Tax Competition and Fiscal Reform: Rewarding Pro-Growth Tax Policy

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Prepared for "A Liberal Agenda for the New Century: A Global Perspective," a Conference cosponsored by the Cato Institute, the Institute of Economic Analysis and the Russian Union of Industrialists and Entrepreneurs, April 8-9, 2004, Moscow, Russian Federation.

Tax competition exists when people can reduce tax burdens by shifting capital and/or labor from high-tax jurisdictions to low-tax jurisdictions. This migration disciplines profligate governments and rewards nations that reduce tax rates and engage in pro-growth tax reform. Tax competition is particularly important in today's global economy, and this process has helped convince many nations to implement pro-market tax policy.

Not surprisingly, high-tax nations dislike tax competition. Working through international bureaucracies like the European Union (EU), the United Nations (UN), and the Organization for Economic Cooperation and Development (OECD), these governments are promoting various tax harmonization schemes to inhibit the flow of jobs and capital to market-oriented economies. Such proposals are fundamentally inconsistent with good tax policy. Tax harmonization means higher tax rates and discriminatory double-taxation of income that is saved and invested. It also means extra-territorial taxation since most tax harmonization schemes are designed to help governments tax economic activity outside their borders.

An "OPEC for politicians" would insulate government officials from market discipline, and the resulting deterioration in economic policy would slow global economic performance. This would have a particularly adverse impact on transition economies, many of which have implemented pro-growth policies. These reforms, including Russia's 13 percent flat tax, should be a magnet for jobs and capital, but these potential benefits will be limited if high-tax nations succeed in hindering the ability of taxpayers to benefit from better tax law in other countries.[1]

The Battlefield

Notwithstanding the risks to world growth, international bureaucracies are pursuing three major tax harmonization initiatives:

1. The Paris-based Organization for Economic Cooperation and Development (OECD) launched a "harmful tax competition" initiative in the 1990s, identifying more than 40 so-called tax havens.[2] The OECD is threatening these jurisdictions with financial protectionism if they do not agree to weaken their tax and privacy laws so that high-tax nations can more easily track – and tax – flight capital. Ironically, the OECD did not blacklist any of its member nations, even though many of them – Switzerland, Austria, Luxembourg, the United States, and the United Kingdom – qualify as tax havens according to the OECD's own definition.
2. The European Union (EU) is a big opponent of tax competition, and the Brussels-based bureaucracy has imposed varying degrees of harmonization on value-added taxes, energy taxes, and excise taxes. The EU's most recent initiative is the "savings tax directive," an indirect form of tax harmonization that ostensibly would require member nations – as well as six non-EU nations – to either impose a special tax on nonresident investors (and give the lion's share of the revenue to the investor's government) or to collect information about the investment earnings

[1] Advocates of information-sharing and other forms of tax harmonization frequently will admit that such policies inhibit the efficient flow of capital. See, for instance, Keen, Michael, and Jenny E. Ligthart, "Cross-Border Savings Taxation in the European Union: An Economic Perspective," *Tax Notes International*, February 9, 2004.

of nonresidents and forward it to their respective governments (who would then tax the income).[3]

3. The United Nations (UN) has called for the creation of an International Tax Organization. This new bureaucracy would have the power to override the tax policy of sovereign nations and would be specifically responsible for curtailing tax competition. Equally worrisome, the UN proposes to give nations the power to tax emigrant income, a ploy that would have particularly adverse affects on nations that attract skilled immigrants.[4]

What is Tax Harmonization?

Tax harmonization exists when taxpayers face similar or identical tax rates no matter where they work, save, shop, or invest. Harmonized tax rates eliminate fiscal competition, much as a price-fixing agreement among gas stations destroys competition for gasoline. Tax harmonization can be achieved two different ways:

- Explicit tax harmonization occurs when nations agree to set minimum tax rates or decide to tax at the same rate. The European Union, for instance, requires that member nations impose a value-added tax (VAT) of at least 15 percent.[5] With this direct form of tax harmonization, taxpayers are unable to benefit from better tax policy in other nations and governments are insulated from market discipline.

