KONZERVATÍVNY INŠTITÚT M. R. ŠTEFÁNIKA
M. R. STEFANIK CONSERVATIVE INSTITUTE

Tax Competition and the European Union

by

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Presented at the Conservative Economic Quarterly Lecture Series (CEQLS)
held by the Conservative Institute of M. R. Štefánik

Bratislava, Slovakia
17 October 2005

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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 lower tax rates and engage in pro-growth tax reform. Like other forms of competition, fiscal rivalry generates positive results. People get to keep more of the money they earn, and economic performance is enhanced because of lower tax rates on work, saving, and investment. The capital mobility that defines tax competition also protects against government abuses. People can better guard against corruption and protect their human rights when they know that they and/or their capital can flee across national borders.

The thought of losing sources of tax revenue scares government officials from high-tax nations, who not surprisingly vociferously condemn tax competition and would like to see it reduced or eliminated. Working through international bureaucracies like the European Union (EU), high-tax governments are promoting various tax harmonization schemes to inhibit the flow of jobs and capital from high-tax jurisdictions to low-tax jurisdictions. These proposals are fundamentally inconsistent with good tax policy. Tax harmonization means higher tax rates, and it also means discriminatory and destructive double-taxation of income that is saved and invested.

People should be allowed to benefit from lower tax rates throughout the world. The EU should not limit the options of capital and labor by creating a cartel that benefits high-tax nations. An "OPEC for politicians" would insulate government officials from market discipline, and the resulting deterioration in economic policy would slow global economic performance.

This issue is critically important for Slovakia. Free market policies like the flat tax have helped Slovakia attract impressive amounts of investment from other nations. Jobs are being created, living standards are rising, and the future is bright. But these positive developments will be hamstrung if bureaucrats in Brussels succeed in undermining Slovakia's fiscal sovereignty.

What is tax harmonization?

Tax harmonization exists when taxpayers face similar or identical tax rates no matter when 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. The EU also has harmonized tax rates for fuel, alcohol, and tobacco, and there are ongoing efforts to harmonize the taxation of personal and corporate income tax rates. 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.

- Implicit harmonization occurs when governments tax the income their citizens earn in other jurisdictions. The European Union, for instance, has a "savings tax directive" that allegedly requires governments to collect financial information on nonresident investors and to share that information with tax collectors from foreign governments. This "information exchange" system tends to be a one-way street since jobs and capital generally flow from high-tax nations to low-tax nations. 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.

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 Intellectual Debate

Fixing the tax treatment of capital income is a major argument for tax competition. Every economic theory – even Marxism – acknowledges that capital formation is the key to long-run growth, yet class-warfare politics often has led to very high effective tax rates on income that is saved and invested. Tax competition creates offsetting pressure, compelling lawmakers to reduce the over-taxation of income that is saved and invested. Examples of this include the widespread corporate tax rate reductions and capital gains tax rate reductions in many European nations – policies that almost surely would not have been enacted in the absence of fiscal competition.

Advocates of tax competition also have additional arguments. Based on the work of the "Public Choice" school of economics, made famous by Nobel Laureate James Buchanan, advocates of CIN also cite the real world effect of institutions on political behavior. From this perspective, 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.

The "real world" effect of tax competition

Tax competition is desirable for a number of reasons. Most important, it facilitates economic growth by encouraging policymakers to adopt sensible tax policy. Tax harmonization, by contrast, usually is associated with higher fiscal burdens. For all intents and purposes, advocates of tax harmonization are seeking to stop the downward pressure on tax rates caused by competition.

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. Today, the average corporate tax rate in the European Union is less than 30 percent.

The European Union's treatment of Ireland also bolsters the view that tax harmonization is a one-way street designed to keep tax rates high. In an unprecedented move, European Union finance ministers voted several years ago to reprimand Ireland for its fiscal policy – even though Ireland at the time had the EU's biggest budget surplus, the second lowest amount of debt, the greatest reduction in government debt, the lowest level of government spending and lowest total taxes. Most observers felt that politicians from other nations were upset that Ireland's 12.5 percent corporate tax rate was putting pressure on them to implement similar reforms. Interestingly, there has never been a reprimand for a country because its taxes were too high.

