 OECD countries	67	63	53	50	47	−20

Note: figures include the lowest state or provincial tax rate, as applicable.
Source: James Gwartney and Robert Lawson, *Economic Freedom of the World: 2001 Annual Report*.
Background note: these are all Gwartney/Lawson rates, except 1980 Luxembourg which is OECD.

as statutory rates.[37] For many corporate decisions, statutory rates are nonetheless the relevant tax factor to consider. As one study noted, "reported income of corporations can be highly elastic with respect to the statutory tax rate since income can be easily shifted from one tax jurisdiction to another without moving real assets."[38]

Capital gains taxes have been cut in numerous countries. For example, Canada cut its capital gains inclusion from 75% to 50% in 2000, thus reducing the effective gains rate to half of the ordinary marginal tax rate.[39] Capital gains cuts have found favor in many countries because of the desire to emulate the United States' high-tech success, which was fueled by capital-gains sensitive "angel" financing, venture capital, and public stock offerings.[40] Note that a number of countries, including the Netherlands, New Zealand, Hong Kong, and Taiwan, do not tax capital gains as a general rule.[41]

Corporate capital-gains taxes have also been cut. Germany's recent tax reforms abolished its 50% capital-gains tax on sales of stakes in other compa-

Table 2: Top Corporate Income tax Rates (%), 1996-2002

(Includes national and state or provincial taxes)

	1996	1997	1998	1999	2000	2001	2002	Change 1996-2002
Australia	36.0	36.0	36.0	36.0	36.0	34.0	30.0	−6
Austria	34.0	34.0	34.0	34.0	34.0	34.0	34.0	0
Belgium	40.2	40.2	40.2	40.2	40.2	40.2	40.2	0
Canada	44.6	44.6	44.6	44.6	44.6	42.1	38.6	−6
Czech Republic	39.0	39.0	35.0	35.0	31.0	31.0	31.0	−8
Denmark	34.0	34.0	34.0	32.0	32.0	30.0	30.0	−4
Finland	28.0	28.0	28.0	28.0	29.0	29.0	29.0	1
France	36.7	36.7	41.7	40.0	36.7	35.3	34.3	−2
Germany	57.4	57.4	56.7	52.3	51.6	38.4	38.4	−19
Greece	40.0	40.0	40.0	40.0	40.0	37.5	35.0	−5
Hungary	33.3	18.0	18.0	18.0	18.0	18.0	18.0	−15
Iceland	33.0	33.0	30.0	30.0	30.0	30.0	18.0	−15
Ireland	38.0	36.0	32.0	28.0	24.0	20.0	16.0	−22
Italy	53.2	53.2	41.3	41.3	41.3	40.3	40.3	−13
Japan	51.6	51.6	51.6	48.0	42.0	42.0	42.0	−10
Korea	33.0	30.8	30.8	30.8	30.8	30.8	29.7	−3
Luxembourg	40.3	39.3	37.5	37.5	37.5	37.5	30.4	−10
Mexico	34.0	34.0	34.0	35.0	35.0	35.0	35.0	1
Netherlands	35.0	35.0	35.0	35.0	35.0	35.0	34.5	−1
New Zealand	33.0	33.0	33.0	33.0	33.0	33.0	33.0	0
Norway	28.0	28.0	28.0	28.0	28.0	28.0	28.0	0
Poland	40.0	38.0	36.0	34.0	30.0	28.0	28.0	−12
Portugal	39.6	39.6	37.4	37.4	35.2	35.2	33.0	−7
Slovak Republic	n/a	n/a	n/a	n/a	n/a	29.0	25.0	n/a
Spain	35.0	35.0	35.0	35.0	35.0	35.0	35.0	0
Sweden	28.0	28.0	28.0	28.0	28.0	28.0	28.0	0
Switzerland	28.5	28.5	27.8	25.1	25.1	24.7	24.5	−4
Turkey	44.0	44.0	44.0	33.0	33.0	33.0	33.0	−11
United Kingdom	33.0	31.0	31.0	31.0	30.0	30.0	30.0	−3
United States	40.0	40.0	40.0	40.0	40.0	40.0	40.0	0
Average for 30 OECD countries	37.6	36.8	35.9	34.8	34.0	32.8	31.4	−6

Source: KPMG.

nies because of competitiveness concerns. In fact, the German reforms prompted the EU to express concern that this may constitute "unfair tax competition" because it will attract foreign holding companies to Germany.[42] Holding companies and corporate headquarters have long been attracted to the Netherlands because it does not tax corporate capital gains, has a "territorial" tax system for businesses, and other advantages.[43]