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[2] The OECD is a Paris-based bureaucracy representing 30 industrialized nations. Most of its members are high-tax European nations. The OECD's report, "Harmful Tax Competition: An Emerging Global Issue," can be found at http://www.oecd.org/daf/fa/harm_tax/Report_En.pdf.

[3] The European Union is a Brussels-based bureaucracy representing the 15-member European Community. A description of the European Union's "Savings Tax Directive can be found at http://europa.eu.int/comm/taxation_customs/publications/official_doc/IP/ip011026/memo0 1266_en.pdf.

[4] The United Nations is based in New York and it professes to represent the entire world. The UN's proposal can be found at http://www.un.org/esa/ffd/a55-1000.pdf.

[5] European Parliament, "Value added tax (VAT)," *Fact Sheet* no. 3.4.5, October 19, 2000. Available at http://www.europarl.eu.int/factsheets/3_4_5_en.htm.

- Implicit harmonization occurs when governments tax the income their citizens earn in other jurisdictions. This policy of "worldwide taxation" requires governments to collect financial information on nonresident investors and to share that information with tax collectors from foreign governments. With this indirect form of tax harmonization, taxpayers are unable to benefit from better tax policy in other nations, and governments are insulated from market discipline.[6]

Both forms of tax harmonization have similarly counterproductive economic consequences. In each case, tax competition is emasculated, encouraging higher tax rates. This hinders the efficient allocation of capital and labor, slowing overall economic performance.

The Academic Evidence

The debate over tax competition is sometimes seen as a proxy for the debate on whether income tax systems should be replaced by a "consumption-base" system such as the flat tax. Supporters of tax reform favor tax competition because it drives policy in the right direction. For instance:

- Tax reform envisions a system with low tax rates on productive behavior. Tax competition promotes tax reform by helping drive down marginal tax rates.

[6] For more information on the dangers of information exchange to economic growth, see Daniel J. Mitchell, "An OECD Proposal to Eliminate Tax Competition Would Mean Higher Taxes and Less Privacy," Backgrounder No. 1395, The Heritage Foundation, September 18, 2000. Available at http://www.heritage.org/library/backgrounder/bg1395.html.

- Tax reform envisions a system where income is taxed only one time. Tax competition promotes tax reform by helping eliminate double-taxation of income that is saved and invested.
- Tax reform envisions a system where governments do not tax income earned in other nations. Tax competition promotes tax reform by rewarding territorial taxation, the common-sense notion that governments tax only income earned inside national borders.

If these policies are desirable, then tax competition is good for the world economy. On the other hand, if economies perform better with high rates and punitive tax burdens on saving and investment, then tax competition is counterproductive. Much of the discussion revolves around whether income that is saved and invested should be more heavily taxed than income that is consumed. And on this issue, there is a growing consensus that double-taxation of capital is misguided. Eric Engen and Kevin Hassett of the American Enterprise Institute write:[7]

> Over the past three decades, numerous studies — including Diamond (1973);[8] Feldstein (1978);[9] Auerbach (1979);[10] Atkinson and Sandmo (1980);[11] Judd (1985, 1999);[12] Chamley (1985, 1986);[13] Lucas (1990);[14] Bull (1993);[15] Chari, Christiano,

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[7] Eric Engen and Kevin Hassett, "Does the Corporate Tax Have a Future?" *Tax Notes* 30th Anniversary Issue, Spring 2003. Available at http://www.aei.org/docLib/20021222_raengehass0212.pdf.

[8] Diamond, Peter (1973). "Taxation and Public Production in a Growth Setting." In *Models of Economic Growth,* edited by J. A. Mirrlees and N. H. Stern. London: Macmillan.

[9] Feldstein, Martin S. (1978). "The Rate of Return, Taxation, and Personal Saving." Economic Journal 88: 482-87.

[10] Auerbach, Alan J. (1979). "Wealth Maximization and the Cost of Capital." *QuarterlyJournal of Economics* 93: 107-127.

[11] Atkinson, Anthony B., and Agnar Sandmo (1980). "Welfare Implications of the Taxation of Savings." *Economic Journal* 90 (September): 529-49.

