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Tax competition's role in economic development

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Tax competition's role in economic development

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Abstract

Many theories of tax competition views that competition leads to inefficiently low tax rates and public expenditure levels. However, more recently other theories have been done in order to investigate the desirable effects of tax competition. Such as the benefices of raising total tax intake due to low corporate tax rates stimulating economic growth. Tax competition in Europe is a little bit different from international tax competition because we have to take in consideration the behavior of economic agents and public institutions in a specific geographic, political, economic and legal setting. This paper describes some approaches to extract the potential benefits of tax competition in order to develop European economy; we will see how tax competition handles inefficiencies in both the private sector and the public sector in Europe. We will also discuss how tax competition effects may represent important changes in the distribution of income.

Keywords: Tax competition, European economy, economy development, income distribution.

1. INTRODUCTION

Since mid-1990s, governments can be setting their taxes freely, and because of globalization the barriers of free capital movements have been reduced. In result, there is a rising in capital flows and great work force mobility and tax competition has appeared.

Tax competition is very important for economic liberalization, which has helped promote good tax policy in many countries around the world (Organization for Economic Co-operation and Development: 1998). Like every kind of competition, fiscal rivalry generates positive results. People get to save more money because of lower tax burdens. In addition, of course the low tax rates on work, saving, and investment increase the economic performance. The capital mobility also protects against government abuses.

Tax competition among governments was the source of many positive impacts in the past 30 years, such as:

-The average of personal tax rate has been dropped from more than 67% in 1980 to less than 42% today.

-The average corporate tax rate has been drove down from 48% in 1980 to 27% today.

-The number of flat tax regimes has jumped from 3 in 1980 to more than 25 today.

In this paper, we begin by providing a definition of tax competition, and then we discuss the efficiency effects and benefits of tax competition in firms and European economics. Finally, we examine the use of tax competition in European companies and governments in order to show its benefits.

2. TAX COMPETITION DEFINITION

Tax competition is a form of regulatory competition. The purpose is to encourage the inflow of productive resources or discourage the exodus of those resources by lowing fiscal burdens. It is a kind of governmental strategy of attracting foreign direct investment, foreign indirect investment and high value human resources by minimizing the overall taxation level or setting some tax preferences, create comparative advantage.

Some economists thing that tax competition a central part of a government policy to create well-paid jobs for improving the lot of labor. Others thing that investors are the main benefiters, as workers could have been better paid because that's mean lower taxation on them, and higher redistribution of wealth. All these and other benefits will lead to economy growth. . (Brill, Alex; Hassett, Kevin: 2007), (Hines, James R.2005:66). But some economists thing that tax competition is harmful because it distorts investment decisions which leads to reducing the efficiency of capital allocation, redistributing the national burden of taxation away from capital, and undermines democracy by forcing governments into modifying tax systems, which the voters don't agree on them all times. It may lead also to increase complexity in national and international tax systems, as governments constantly modify tax systems to take account of the competitive tax environment. (IFC Forum: 2011)

3. TAX COMPETITION ECONOMIC MODEL

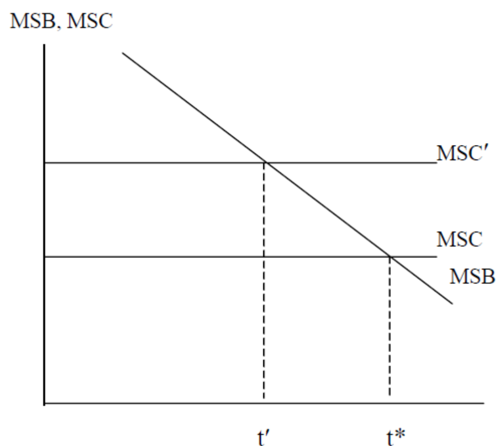
The standard model contains perfect competition and two factors of production: capital and labor. The capital can move freely across countries, but labor is completely immobile. Government levying taxes on capital and labor employed within their national borders, to finance public goods, and that makes taxes a source based. If we assume that tax rates on capital and labor are identical, then maximizing the utility of a representative consumer, government sets marginal social benefits (MSB) of an increase in the provision of the public good equal to

marginal social costs (MSC). If capital where immobile, MSC is the tax rate increase needed to finance the additional supply of the public good. When capital is mobile, however, an increase in tax rates leads to an outflow of capital, reducing the tax base and income of the representative consumer. So, marginal social cost will rise and the optimal tax rate will decline. This is illustrated in figure 1 where the downward sloping MSB curve reflects the benefits of higher tax revenue and MSC and MSC′ are constant marginal social costs when capital is immobile and perfectly mobile, respectively. Comparing the tax rates and the implicit amount of public spending, the lower tax rate t′ implies a sub-optimal supply of the public good.

