Why tax competition benefits Europe

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The latest *International Tax Competitiveness Index*, published by the Tax Foundation, illustrates the wide variation in the quality of tax systems across Europe. Many view tax competition between countries as a 'bad thing' and have welcomed the global tax plan to raise more revenues from multinational companies. However, attempts to harmonize corporate taxes are unlikely to bring the benefits that are hoped for, not least because any increase in the tax burden on companies will inevitably be passed on to real people.

The benefits of tax competition are also underappreciated. Tax competition has contributed to the reduction of tax rates and broadening of tax bases, which make the tax system more efficient and fairer. Like any other form of competition, tax competition also encourages innovation. Finally, tax competition acts as a check on governments' ability to raise taxes, helping to correct the tendency of politicians to overspend and overtax.

Introduction

The Tax Foundation, a leading Washington-based think tank, has just published the 2021 edition of its *International Tax Competitiveness Index,* or ITCI (Tax Foundation, 2021). The ITCI seeks to measure the extent to which a country's tax system adheres to two important aspects of good tax policy: *competitiveness* (with an emphasis on the benefits of low marginal tax rates) and *neutrality* (raising the most revenue with the fewest economic distortions).

This briefing note begins with a summary of the findings of the ITCI for Europe. This then leads to a critical assessment of the latest moves towards the global harmonization of corporate taxes (led by the OECD), and a restatement of why tax competition (including between EU member states) should be welcomed rather than feared.

Findings of the ITCI for Europe

The 2021 ITCI could prove to be the last report before a major turning point in global tax policies. There had been clear downward trends in the marginal tax rates levied on both corporate and individual income across the OECD for many years. Indeed, several countries, including France, Greece, and Switzerland, were still cutting their main rates of corporation tax in 2021.

Two factors may change these trends in future. The first is the hit to government finances from the pandemic and the resulting pressure for tax increases to bring public borrowing back under control. The second is the perception that companies (especially multinationals) and wealthier households are not paying their 'fair share' of tax.

Despite (or perhaps because of) many cuts in corporate tax rates, the share of total tax revenues raised from corporate taxes has, if anything, been trending higher (OECD, 2020).

In the meantime, though, the results of the 2021 ITCI highlight some important differences between the tax systems of different European countries. In particular, the EU had both the best and the worst of systems among all the OECD economies.

Estonia has the most competitive tax system in the OECD – and Italy the worst.

For the eighth year in a row, Estonia has come top. This reflects many positive features, including a relatively low 20% tax rate on corporate income that is only applied to distributed profits, a flat 20% tax on individual income, and a land value tax. (Interestingly, Latvia and Lithuania are second and sixth respectively, scoring highly for similar reasons.)

At the other extreme, Italy has the least competitive tax system in the OECD, reflecting punitive wealth and financial transaction taxes, a high compliance burden, and a relatively small base for value-added tax. Portugal, France, and Poland complete the bottom four.

Does the OECD's global tax plan live up to the hype?

However, rather than reforming their own tax systems, policymakers are increasingly focused on reducing what is perceived to be 'harmful' tax competition. This is clearest in the global tax plan, developed by the OECD and recently agreed by 136 countries representing more than 90% of world GDP (OECD, 2021).

To recap, the global tax plan has two parts, or 'Pillars'.

Pillar One applies to about one hundred of the biggest and most profitable multinational companies, with global sales above EUR 20 billion and profit margins of more than 10%. Under the plan, 25% of their profits above the 10% threshold would be reallocated and taxed in the countries where they sell their products or services. This part of the plan is expected to redistribute the right to tax more than USD 125 billion of profits every year, with the main winners being developing countries.

Pillar Two applies a global minimum tax rate of 15% to any multinational company with annual revenues above EUR 750 million. This is expected to raise around USD 150 billion in additional tax revenues globally.

These measures are intended to tackle two perceived types of unfairness in the current system. Pillar One addresses the concern that companies can earn significant profits in a country without paying much tax there. Pillar Two is meant to make it harder for companies to reduce their tax bills by artificially shifting profits to low-tax jurisdictions.

The plan has received near-universal praise, with only a small amount of criticism (and that most often from people who think it does not go far enough). However, there are several problems with the proposals.

For a start, it is worth asking whether it is right to focus on raising more from corporate taxes at all. Companies are not independent sources of revenue that can be tapped at will and without any consequences for the rest of the economy.

In fact, companies are only legal entities and cannot bear the economic burden of taxation themselves. That burden always lands on real people, including customers in the form of higher prices and employees as lower wages. Of course, some of the bill will be picked up by shareholders, who might be relatively well off. But not every shareholder is a tech billionaire.

> The OECD's own research has found that corporate taxes are the most harmful for economic growth (OECD, 2008).

Many countries may also be disappointed with the amount of any money raised from the additional taxes. The main effect of Pillar One will be to redistribute tax revenues between countries, rather than increase the overall take. Indeed, many 'tech giants' may end up paying less tax in some countries under the new system, especially if existing Digital Services Taxes are scrapped as part of the package. As for Pillar Two, only three OECD members (Hungary, Chile, and Ireland) had a statutory corporation tax rate of less than 15% before the deal was struck (OECD, 2021b).

A further problem is complexity. The precise details of how profits will be allocated between countries under Pillar One have yet to be worked out. But we do already know that there will be exceptions made for sectors, including financial services, mining, and shipping.

The setting of a 15% global minimum tax is not straightforward, either. This will apply to the 'effective tax rate', not the headline rate, which leaves plenty of scope for interpretation – and manipulation.

The 'fairness' arguments need challenging, too. For example, it is widely assumed that foreign and local companies should pay a similar amount of tax on profits made in a country, even if the foreign company does not have a physical presence there. But the foreign company is not then making the same demands on local infrastructure. It should be sufficient to ensure they pay the same taxes on any local resources that they do use, such as employees and buildings, and any local sales taxes.

> The OECD's global tax plan is more complicated than it may first appear – and unlikely to deliver the benefits that are hoped for.

Finally, the drive towards tax harmonization is a slippery slope. If you accept the principle that tax competition is bad in the context of companies, is it really a big leap to argue that it also applies to people? Should Estonia be forced to change its tax system to be more like Italy? It is therefore worth restating why tax competition (including between EU member states) should be welcomed rather than feared.

The benefits of tax competition

Lots of effort has been put into identifying ways in which tax competition could be harmful. This is usually expressed in terms of preferential tax regimes designed to attract multinational companies, which can 'distort trade and investment patterns, erode national tax bases and shift part of the tax burden onto less mobile tax bases, such as labor and consumption' (OECD, 1998). But even if we accept that the burden of tax stays with companies, rather than being passed on to real people, this ignores the many benefits of tax competition (Teather, 2005).

In short, tax competition has contributed to the reduction of tax rates and broadening of tax bases, which make the tax system more efficient (less distortive) and fairer. Like any other form of competition, tax competition also encourages innovation. This is good for economic growth.

Tax competition acts as a check on governments' ability to raise taxes. Of course, those who believe in 'big government' may think that is a 'bad thing'. But this makes idealistic assumptions about politicians. 'Public choice theory' and numerous 'real world' examples show that even benevolent governments make poor choices.

Politicians tend to overspend and overtax. Tax competition therefore serves the useful purposes of keeping the burden of tax down, while encouraging governments to make their tax systems as efficient as possible.

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