CONFERENCE PROCEEDINGS

TAX COMPETITION AND CO-ORDINATION OF TAX POLICY IN THE EUROPEAN UNION

VIENNA, JULY 13TH -14TH, 1998

The Case for Tax Competition in the EU

Bruno S. Frey,
Professor of Economics, University of Zurich,
Switzerland

Government performance is one of the major problems of our time. While governments are generally considered to be rather inefficient and costly, politicians and bureaucrats seem to have little interest in providing those services which the citizens really want. The goal of this short comment is to show that tax competition is the crucial mechanism to induce government to work efficiently and to follow the wishes of the population. There should be a fifth freedom which complements the four economic freedoms concerning the mobility of labour, capital, goods and services, in order to ensure competition between governments with respect to taxation. The beneficial effects of tax competition contrast with the damaging effects of tax co-ordination or tax harmonisation. The latter suppress an effective mechanism to achieve efficient governance.

I will conclude that:

- tax harmonisation should not be undertaken within the European Union;
- there are more important tasks to be undertaken by the EU, for example, the fight against unemployment and the democracy deficit, as well as institutional changes required for extending the EU being the most important.

I will proceed in the following way: The arguments are advanced in the form of three propositions which will then be shortly discussed (Sections 1, 2, 3). The final section 4 offers conclusions.

1. Economic and Political Distortions

Proposition 1: *Tax distortions are at best one aspect of resource allocation; political decision - making distortions are equally, if not more important.*

The proponents of tax harmonisation see the world along one dimension - distortions of resource allocation induced by tax differences. If these distortions are small, obviously no central government intervention is needed because such actions produce transaction costs. On the other hand, so the argument goes, unequal taxation leads to unequal burdens on producers. This hampers competition and leads to a suboptimal allocation of resources. Following classical welfare theory in that case, harmonisation, i.e. an equalisation of tax rates, may be welfare-

improving if the transaction costs involved are sufficiently low (an assumption which is not necessarily met as bureaucratic action is often accompanied by substantial resource costs).

A completely different focus is used when political decision-making is looked at. There are in particular two aspects to be considered: (a) Public production and services are provided at too high cost, and (b) Governments have insufficient incentives to care for the preferences of the population. Again, if the costs of these political distortions are small, no problem arises: The politico-economic system works well. On the other hand, if governments waste resources and act in ways contrary to the wishes of the population, an effective counter strategy would be to intensify competition between governments. This can be reached in two ways. Firstly, democratic institutions such as elections and the various types of referenda may be strengthened. However, it is commonly accepted that the European Union has rather weak democratic institutions and suffers a "democracy deficit". Secondly, "exit" may be facilitated by lowering the costs of mobility and enabling actors to choose jurisdictions that provide a better mix of public expenditures and taxes. Given the same level and quality of public services, workers and investors should have the possibility to choose those jurisdictions which offer these services at the lowest cost, i.e. impose the lowest taxes.

Table 1 summarises the two fundamentally different dimensions just discussed. The adherents of tax harmonisation assume either explicitly, but most often only implicitly, that governments function well. Their thinking is thus restricted to moving up and down the first column. Normally, they assume (often without empirical support) that the economic allocative distortions due to tax differences are large. They are therefore convinced that tax differences should be eliminated. Scholars, on the other hand, who are used to jointly considering the political aspects of society, are more careful. They take political decision-making distortions to be a real and significant problem of modern society. Therefore, they also move along the horizontal dimension of Table 1. Based on the consideration that an empirical analysis of the economic cost of tax induces distortions, they tend to regard them as being rather small in size compared to the huge cost of government inefficiency. As a result they emphasise the importance of tax competition.

Table 1

		Political Decision-Making Distortion	
		small	large
Economic Allocative Distortion	small	do nothing	tax competition
	large	(possibly) harmonisation	? ?

2. Two Sides of the Budget

Proposition 2: *Distortions by taxation are typically small.*

The proponents of tax harmonisation concentrate exclusively on the possible resource cost induced by different taxes. They often completely overlook the other side of the budget, namely, that taxes are raised in order to finance public expenditures. After all, taxes are not good as such – they obviously reduce the spending power of the citizens – but they are a means of enabling the state

to provide the services which the private sector is unable, or less able, to supply. If one looks at taxes in this context, it is possible that the net benefits to the citizens of a regime with low taxes and correspondingly low expenditures is similar to a regime with high taxes and correspondingly high public expenditures.

It follows that:

- Jurisdictions with high taxes need not be at a competitive disadvantage. The high taxes may be accompanied by a high level of government services so that citizens and investors may well be satisfied. Consider, for instance, the location decisions by firms. They would be foolish to establish plants in jurisdictions where only taxes are low but they should also consider the public services, in particular, aspects such as traffic and communication infrastructures, or security.

- In the same vein, jurisdictions with low taxes have no unjustified competitive advantage because they are able to provide less public services, or public services of lower quality. It is thus a mistake to define taxation as "damaging" if the tax rates of a particular jurisdiction are lower than average. Unfortunately, this definition of "damaging taxation" seems to be highly prevalent both in the EU and in the OECD.

3. Global Problems

Proposition 3: *Most allocative distortions by taxes that do exist are beyond the scope of the European Union.*

There are two important cases. The first refers to global environmental problems such as the greenhouse effect. Obviously a global common good is involved, and has therefore to be addressed and solved at a global level. Though the EU has become quite large, in the global context it is just one of the relevant players. It is therefore indeed debatable whether the EU should impose an environmental tax in order to reduce the greenhouse effect, provided the other players such as the United States, Brazil, China or India are not doing so and therefore have a competitive advantage.

The second case refers to the flow of financial capital to tax havens. Such havens can exist anywhere in approximately 150 countries around the world in which financial capital can very easily be transferred. There seems to be little point in trying to fight tax havens in the rather limited scope of the European Union. Even if it were possible to eliminate all such havens in the EU, this would only result in financial capital moving outside the EU with the corresponding losses in terms of less liquidity and higher interest rates.

4. Conclusions

The considerations lead me to two policy results:

- The harmonisation of tax may damage economic welfare while tax competition promises to considerably raise the welfare of the citizens of the EU. Political decision-making is

systematically improved yielding a better provision of public services. They are supplied at lower cost, and they are better geared to the wishes of the population.

- The European Union should find better use of its scarce resources to address major and pressing problems, for example, unemployment. It is no less than a scandal how many people in the EU are jobless. As empirical research has recently been able to demonstrate, lowering the burden of taxation and social security contributions would significantly increase employment. The resulting public deficit can be evaded by reducing public expenditures (everyone knows that in all countries, as well as at the EU-level, there are many possibilities of lowering public outlays especially subsidies for lagging industries) and partly by introducing ecological taxes on local environmental pollution.

Another major problem of the EU is its institutions. The "democracy deficit" would be overcome if the citizens of the various nations would have trust in this supra-national organisation. New institutions, in particular decision-making rules, are urgently required with the enlargement of the EU to the East. It is inconceivable that so many new nations with completely different economic structures and so much lower per capita incomes are to be integrated into the existing body of the EU without the whole structure of political decision-making as well as of transfers being fundamentally changed. The EU has thus many urgent problems to which it should devote its ingenuity but tax harmonisation should certainly not be part of them.