[12] Judd, Kenneth L. (1985). "Redistributive Taxation in a Simple Perfect Foresight Model." *Journal of Public Economics* 28: 59-83. And Judd, Kenneth L. (1999). "Optimal Taxation and Spending in General Competitive Growth Models." Journal of Public Economics 71: 1-26.

[13] Chamley, Chistophe (1985). "Efficient Taxation in a Stylized Model of Intertemporal General Equilibrium." *International Economic Review* 26: 451-68. And Chamley, Chistophe (1986). "Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives." *Econometrica* 54: 607-22.

and Kehoe (1994);[16] and Jones, Manuelli, and Rossi (1993, 1997)[17] — have concluded that an optimal tax system in most cases will not include a tax on capital. Judd (2001)[18] provides a useful intuition for the result. A capital tax introduces a distortion into an economy, a distortion that "explodes" over time. Hence, even a small capital tax will not be optimal.

The Chairman of President Bush's Council of Economic Advisors also recognizes the importance of "consumption-base" taxation. His influential article explains that excessive taxation of capital is so damaging to economic performance – and therefore wage growth – that workers should voluntarily choose to accept more taxes on labor so that taxes on capital can be reduced.[19] This is a well-established position in the academic literature,[20] and it even has some adherents in rather unusual places. Three OECD economists wrote, "…the best way to improve economic performance would be to replace current wage-income and capital-income taxes by a general tax on consumption…This would eliminate tax distortions on intertemporal decisions (i.e.

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[14] Lucas, Robert E. Jr. (1990). "Supply Side Economics: An Analytical Review." *Oxford Economic Papers* 42: 293-316.

[15] Bull, Nicholas (1993). "When All the Optimal Dynamic Taxes Are Zero." Federal Reserve Board Working Paper Series #137.

[16] Chari, V. V., Lawrence J. Christiano, and Patrick J. Kehoe (1994). "Optimal Fiscal Policy in a Business Cycle Model." *Journal of Political Economy* 102: 617-52.

[17] Jones, Larry E., Rodofo E. Manuelli, and Peter E. Rossi (1993). "Optimal Taxation in Models of Endogenous Growth." *Journal of Political Economy* 101: 485-517. And Jones, Larry E., Rodofo E. Manuelli, and Peter E. Rossi (1997). "On the Optimal Taxation of Capital Income," *Journal of Economic Theory* 73: 93-117.

[18] Judd, Kenneth L. (2001). "The Impact of Tax Reform in Modern Dynamic Economies." *In Transition Costs of Fundamental Tax Reform,* edited by K. A. Hassett and R. G. Hubbard. Washington, D.C.: AEI.

[19] Mankiw, N. Gregory (2001). "Commentary: Balanced-Budget Restraint in Taxing Income From Wealth in the Ramsey Model." In *Inequality and Tax Policy,* edited by K. A. Hassett and R. G. Hubbard. Washington, DC: AEI.

[20] Jing Xu of the Department of Finance in Canada concluded, "…the capital income tax is more distorting than either labour income or sales taxes, and the sales tax is the least distorting. This ranking is consistent with the standard result in the neo-classical growth literature." See Jing Xu, "Taxation and Economic Performance: A Cross-Country Comparison and Model Sensitivity Analysis, Working Paper 99-01, Canadian Department of Finance, 1999.

savings and investment). Indeed, most model simulations, including those included in this paper, illustrate the benefits of such tax-switching for efficiency and growth."[21]

The question then shifts to the practical issue: Does tax competition encourage lower taxes on capital? Are saving and investment sensitive to tax rates? An OECD study concludes that tax policy has a significant effect on economic behavior:[22]

> Several empirical studies suggest that financial capital flows also are sensitive to tax regimes. Bovenberg *et al.* (1990)[23] found that bilateral flows of portfolio capital between Japan and the United States in the 1980s are explained partly by relatively higher taxes on personal savings (e.g. personal taxes on interest income) and relatively low taxes on investment (e.g. corporate taxes). Recent work by Grubert and Mutti (1991)[24] shows that the rates of return and the profit margins for US companies operating abroad are higher in low-tax countries than in high-tax countries, which is consistent with profit shifting.