The benefits of tax competition can be appreciated by looking at tax policy changes that have swept the world in the last 25 years. To be sure, tax competition should not be seen as the only factor leading to the following tax changes. In some case, it may not even be the driving force. But in each case, tax competition has encouraged the shift to tax policy that creates more growth and opportunity.

- The Thatcher/Reagan tax rate reductions – Margaret Thatcher became Prime Minister of the United Kingdom in 1979 and Ronald Reagan became President of the United States in 1981. Both leaders inherited weak economies but managed to restore growth and vitality with free market reforms. Sweeping tax rate reductions were a significant component of both the Thatcher and Reagan agendas. The top tax rate was 83 percent when Thatcher took office, and she reduced the top rate to 40 percent. The top tax rate economic in the United States was 70 percent when Reagan was inaugurated, and he lowered the top rate to 28 percent.

  The United Kingdom and the United States both benefited from tax rate reductions, but other nations also profited because they were compelled to lower tax rates – and this shift to better tax policy is an ongoing process. The accompanying chart shows the sweeping tax rate reductions that have occurred since 1980.

  Tax competition surely played a role in this global shift 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, estimated that economies grow ˝ of one percent faster for every 10-percentage point reduction in marginal tax rates.

- The Irish Miracle and corporate rate reduction in Europe – In addition to reductions in tax rates on personal income, tax competition has helped encourage lower tax rates on corporate income. The Reagan tax rate reductions once again deserve credit for starting the process, and the accompanying chart demonstrates that corporate tax rates have fallen dramatically since 1986.

But 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 an anemic economy. This weak performance was caused, at least in part, 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.

These rates were slightly reduced in the 1980s, but the top tax rates in 1991 were still very high – 52 percent on personal income, 50 percent on capital gains, and 43 percent on corporate income. This is when Irish leaders decided that tinkering with the tax code was not a recipe for success. Over the next 10 years, tax rates were slashed dramatically, especially on capital gains and corporate income. 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 aggressive "supply-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. The late 1990s were particularly impressive, as Ireland enjoyed annual growth rates in excess of 9 percent. 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. The Irish people have been the big winners. Once a relatively poor nation, Ireland now enjoys the second highest standard of living in the European Union. Even the government has reaped benefits. In the mid-1980s, when the corporate income tax rate was up near 50 percent, it only raised revenue barely in excess of one percent of GDP. As seen in chart 4, however, today's 12.5 percent corporate tax collects revenue totaling nearly 4 percent of GDP.

Thanks to tax competition, 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. These lower tax rates will improve economic performance and hopefully encourage European policymakers to make reductions in other tax rates as well.

- Tax reform in Eastern Europe – One of the most amazing fiscal policy developments is the adoption of flat taxes in former Soviet Bloc nations. The three Baltic nations – Estonia, Lithuania, and Latvia – adopted flat tax systems in the 1990s. Tax reform in the Baltics triggered a virtuous cycle of tax competition. Russia followed with a 13 percent flat tax that took effect in January 2001. Ukraine just approved a 13 percent flat tax, and Slovakia is implementing a 19 percent flat tax. Even Serbia has a variant of a flat tax.

These flat tax regimes, by themselves, will not solve all the problems that exist in post-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. The Russian Federation was the next to adopt a flat tax.

The evidence from Russia, where the 13 percent flat tax has produced dramatic results, is particularly striking. The Russian economy has expanded by about 10 percent since it adopted a flat tax. That may not sound like much, but it is rather noteworthy considering the slowdown in the global economy. The Russian economy certainly performed better than the United States, and easily outpaced the anemic growth rates elsewhere in Europe.

In addition to faster growth, Russia's tax reform has had a dramatic effect on tax compliance, something even the *New York Times* was forced to concede. 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.

Conclusion

Tax harmonization policies are designed to hinder the flow of jobs and capital from high-tax nations to low-tax nations. This is a form of cartelization – akin to an OPEC for politicians. The policies being advocated by the EU are contrary to economic liberalization, and they would insulate government from the discipline of market pressure.

More importantly, these policies would deny people the benefits of economic growth. Tax harmonization is designed to protect jurisdictions with high tax rates and pervasive double-taxation. Tax competition, by contrast, pushes lawmakers to make the right decisions – choices that will lower tax rates and reduce double-taxation. The Founding Father of Economics, Adam Smith, correctly noted more than 200 years ago that:

> *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)