Another policy response to tax competition has been the reduction and elimination of special taxes on wealth, which have been undermined by capital mobility. In the 1990s, Norway and Sweden reduced their wealth taxes and Denmark, the Netherlands, Austria, and Germany abolished them.[44] One survey of 19 countries found that the average wealth tax has fallen 40% since the mid-1980s.[45]

Tax competition has also driven down withholding taxes. These are taxes placed on payments to foreigners of interest, dividends, and other investment returns. Withholding taxes create an investment disincentive by placing an "exit fee" on repatriated income. A survey of 19 major economies found that the withholding tax on bank interest has been more than cut in half in the past decade.[46]

The strongest pressures towards tax competition occur between countries that have deep trade, investment, and cultural ties. For example, after the United States cut tax rates in 1986, Canadian policy makers were very concerned that American companies would shift profits from their more highly taxed Canadian subsidiaries to their American operations.[47] They could do this relatively easily by increasing debt financing in their Canadian subsidiaries to shift taxable income out of Canada. As a consequence, Canada moved quickly to cut its corporate tax rate to avoid losing its tax base.

In summary, tax competition has caused substantial cuts in individual and corporate statutory income tax rates. Other reforms have included reductions in wealth taxes, withholding taxes, and capital gains taxes. While those tax reductions have been very beneficial, tax competition has not yet reduced overall tax levels in most countries. In fact, total taxes as a percentage of GDP rose from 32.1% in 1980 to 37.3% by 1999, on average, in the OECD.[48]

Why has tax competition not yet reduced overall levels of taxation in most countries? Partly because governments have taken defensive measures to protect their tax bases. Defensive measures have included enactment of complex tax rules on foreign business income and efforts to limit tax competition through international political pressure on nations with low taxes.

The Effects of International Tax Competition

Tiebout's Theory

The economics literature on tax competition traces its lineage to a study in 1956 by Charles Tiebout that examined the provision of public goods by local governments.[49] According to Tiebout's analysis, competition between local governments for mobile households enhances society's overall welfare. To avoid losing residents, governments must tailor public spending and tax levels to suit local preferences. Individuals sort across jurisdictions according to their demand for public goods relative to local tax levels. If some households desire well-financed public schools, they may choose to pay higher property taxes. If not, they may move to a jurisdiction with lower taxes and more efficient, or more limited, government services.

The competition among governments is akin to market competition for products. Market competition encourages efficient production and satisfaction of consumers' demands. Tax competition provides politicians with incentives to improve government efficiency and satisfy voters' demands. The result of tax competition should be that the level of taxes reflects typical preferences within each jurisdiction. Tiebout's theory focused on local governments but with growing flows of labor and capital internationally, national governments are becoming more like local governments as they compete for taxpayers across national borders.

Finding Inefficiencies in Tiebout's Theory

Since Tiebout's study, numerous stylized models have been built in order to assess the effects of tax competition.[50] Given certain assumptions, tax competition has been found to enhance welfare. Using other assumptions, some have concluded that tax competition reduces welfare, distorts investments, and leads to a "race to the bottom." For example, a fact sheet from the European Parliament says that harmonization of business taxes within Europe "may be required to prevent distortions of competition, particularly of investment decisions. Where tax systems are non-neutral … resources will be misallocated."[51] Similar concerns have

led the OECD to pursue a global program of curtailing "harmful tax competition." In its 1998 report, *Harmful Tax Competition: An Emerging Global Issue*, the OECD concluded that "harmful" tax policies create "potential distortions in the patterns of trade and investment and reduce global welfare." [52] Criticisms of tax competition often rely on economics language such as "distortion," "welfare," and "non-neutral," but are based on questionable assumptions and seem to have more to do with politics than economic theory.

Do Low Taxes Harm Global Welfare?

What is the harm in "harmful" tax competition? The OECD's 1998 report identifies six negative effects of regimes with low taxes.[53] Of the six, it appears that at least four are probably more true of regimes with high taxes: "distorting financial and, indirectly, real investment flows"; "undermining the integrity and fairness of tax structures"; "discouraging compliance by all taxpayers"; and "increasing the administrative costs and compliance burdens on tax authorities and taxpayers." The fifth harm cited is hollow bureaucrat-speak: "re-shaping the desired level and mix of taxes and public spending." The sixth harm—"causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption"—gets it backwards. This last effect is a desired and expected shift in a globalized economy.

