Competitive Taxation and Tax Competition: The Winner Takes it All?

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The Debate

What makes a tax system competitive? How can countries multiply the competitiveness of the existing system?

These question-marks are attracting substantial research by today's policy makers, at national and international level as well as by business lobbyists. Most importantly, their potential replies entail significant impact for taxpayers and the society in general. Indicatively, one of the principal objectives of European Commission's 2015 **Action Plan for A Fair and Efficient Corporate Tax System** was to create "a competitive and growth-friendly corporate tax environment for the EU". On a similar pattern, the 2018 **Digital Tax Package** seeks to enhance the competitiveness of the Single Market. At the other side of the Atlantic, the fiercely debated **U.S. tax reform** had one clear-cut objective, to increase the competitiveness of the U.S. tax system.

Definition

Defining the term "competitive" is a prerequisite in order to capture the issue and its implications. From an economic perspective, "competitive" is used by the World Economic Forum to imply the set of institutions, policies and factors that determine the level of a country's productivity. In other words, competitiveness means productivity, welfare, high standards of living.

In this context, a competitive tax system may be understood as a tax system that is appropriate to enhance productivity and economic welfare and that contributes to raise living standards at a sustainable level and rate.

However, tax competitiveness can also be conceived in a much more narrow manner, e.g. focusing on the tax legislation. Hence, "competitive" is used in the **International Tax Competitiveness Index** to refer to tax legislation that keeps marginal tax rates low. Assuming that in principle investment can be considered to the extent the cost of holding the capital exceeds the return after tax and risk costs, the marginal tax rate refers to the threshold situation where effective taxation of the return shall be determinant.

Background

Being a fundamental source of financing of public expenditure, taxation constitutes a central feature of a country's economy:

- Tax revenue is a condition precedent to the pursuit of national policies and subsequently the maintenance and improvement of living standards.
- The system is however also structured on the basis of a range of principles and objectives, such as re-distribution of wealth, promotion of socially beneficial behaviors etc.
- In terms of impact, taxpayers may be encouraged or discouraged by the tax system in relation to the undertaking of risks, the pursuit of investment and private initiative.

Considering that in general countries seek to enhance the national economy, the structure of the tax system has always been a key matter of **study** and discussion. Striking the right balance amongst the above requires careful evaluations and delicate calculations, to be regularly revised in view of the changing economic environment.

Yet, in the last few years, the intensity of the discussion has multiplied, since globalization and digitalization are substantially complicating the questions. In essence, these two trends have exalted capital mobility. On the one hand, a large part of the worldwide business activity is exercised by multinational enterprises present in a number of different jurisdictions. On the other, intangible assets – which by definition are more flexible than tangible ones in terms of location – have acquired core role in current business models. Moreover, digital technologies have enabled the distribution of the value chain components around the globe, significantly complicating the re-construction of the value chain and its connection with a specific jurisdiction.

Tax Policy Constraints

With this background, tax considerations have gained increased relevance for investment location decisions. While the tax system is only one out of series of factors determining the competitiveness of a country's economy, in globalization and digitalization conditions, business decisions seem to be increasingly driven by the tax factor, seen both as effective taxation and as structure of the tax system.

According to OECD's 2011 report **What is a Competitive Tax System?**, in this context, national policy-makers seem to be under a twofold pressure regarding the design of the tax system: they compete for foreign investment as well as for taxable bases.

Highly mobile capital means reduced constraints to investors' decision on the location of the investment. Taking into account that investors seek the highest possible after tax return on such capital, locations promising low tax rates on return on capital have a competitive advantage to be preferred. Vice versa, high effective tax rates may be expected to cut on the attractiveness of any given country to foreign investors. In this light, OECD identifies that one of the most important challenges for modern tax policy-makers is how best to balance reduction of effective taxation on investment with effective collection of tax revenue that will allow amongst others optimization of infrastructure.

Attracting investment however does not seem to be enough. The next big challenge, according to the OECD, relates to the protection of the taxable base arising from the investment. In fact, there is important evidence of businesses using so-called aggressive tax planning strategies to manipulate and eventually minimize effective taxation of the business income. Aggressive tax planning, in essence, involves borderline interpretation of tax legislation, creative combination of tax laws of different jurisdictions, emphasis on the form of the business structure instead of the substance. Such business practices are encouraged by harmful tax competition, i.e. the legislative approach focused on strengthening a country's (tax haven's) competitiveness precisely through the reduction of the tax burden in favor of mobile elements of foreign taxable bases. Tax havens thus offer fertile ground for businesses to dress their activities in such form that they can take advantage of such favorable tax regimes. The risk is that the other countries' taxable bases are eroded and non-heavenly policy-makers lack the necessary resources to pursue their objectives, including for the improvement of the country's competitiveness.

What makes a tax system competitive?

It is not questionable that sound tax policies cannot ignore the above constraints and that targeted action must be taken – and is already being taken – in order to counter aggressive tax planning and harmful tax competition. Nevertheless, in the aforementioned 2011 report, the OECD firmly acknowledges that "if the competitive pillars of an economy are strong, it is generally more able to impose corporate income tax without discouraging investment". Thus, arises the relevance of the consistent development of all the key pillars of competitiveness, i.e. 1. institutions, 2. infrastructure, 3. macroeconomic environment, 4. health and primary education, 5. higher education and training, 6. goods market efficiency, 7. labour market efficiency, 8. financial market development, 9. technological readiness, 10. market size, 11. business sophistication, 12. innovation.

In this regard, the tax system has been evidenced to have potentially considerable effects to the majority of these pillars.

By way of an example, the perceived fairness of the tax system, i.e. the just distribution of the effective tax burden on taxpayers, is held to promote tax compliance. Tax compliance in turn enables the effective collection of tax revenue with minimal resource allocation.

For the same reason, effective tax administration that does not permit tax evasion while favoring cooperative relations with taxpayers constitutes another important advantage of a tax system.

Most importantly, condition precedent to tax compliance may be considered tax certainty, i.e. the extent to which taxpayers can predict in advance and securely their tax obligations on the basis of tax law and administrative practice. Thus, on the one hand, minimal resources need to be allocated by tax administration to ensure tax collection and equally minimal resources need to be allocated by taxpayers for tax risk management.

Other potential positive effects of the tax system outlined by the OECD include:

- Promotion of entrepreneurship through growth-oriented tax regimes;
- Enhancement of labour market efficiency through taxes that allow labour market participation;
- Facilitation of trade through removal of tax obstacles;
- Strengthening of the financial market through the implementation of taxes that avoid to affect investment financing decisions;
- R&D-favorable tax regimes that encourage technological development and integration.

Concluding Remarks

While globalization and digitalization exalt capital mobility, the effective tax rate becomes increasingly core for the determination of a country's attractiveness to investors.

However, the reduction of the effective tax rate on business income is no sustainable solution per se.

It risks to lead to adverse effects by multiplying the tax burden on the least mobile taxpayers and elements of the tax base, at the expense of tax fairness and tax compliance.

Alternatively, it risks to deprive the country from the funds necessary to enhance other key pillars of competitiveness.

Such reduction of tax rates would in effect favor only aggressive tax planners in search of the most favorable tax regime for the mobile elements of their taxable bases (in another country). Yet, even such type of investors would not consider moving the productive elements of their income to a country lacking competitive infrastructure, dispute settlement, highly qualified labour.

All the factors affecting a country's competitiveness should be equally developed in a consistent manner for the domestic economy to be and remain attractive to business, productive. There is no winner to take it all.