Not like in extreme cases where capital is either perfectly mobile or completely fixed, figure 1 suggests a negative relationship between factor mobility and tax rates. In other words, since increased factor mobility can be thought of as a reduction in trade costs, continuing integration will be associated with ever decreasing tax rates, the race to the bottom case.

If we allow taxes on capital and labor to differ, it can be shown that the immobile factor will face a greater tax burden as countries attempt to keep their tax bases within their national border. The model also suggests that larger countries, measured by the stock of labor, are able to maintain higher tax rates than smaller countries since the negative effect of capital outflows of higher taxes is smaller in per capita terms when labor is assumed to be immobile. However, smaller countries may be better off since they will have higher capital per labor ratios and there is an incentive for them to play the role of tax havens and thereby achieve higher welfare than larger countries (Schulze & Ursprung.1999:22).

Figure.1: The tax competition economic model



Source**:** Åsa Hansson and Karin Olofsdotter (2003:03).

4. BENEFITS OF TAX COMPETITION

4.1. Lower taxes mean greater wealth

The most important result of tax competition is its savings rates beneficial impacts. Because of tax competition we can keep tax rates down, particularly those on highly mobile investment capital, and so increasing savings, then it will lead to growth in wealth.

The results of high taxes on investment returns is low post-tax returns. If government decide to save income rather than spend it because it expects a growth in investment, than high taxes on investment will reduce the chance of saving, which will lead to inflation. Higher taxes on business profits also reduce investment in a more direct way; much investment finance is based on company's own profits to fund future business growth, and higher taxes on business profits leave less capital for this purpose.

Taxation can really damage the economic growth. Work and other economic activity is a combination of costs and benefits. With high levels of tax, the gains from following a paid occupation need to be much higher before it is worth following a paid occupation rather than subsistence 'do it yourself' (Arthur, T: 2003). This effect is likely to be even more marked in the case of entrepreneurship. High taxes reduce the value of the potential rewards that can be given, so making entrepreneurship less attractive.

For all these reasons, high taxes reduce economic growth. This then affects the whole of society, because lower growth leads to fewer jobs, and so higher unemployment and lower net wages. (Bassanini and Scarpetta: 2001)

4.2. Efficient global capital markets

Investors including multinational organization put a lot of money into banks and other financial institutions, but that money does not stay in there because they do not generally have much local industry in which it can be invested. Financial organizations in the world are generally small with little opportunity for large scale economic activity, so the money has to be reinvested back into companies in the industrialized countries primarily the OECD members.

There are three levels at which the investment could be taxed: when companies in which the fund invests make profits or pay dividends; when the fund receives dividends or makes a profit from selling shares; and when the investors receive their payments from the fund. If all this happens within the same country the tax system usually has rules to make sure that the money is taxed only once. unfortunately, countries have different tax systems, so if the investors

are in different countries then the money can be taxed three times. This problem has been recognized, and the OECD has attempted to solve it.

This is why there are 'tax treaties' between countries which try to prevent this double taxation, but they generally insist that the investor owns 10−20 per cent of the company before they can be used; this may be fine for multinational corporate groups but is not much help to private investors. Tax havens can help a little in this case, if the fund is based in a tax haven then there can be at most two lots of tax (levied on the company in which the investment takes place, and on the investor) rather than three; this doesn't solve the problem but reduce risks.

By providing such an environment the havens make international capital markets more efficient and they increase the amount of available international investment capital, and enable it to be invested down into the most profitable companies, whatever countries they are in, without distortions caused by the need to avoid double taxation.

By increasing the efficiency of global capital markets, and ensuring that funds can flow to the most appropriate investments, this will increase the efficiency of the allocation of capital and, in turn, increase the global standard of living.

4.3. Impact on business

If global capital markets are more efficient, this will have a huge impact in forcing business to be more efficient. This is already happened with international companies when they invest in other countries without tax burden. Tax competition not only give investors a wider choice of where to put their money but also allow capital to move more easily between different countries. This has helped developing nations, which rely on foreign capital because they don't have enough capital, but it improves all large companies.