There also is an extensive literature on tax competition. And while the authors may not agree whether tax competition is a good thing, there is almost universal acknowledgement that it results in lower tax rates and less taxation of saving and investment. Sometimes the lower tax burden on capital came about because governments improved tax law. In other cases, the lower tax on capital occurred because resources migrated to lower-tax jurisdictions.

Alfano (2003), for instance, explains that fiscal competition boosts long-run growth (though the EU savings tax directive, if implemented, will reduce saving and

[21] Willi Leibfritz, John Thornton and Alexandra Bibbee, "Taxation and Economic Performance," Organization for Economic Cooperation and Development, Economics Department *Working Papers*, No. 176, 1997.
[22] Willi Leibfritz, John Thornton and Alexandra Bibbee, "Taxation and Economic Performance," Organization for Economic Cooperation and Development, Economics Department *Working Papers*, No. 176, 1997.
[23] BOVENBERG, A.L., K. Andersson, K. Aramaki and S. Chand (1990), "Tax incentives and international capital flows: the case of the United States and Japan," in A. Razin and J. Slemrod (eds.), *Taxation in the Global Econom*y, Chicago: University of Chicago Press.
[24] GRUBERT, H. and J. Mutti (1991), "Taxes, tariffs and transfer pricing in multinational corporation decision making", *Review of Economics and Statistic*s, Vol. 73.

stunt growth).[25] Altshuler and Goodspeed (2002) show the sensitivity of European nations to changes in US tax policy.[26] Desai (1998) finds that US companies grew faster when operating in low-tax jurisdictions.[27] Oates (2001) discusses how tax competition encourages policy makers to make more sensible fiscal decisions.[28]

Mendoza and Tesar (2003) report that tax reform in the US would substantially increase growth and attract capital from Europe.[29] Rauscher shows that jurisdictional competition improves government efficiency and limits the size of government.[30] Edwards and Keen (1995) note that taxes on capital are increasingly unsustainable with fiscal competition.[31] Janeba and Schjelderup (2002) make an important point by showing that Europeans have the most to gain from tax competition because of the excessive size of government.[32] Janeba and Wilson (2002) explain that decentralization enhances competition and improves economic performance.[33]

Last but not least, several Nobel Prize winners have commented on tax competition. James Buchanan points out that "…the intergovernmental competition that a genuinely federal structure offers may be constitutionally 'efficient'…" and that "…tax

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[25] R. Alfano, "Tax Competition in EU Scenario: An Empirical Application, ….

[26] Rosanne Atlshuler and Timothy J. Goodspeed, "Follow the Leaders? Evidence on European and US Tax Competition," July 19, 2002. Available at http://econ.hunter.cuny.edu/faculty/goodspeed/papers/follow_the_leader.pdf.

[27] M Desai, "Are We Racing to the Bottom? Evidence on the Dynamics of International Tax Competition,"…

[28] W Oates, "Fiscal Competition or Harmonization? Some Reflections,"…

[29] Enrique G. Mendoza and Linda L. Tesar, "A Quantitative Analysis of Tax Competition V. Tax Coordination Under Perfect Capital Mobility," Working Paper 9746, National Bureau of Economic Research, May 2003.

[30] Michael Rauscher (1998), "Leviathan and Competition Among Jurisdictions: The Case of Benefit Taxation," Journal of Urban Economics, 44, 59-67.

[31] Jeremy Edwards and Michael Keen, (1996) "Tax Competition and Leviathan," European Economic Review, 40, pp. 113-134.

[32] Eckhard Janeba and Guttorm Schjelderup, "Why Europe Should Love Tax Competition – and the US Even More So," August 15, 2002. Available at http://stripe.colorado.edu/~janeba/ejgs.pdf.