The OECD argues that "harmful tax competition" causes harm by eroding some nations' tax bases. And yet, the OECD says it supports the reductions in income tax rates that have occurred in response to globalization, noting that "the more open and competitive environment of the last decades has … encouraged countries to make their tax systems more attractive to investors. In addition to lowering overall tax rates, a competitive environment can promote greater efficiency in government expenditure programs."[54] Such beneficial tax reforms, however, would also seem to "erode" tax bases in countries with unreformed tax systems. That is a key inconsistency in the OECD's position.

Tax Competition is Not a Zero-Sum Game

The perspective adopted by critics of tax competition is that of "global welfare." Suppose that the United States cut taxes to boost investment but did not take into account the effect on Germany. That would be deemed an inefficiency or "fiscal externality" of tax competition. If countries do right by their own citizens with tax cuts, they are found to harm other nations. That conclusion clearly flies in the face of national sovereignty. It does not make sense for countries to refrain from domestic tax reforms because of concern for other jurisdictions that may have uncompetitive high-rate tax regimes.

This concern for "global welfare" and the allegation of harmful "fiscal externalities" assumes the false view that tax policy is zero-sum economics. In reality, the large economic gains possible from tax-rate cuts mean that tax competition is not a zero-sum game for particular countries or the world as a whole. As a country adopts a more efficient tax system to maximize growth, other countries follow suit, with the result that global investment and output rise. The round of income tax reductions following American tax reforms in 1986 are a good example. All countries end up better off as each country pursues its own interest.

The supposed "global welfare" cost of tax competition is based on how tax differences alter the allocation of an assumed fixed amount of investment across countries. But, far more serious welfare costs occur within countries that have high income tax rates, particularly on capital and skilled workers. High marginal income tax rates create large "deadweight losses." Those losses, or inefficiency costs, rise more than proportionally as marginal tax rates increase, so even modest rate reductions lead to large economic gains.[55] Tax competition creates downward pressure on inefficient capital taxes and thus boosts investment and economic growth worldwide.

Public Interest versus Public Choice

Most policy makers would probably agree that reductions in tax rates enhance economic growth. But, there is a concern that tax competition ends up driving tax rates "too low." But how low is too low? As University of Chicago professor, Julie Roin, notes, "advocates of tax harmonization appear to regard any departure from the level and distribution of the tax burden set in the non-competitive world as unduly low."[56] That is in large part because of the assumptions built into their models. The status-quo government is taken to be the optimal size as reached by efficient political decision-making.

In a recent study, the European Parliament exhibited the status-quo mind set by criticizing tax competition on the basis that "each country has an incentive to lower corporate taxes below the level

that would be consistent with its natural position."[57] But, what in the world is the "natural" position? The "public-interest" theory of government is implicitly assumed by critics of tax competition: government is assumed to be a benevolent maximizer of the citizen's welfare. Tax competition is seen as throwing a wrench into the optimal fiscal balance achieved when governments have monopoly control over capital and labor.

By contrast, the "public-choice" view regards public officials as engaged in self-interested behavior that may or may not maximize a society's welfare. Rather than steering policy toward the general public good, policy makers try to obtain greater power by maximizing budgets, salaries, and perquisites. This results in excessive and misallocated spending. Therefore, tax competition can enhance welfare by constraining governments from growing inefficiently large. Governments that do not face competition operate like private monopolists with few incentives to reduce waste and increase quality.

The idea that tax competition will lead to a "race to the bottom" ignores the real-world benefits of the competitive process, which forces tough choices to be made and bad ideas to be discarded; and encourages organizations to innovate and to produce better products at lower costs. Gary Becker, winner of the Nobel Prize in Economics, observed that "competition among nations tends to produce a race to the top rather than to the bottom by limiting the ability of powerful and voracious groups and politicians in each nation to impose their will at the expense of the interests of the vast majority of their populations."[58]

Neutrality and Diversity

Concerns about international tax competition also stem from the concept of tax "neutrality." Economists generally support tax systems that do not distort economic decisions by, for example, favoring one industry over another. While no tax is completely neutral, governments should collect revenue in a manner that minimizes such distortions. But the good idea of tax neutrality within national borders is not easily translated to cross-border economic issues. For example, some tax economists support "capital export neutrality," while others support "capital import neutrality."[59] Those two views of neutrality lead to greatly different policy prescriptions.

The broader issue is that taxation is just one of many government policies that may be said to cause "non-neutralities." Competition among government systems occurs on many dimensions, including taxation, spending, regulation, court efficiency, and other items captured in *Economic Freedom of the World*. All those policy differences may generate flows of investment and labor across borders. It is not clear why tax policies require international harmonization when huge non-neutralities exist in many other government attributes.