Companies in the past could be very inefficient, because exchange controls meant that investors in their country had little choice where to invest. But as international capital markets developed, investors had to improve if they were to continue to attract capital to finance their business operations.

Instead of relying on a captive national pool of capital for investment, business now has to compete in the global capital markets. This means that only the most efficient operations will be able to offer high enough returns to attract capital, and therefore businesses will be forced to reduce inefficiencies in order to survive. Although these efficiency gains can lead to some short term employment problems, in the medium term the drive for increased efficiency is beneficial for all parties. Not only do consumers benefit from lower prices, but also employment in an efficient operation adds more value and will therefore in the long term be more profitable and

secure. The expansion of the domestic economy in this way is the best long-term guarantor of employee wealth.

4.4. Impact on governments

4.4.1. Restraint

Tax competition have impact on the behavior of governments. Supporters of the free market should recognize that tax competition is beneficial, like all forms of competition. It is competition which forces suppliers to provide the public with the goods and services, with the right price. In the absence of competition, monopoly suppliers have less incentive to be efficient, and less need to provide what consumers want.

This is generally accepted when applied to commercial situations, but should be equally obvious in the case of governments. The government is, within its borders, the ultimate monopoly supplier, and it force us to pay for its services whether or not we want them or even use them. (Benn, E: 1925).

As a monopoly supplier, government is therefore expected to be naturally inefficient, and therefore increase taxation. There are, of course, other constraints on governments, such as the threat of revolution or total economic collapse, but these may harm the taxpayer and society through the loss of activity and investment as much as they harm the government through the loss of tax revenues. In contrast tax competition allows taxpayers to move to a country with a more congenial tax system, rather than damaging themselves by simply withdrawing their labor or investment.

4.4.2. Efficiency

Tax competition act as a spur to greater efficiency in the public sector. Governments will be faced with not only electoral demands for improvements in public services, or transfer payments to client groups, but also the countervailing pressure of tax competition restricting their ability to increase revenues by raising taxes. The only way to resolve this is to make better use of the limited resources available.

The efficiency is not only about how governments carry on their activities; but what activities they should be undertaken.so tax competition has an import ant role in giving the government an incentive to act and to keep the brake on further growth of waste.

5. TAX COMPETITION IN WORLD'S ECONOMY

Tax competition in encouraged many EU members from the former Soviet bloc to enact flat taxes, which have been beneficent for them. from 1986 to 2009 the average top rate of corporate tax in the OECD has fallen by 10 percentage points.

Europe's tax rate would be only as low as the highest-taxing member. High-tax governments assume businesses will always come to a given country if the size of that country marketplace is big enough. But this is not always good, because major companies are always searching for the best taxation regime when considering where to locate their increasingly mobile operations, and where to create jobs.

The best way is to reduce tax rates and simplify tax regime. That way people and companies would be willing and able to pay their money to exchequers. In Europe, Brussels can play a role in European tax reform if it can help improve coordination and transparency. There's also potentially a role in this regard for global groupings such as the G-20 to develop reporting standards.

For now, harmonization seems unlikely to become a reality. But fiscal ideas have consequences, and it's important for leaders to keep making the case that tax-policy competition within the single market has been good for country's economy.

Competition between countries has to be installed for companies' job-creating investments. A harmonized tax system would encourage companies and investors to seek new solutions outside their country in order to avoid paying what would be higher. (Syed KAMALL: 2014)

6. CONCLUSION

The benefits of tax competition have been visible for the last twenty years; the post-war climate of high taxation was coupled with insularity and strong controls on emigration of capital and business. As controls were swept away, allowing people and investment funds to move more readily again, governments once again faced the possibility of a flight of money, investment. Furthermore, in an increasingly multinational economy it was necessary for a country not only to retain its own people and capital but also to attract people and capital from abroad.

These changes, and this need to be competitive internationally in the face of tax competition, forced governments to adopt more internationally competitive taxation systems and hence more efficient and streamlined government operations. The era of free international capital markets and the increased tax competition that these allowed led to the public finance reforms, punitive taxation of investment returns was ended, and for companies a system of high tax rates but a narrow tax base was replaced by a more business-friendly approach of low rates applied to a broad tax base roughly in line with accounting profits, which removed many perverse incentives.

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