[33] Eckhard Janeba and John Douglas Wilson, "Decentralization and International Tax Competition," September 2002. Available at http://stripe.colorado.edu/~janeba/decentralization.pdf.

competition among separate units…is an objective to be sought in its own right."[34] Milton Friedman, meanwhile, writes, "Competition among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or enterprises in the goods and services they offer for sale and the prices at which they offer them."[35] And Gary Becker 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."[36] Last but not least, Adam Smith, the Father of modern economics, noted the relationship between capital flight and misguided tax policies:

> An inquisition into every man's private circumstances, and an inquisition which, in order to accommodate the tax to them, watched over all the fluctuations of his fortunes, would be a source of such continual and endless vexation as no people could support.... The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour would necessarily be more or less diminished by its removal.
> --Adam Smith (An Inquiry into the Nature & Causes of the Wealth of Nations**:** 1776)

[34] Geoffrey Brennan and James Buchanan (1980), The Power to Tax: Analytical Foundations of a Fiscal Constitution (Cambridge University Press: Cambridge).
[35] Letter to Center for Freedom and Prosperity, TK
[36] Gary Becker, "What's Wrong with a Centralized Europe? Plenty," *Business Week*, June 29, 1998.

The "Real World" Effect of Tax Competition

Tax competition facilitates economic growth by encouraging policymakers to adopt sensible tax policy.[37] Tax harmonization, by contrast, usually is associated with higher fiscal burdens.[38] The history of corporate tax rates in the European Union is a good example. As early as 1962 and 1970, there were official reports calling for harmonization of corporate tax systems. In 1975, the European Commission sought a minimum corporate tax of 45 percent. This initiative failed, as did a similar effort in the early 1990s to require a minimum corporate tax rate of 30 percent.[39] Today, thanks to competition, the average corporate tax rate in the European Union is less than 30 percent.

The benefits of tax competition can be appreciated by looking at tax policy changes that have swept the world in the last 25 years. Tax competition should not be seen as the only factor leading to the following tax changes, but it surely has encouraged the shift to tax policy that creates more growth and opportunity.[40]

- <u>The Thatcher/Reagan tax rate reductions</u> – Margaret Thatcher and Ronald Reagan inherited weak economies about 25 years ago but managed to restore growth and vitality with sweeping tax rate reductions. The top tax rate was 83 percent when Thatcher took office, and she reduced the top rate to 40 percent.[41] The top tax rate in the United States was 70 percent when Reagan was

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[37] The web version of this chapter includes an appendix with a more indepth discussion of the economic merits of tax competition.
[38] It is possible that harmonization could be used to limit tax rates. In the European Union, for instance, value-added taxes cannot exceed 25 percent.
[39] European Parliament, "Personal and company taxation," *Fact Sheet* no. 3.4.8, October 19, 2000. Available at http://www.europarl.eu.int/factsheets/3_4_8_en.htm.
[40] Researchers have discovered that tax competition is a primary cause of lower tax rates. See Devereux, Michael P., Ben Lockwood, and Michela Redoano (2002) "Do Countries Compete Over Corporate Tax Rates?" mimeo, University of Warwick.

inaugurated, and he lowered the top rate to 28 percent.[42] The United Kingdom and the United States both benefited from tax rate reductions, but other nations also profited because tax competition compelled them to lower tax rates. And lower tax rates unambiguously have helped the world economy grow faster. Even the OECD, which is hardly sympathetic to pro-growth tax policy, estimates that economies grow ½ of one percent faster for every 10-percentage point reduction in marginal tax rates.[43]

- The Irish Miracle and corporate rate reduction in Europe – The Irish Miracle is perhaps the most impressive evidence of how tax competition advances good tax policy. Less than 20 years ago, Ireland was the "sick man of Europe" – an economic basket case with double-digit unemployment and anemic growth caused by an onerous tax burden. The top tax rate on personal income in 1984 was 65 percent, the capital gains taxes reached a maximum of 60 percent, and the corporate tax rate was 50 percent.[44] In the 1990s, tax rates were slashed dramatically, especially on capital gains and corporate income.[45] Today, the personal income tax rate is 42 percent, the capital gains tax rate is just 20 percent and the corporate income tax rate is only 12.5 percent. These "supply-

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[41] Gwartney, Jim and Robert Lawson with Walter Park and Charles Skipton. *Economic Freedom of the World: 2001 Annual Report.* Vancouver: The Fraser Institute, 2001. Data retrieved from http://www.freetheworld.com

[42] For more information about the Reagan tax cuts, see Daniel J. Mitchell, "Lowering Marginal Tax Rates: The Key to Pro-Growth Tax Relief," Heritage Foundation, Backgrounder no. 1443, May 22, 2001. Available at http://www.heritage.org/Research/Taxes/BG1443.cfm.