Rather than tax harmonization, diversity in tax systems seems superior. That way knowledge may be gained about policy successes and failures abroad, allowing better tax policies to be implemented domestically. Attempts to place global restrictions on tax systems through international regulations would put a straitjacket on the beneficial evolution of independent national fiscal systems.

Restrictions on Tax Competition: A Threat to Economic Freedom

Layering Tax Rules on Foreign Business Investment

Countries have responded to international tax competition in a variety of ways. As noted, most major countries have cut tax rates on individual and corporate income. But, many countries have also enacted complex tax rules on multinational corporations to prevent firms from enjoying low tax rates offered by other countries. Such defensive tax rules stifle international tax competition and are merely band-aids that delay needed reforms in inefficient corporate tax systems.

Corporations face a complex set of tax incentives and disincentives on international investments and may respond to differing tax climates in many ways, including moving the location of facilities, altering the debt to equity structure of subsidiaries, changing subsidiary dividend policies, or using "transfer pricing" to shift profits from countries with high taxes to those with low taxes.

The complex tax rules affecting those corporate decisions can be only briefly touched on here. About half of the countries of the OECD, including the United States, tax corporations on their worldwide income.[60] For example, a resident of the United States who owns stock in a British corporation or an American corporation that has a production facility in Germany report the income from those foreign activities on a US tax return. Other countries of the OECD have "territorial" business-tax systems under which

income from foreign sources is generally not taxed.[61] But, even countries that use a worldwide tax approach have traditionally limited their claims to taxing income from foreign sources.

One important limit is that business profits earned abroad in majority-owned subsidiaries are generally not taxed by home governments until repatriated. But, governments are enacting rules to limit the ability of firms to "defer" tax on subsidiary earnings. For example, the United States' "subpart F" anti-deferral rules aim to tax, when earned, a subsidiary's passive investment income, such as dividends and interest.[62] For example, if an American manufacturing subsidiary in Ireland earned profits that it then invested in British equities, those investment earnings would be immediately taxed in the United States. "Subpart F" rules also aim to immediately tax foreign income from "base-company" sales and services, that is, sales into third countries from certain American foreign subsidiaries. For example, profits from export sales to Germany from an American-owed Swiss subsidiary may be immediately taxable in the United States. In all there are six, often-overlapping, anti-deferral regimes that create a complex web of rules for those investing abroad.[63]

Other countries have followed the lead of the United States. For example, after Britain abolished exchange controls in 1979, the tax base became more vulnerable. Britain responded with cuts in corporate and individual tax rates but it also enacted anti-deferral legislation in 1984.[64] Similarly, as Germany has opened its borders it has both cut tax rates and added new tax rules on foreign income. Germany had a particularly high rate of corporate tax to defend and German companies have been aggressive in reducing their taxable income.[65] The German government responded by cutting the corporate tax rate from about 60% in the early 1990s to 38% by 2002.[66] The title of a 1994 tax cut law indicates the pressure from tax competition Germany felt: "Law to Secure the Competitiveness of Germany as a Location for Enterprises in a Common Market."[67] The government also introduced anti-deferral rules in an attempt to stem the outflow of capital to countries with lower taxes.

The OECD has been urging countries to adopt anti-deferral rules.[68] The growth in such rules has blunted international tax competition by denying companies the benefits of investing in countries with low taxes. Further, this defensive response to globalization comes at a high cost in tax complexity and inefficiency: one study found that, for the 500 largest American companies, 46% of the costs of complying with federal tax law stemmed from rules on foreign income.[69]

Some countries have not followed the path of aggressively expanding taxation of foreign income. The Netherlands, as noted, has a very attractive environment for corporate location. The government of the Netherlands officially touts its lack of anti-deferral (or "CFC") rules as an important advantage:

> The Netherlands is one of the few countries in Europe that does not (yet) bear the burden of Controlled Foreign Company (CFC) rules. CFC rules aim to prohibit the use of low tax environments and other tax planning ideas. By their nature, these rules contain many elements of overkill and prohibit establishment of a tax efficient group structure. It is therefore very important to choose a holding location that does not have CFC rules.[70]

Placing complex tax rules on foreign investment can backfire because corporations have the option of reincorporating abroad. The US Treasury recently announced that there has been a "marked increase" in the number and size of American companies that are reincorporating abroad because the United States has an unattractive system for taxing multinationals.[71] This was highlighted by the 1998 Daimler-Chrysler merger, which established the merged firm's headquarters in Germany, in part for tax reasons.[72] While cross-border mergers used to be rare, in the past decade the number has exploded and value has soared, opening the door to tax competition through foreign reincorporations.[73] Ultimately, governments need to implement low-rate, consumption-based tax systems that provide fewer incentives for companies to avoid and evade taxes in the increasingly globalized economy.