[43] Willi Leibfritz, John Thornton and Alexandra Bibbee, "Taxation and Economic Performance," Organization for Economic Cooperation and Development, Economics Department *Working Papers*, No. 176, 1997.

[44] Historical tax data provided by e-mail from the Economic and Budget Division of the Irish Finance Department, March 29, 2001.

[45] For a thorough history of Irish economic reform, see James B. Burnham, "Why Ireland Boomed," *The Independent Review*, vol. VII, no.4, Spring 2003, pp. 537– 556. Available at http://www.independent.org/tii/media/pdf/tir74burnham.pdf.

side" tax rate reductions have yielded enormous benefits. The Irish economy has experienced the strongest growth of all industrialized nations, expanding at an average of 7.7 percent annually in the 1990s.[46] The late 1990s were particularly impressive, as Ireland enjoyed annual growth rates in excess of 9 percent. [47] In a remarkably short period of time, the "sick man of Europe" has become the "Celtic Tiger." Unemployment has dropped dramatically and investment has boomed.[48] But Ireland's tax rate reductions have had a positive effect on the rest of Europe. The Irish Miracle has motivated other EU nations to significantly reduce their tax rates in recent years. As mentioned above, the average corporate tax rates has fallen below 30 percent and there is every reason to think that corporate tax rates in Europe will continue to decline.

<u>Tax reform in Eastern Europe</u> – The three Baltic nations, Estonia, Lithuania, and Latvia, adopted variants of a flat tax in the 1990s.[49] Russia followed with a 13 percent flat tax that took effect in January 2001, and Ukraine approved a 13 percent flat tax. Slovakia is implementing a 19 percent flat tax,[50] and even Serbia has a variant of a flat tax.[51] This virtuous cycle of tax competition is expected to spread to additional Eastern European nations. These flat tax regimes, by themselves, will not solve all the problems that exist in post-

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[46] Organization for Economic Cooperation and Development, *OECD in Figures*, 2002. Available at http://www1.oecd.org/publications/e-book/0102071E.PDF.

[47] James B. Burnham, "Why Ireland Boomed," *The Independent Review*, vol. VII, no.4, Spring 2003, pp. 537– 556. Available at http://www.independent.org/tii/media/pdf/tir74burnham.pdf.

[48] Benjamin Powell, "Economic Freedom and Growth: The Case of the Celtic Tiger," The Cato Journal, vol. 22, no. 3, Winter 2003. Available at http://www.cato.org/pubs/journal/cj22n3/cj22n3-3.pdf.

[49] The Wall Street Journal Europe, "Eastern Tax Enlightenment," July 7, 2003.

[50] Alvin Rabushka, "The Flat Tax in Russia and the New Europe," National Center for Policy Analysis, *Brief Analysis* no. 452, September 3, 2003. Available at http://www.ncpa.org/pub/ba/ba452/ba452.pdf.

[51] Republic of Serbia Ministry of Finance and the Economy, Individual Income Tax Law. Available at http://www.mfin.sr.gov.yu/html/modules.php?op=modload&name=Subjects&file=index&req=viewpage&pageid=213.

communist nations. But the evidence already shows that good tax policy is having a desirable impact. The Baltic nations, for instance, are the most prosperous of the nations that emerged from the former Soviet Union.[52] The Russian Federation was the next to adopt a flat tax, and it is enjoying an economic renaissance.[53] The Russian economy has expanded by about 10 percent since it adopted a flat tax,[54] better than the United States, and easily outpacing the anemic growth rates elsewhere in Europe. Russia's tax reform also has had a dramatic effect on tax compliance, something even the *New York Times* was forced to concede.[55] Over the last two and one-half years, inflation-adjusted income tax revenue in Russia has grown by about 60 percent, demonstrating that people are willing to produce more and pay their taxes when the system if fair and tax rates are low.[56]

Can Tax Harmonization be Justified?