Curbing Tax Competition through an International Tax Cartel

The release of the OECD's 1998 report on "harmful tax competition" has created continuing controversy regarding the report's wide sweep and aggressive stance. The OECD followed up with reports in 2000 and 2001, which identified "harmful" tax practices by OECD member countries and listed 41 jurisdictions considered to be tax havens.

The Bush administration in the United States has slowed down the ambitious plans of the OECD to move toward constructing an international cartel to curb tax competition. US Treasury Secretary Paul O'Neill expressed his reservations about the OECD's project in congressional testimony last year: "I felt that it was not in the interest of the United States to stifle tax competition that forces governments—like businesses—to create efficiencies."[74] In the US House of Representatives, majority leader Dick Armey has argued that the United States should not support "a global network of tax police," and that it is unfair for large wealthy countries to bully small, often poorer nations, to change successful economic policies.[75]

Much of the focus has been on indirect efforts to curb tax competition. In particular, the OECD is pressuring offshore financial centers, or tax havens, to agree to exchanges of information about taxpayers. Offshore financial centers combine low-tax climates with high levels of financial privacy, so these demands strike at the core of the economic success of these jurisdictions. There are also demands for more transparency in tax systems to eliminate special deals and negotiated special rates of taxation.

However, attracting financial services can be a successful development strategy for countries that have few natural resources on which to build a growing economy. In addition, targeted nations have argued that threatened sanctions are breaches of international law and violations of their sovereignty.[76] They resent the unfairness of the whole process, including the fact that most major countries of the OECD also have "harmful" tax rules that, in many cases, have not been fixed. Nonetheless, some targeted jurisdictions have made deals, changing some of their laws to be spared from attacks by the OECD wolves.[77]

The United Nations has also come out in favor of restricting international tax competition. A high-level UN panel last year suggested creating an International Tax Organization (ITO) that would develop norms for tax policy, engage in surveillance of tax systems, and push countries to "desist from harmful tax competition."[78] Such a body would likely have a strong bias toward tax increases. The UN report suggests creation of a "global source of funds" from a "high yielding tax source."[79] It also suggests study of a "Tobin tax" on foreign-exchange transactions to finance "global public goods." And, it says that an ITO "could take a lead role in restraining the tax competition designed to attract multinationals."[80]

Some think that an ITO might be like the World Trade Organization, which handles trade disputes. But, while economists nearly universally agree on the benchmark of free trade, there is no such agreement in the tax world. Proponents of broad-based income taxes and proponents of consumption-based taxes would come to vastly different conclusions about what an ITO should enforce.

In fact, there is an underlying bias among tax competition critics in favor of high-rate broad-based income tax systems. The OECD says that "countries should remain free to design their own tax systems as long as they abide by internationally accepted standards in doing so."[81] Those in favor of replacing income tax systems with consumption-based tax systems should be very vigilant that the OECD or other international bodies do not create international "standards" that lock in high-rate income taxes and preclude pro-growth, consumption-based tax reforms.

Responding to Tax Competition with Consumption-Based Tax Reforms

In recent years, there has been great interest in replacing individual and corporate income taxes with consumption-based tax systems. Proposals have included retail sales tax systems and a consumption-based "flat tax," based on the design of Robert Hall and Alvin Rabushka of the Hoover Institution. Consumption-based tax reform would be not only good domestic tax policy but also a positive way for countries to respond to rising international tax competition.

Consumption-based tax reforms would increase investment and economic growth and would greatly simplify tax systems. Consumption-based taxes would be "territorial" and would not tax foreign economic activity, allowing the elimination of most international tax rules. A territorial tax would also allow businesses to compete in foreign markets without tax burdens imposed by governments in the home country.

To replace the revenue currently raised by corporate and individual income taxes, a consumption-based tax would require a rate much lower than the top marginal income tax rates found in most countries today.[82] This factor alone would greatly reduce the need for the complex defensive tax measures, such as anti-deferral rules, that governments are taking. Lower marginal tax rates and a simpler consumption tax base would reduce wasteful tax evasion and avoidance behavior by individuals and corporations.

Countries that adopt consumption-based systems would be very attractive locations for business investment. If some major countries pursued such reforms, other countries would have a strong incentive to enact similar reforms.[83] As tax rates on capital income fell around the world, economic distortions caused by taxes would be reduced. Unless international tax competition is stifled, greater economic freedom through lower marginal tax rates will lead to more efficient tax systems, greater capital investment, and rising incomes around the world.

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