While advocates of tax harmonization often are stereotyped as left-wing ideologues who want to expand the size of big government, this is not necessarily a fair portrayal. Some critics of tax competition believe in the theory of Capital Export Neutrality (CEN), which postulates that economic growth will be maximized if individuals are unable to benefit from lower tax rates in other jurisdictions.

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[52] Gross National Income per capita, 2002, Atlas Method, World Development Indicators, World Bank, July 2003

[53] ibid.

[54] Alvin Rabushka, "The Flat Tax at Work in Russia: Year Two," The Russian Economy, February 18, 2003. Available at http://www.russiaeconomy.org/comments/021803.html.

[55] Sabrina Tavernese, "Russia Imposes Flat Tax on Income, and Its Coffers Swell," New York Times, March 23, 2002.

[56] Alvin Rabushka, "The Flat Tax at Work in Russia: Year Three, January-June 2003," The Russian Economy, August 13, 2003. Available at http://www.russiaeconomy.org/comments/081303.html.

The CEN theory starts with a very reasonable assumption. Supporters assume a world with no taxes, and they correctly assert that resources will be allocated in that world based on economic criteria and efficiency will be maximized. In the real world, however, advocates of CEN note that taxes often differ from one jurisdiction to another, and they argue that these differences affect the allocation of resources. And if resources are allocated efficiently in the hypothetical no-tax world, then real-world tax differentials must – by definition – cause economic output to suffer. The European Commission, for instance, has written that:

> “some harmonisation [sic] of business taxation (both corporation tax and the personal taxation of dividends) may be required to prevent distortions of competition, particularly of investment decisions. Where tax systems are non-neutral - i.e. where relative post-tax rates of return do not correspond to relative pre-tax rates of return - resources will be misallocated."

The CEN theory has a certain consistency and logic, and it is the primary justification for the explicit tax harmonization proposals advocated by the EU, and it is also the main justification for the implicit tax harmonization proposals supported by the OECD.

In the last twenty years, however, the CEN theory has fallen out of favor. Many economists point out that tax competition puts downward pressure on tax rates, and these lower tax rates enhance economic efficiency. Indeed, there is strong evidence that the economic benefit of lower rates – particularly stemming from the reduction of punitive tax rates on savings, investment, and entrepreneurship – exceeds the theoretical economic cost of the resource misallocation associated with different tax rates. Moreover, economists today also cite the real world effect of institutions on political behavior. They note that tax competition serves as a valuable check on the ability of interest groups to damage an economy by creating coalitions that pillage the political minority (often with confiscatory tax burdens) at the expense of the market's efficiency.

Competitive Tax Harmonization: The Best of Both Worlds?

Ironically, tax competition may be the best way of capturing the supposed benefits of tax harmonization. Economic theory states that competitive markets result in a convergence of prices since producers discover that they lose customers if they charge more than the market price and lose earnings if they charge below the market price. This suggests that tax competition not only may lead to lower tax rates, but also that tax rates will tend to converge – which is exactly what supporters of CEN claim is economically efficient.

In other words, there are two ways to eliminate tax rate differentials. The first option, supported by high-tax welfare states, is to create a tax cartel. Tax rates will converge, but at a high level that dampens economic output – what economists refer to as deadweight costs. The other approach is tax competition, which means that tax rates will converge, but at a low level that is conducive to economic growth.

Conclusion

Tax harmonization policies are designed to hinder the flow of jobs and capital from high-tax nations to low-tax nations. The policies being advocated by the OECD, EU, and UN are contrary to economic liberalization, and they would insulate governments from the discipline of market pressure. An OPEC for politicians is the wrong approach.

More importantly, tax harmonization is designed to protect jurisdictions with high tax rates and pervasive double-taxation. This means less economic growth and reduced opportunity. Tax competition, by contrast, encourages lawmakers to make the right decisions – choices that will boost the economy by lowering tax rates and reducing the punitive treatment of capital.