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2006

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Recommended Citation

Hines, James R., Jr. "Harmful Tax Competition and its Harmful Remedies." Review of Tax Competition in Europe, by W. Schön editor, and Tax Competition and EU Law, by C. Pinto. Brit. Tax Rev., no. 2 (2006): 209-12.

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Book Review

Harmful Tax Competition and its Harmful Remedies

TAX COMPETITION IN EUROPE. EDITED BY WOLFGANG SCHÖN. (Amsterdam, the Netherlands: IBFD Publications BV, 2003) 518 pages. €135.

TAX COMPETITION AND EU LAW. BY CARLO PINTO. (The Hague, the Netherlands: Kluwer Law International, 2003) 437 pages. £109.00.

THERE is, among some of your reviewer's friends, an abhorrence of tax competition, and a fascination with tax harmonization, that defies simple understanding. The way that the case is typically presented, European tax harmonization is desirable because eliminating tax differences between European nations would promote economic efficiency. With greater economic efficiency, there is more of everything to go around, so it becomes possible to maintain life exactly as it currently is, except that now, instead of every family having one toaster, they can have two.

A wise goal, a worthy goal, this economic efficiency—though the drive to eke more out of existing resources in order to give every household that second toaster hardly seems the stuff of vicious and prolonged political controversy. Since the potential output benefits of European tax harmonization, if they are positive at all, are likely to be very small, perhaps this is not, ultimately, an argument about the kind of efficiency you can get when a firm slightly contracts its German operation in order to expand slightly its Italian operation. Quite possibly this is, in fact, an argument about the future of European society—about whether, and how, to sustain government expenditures at the levels to which they grew in the late twentieth century. Economic efficiency is just intellectual cover for what the fight really concerns, which is the cost and desirability of the modern welfare state.

Is there a necessary connection between tax competition and the level of government expenditures? Probably not, since modern governments raise most of their revenue from sources that are not subject to significant competitive pressures. The antagonists, for some reason, have a hard time hearing that message. For the rest of us, who do not want to fight, but merely to understand, an evaluation of the underlying law and economics holds the prospect of sharpening our appreciation of these issues. Hence these recent books by Wolfgang Schön and Carlo Pinto are welcome arrivals.

Everyone knows the simple textbook case in favour of tax harmonization, one that starts from imagining a world consisting of two countries, identical in all respects other than their corporate tax rates. In this world, the country with the lower corporate tax rate receives greater corporate investment, coming from both domestic and foreign sources. This is inefficient, in the sense that the two countries would produce greater aggregate output if corporate capital were instead allocated evenly between them.

This story is nice, but the question is whether it has anything to say about tax competition. Countries are obviously not identical—and if they were, wouldn't they then adopt identical tax policies, eliminating any problem associated with differences?

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The point, more broadly, is that purposeful tax policies reflect local conditions, and tax rates differ because local conditions differ. There is no theory of optimal tax policy design that says that different countries should choose the same tax policies, that they should coordinate, say, on a corporate tax rate of 30 per cent. Far from it: the efficient rate of taxation depends on supply and demand conditions, the degree to which taxation discourages taxed activities. Since these differ everywhere, it will generally make sense for one country to have a higher petroleum tax while a different country raises the same revenue with a higher top individual income tax rate. In fact, the modern theory of optimal taxation carries only one harmonizing implication, which is that it is always more efficient to tax consumption or labour income rather than capital income, since the intertemporal consumption distortions induced by capital income taxes compound over time, creating huge inefficiencies, the cost of which is generally borne by labor. Hence all governments, even those acting only in the interest of local workers, have incentives to impose zero rates of tax on capital income. If governments act rationally in response to these incentives then capital tax rates would be harmonized at zero—but this is rather not what the harmonizers have in mind.

What is it, then, that sensible tax harmonization advocates are thinking? For that we now have these two books.

Wolfgang Schön edited *Tax Competition in Europe*, and wrote the very thoughtful summary chapter that opens the volume. His summary chapter walks a fine line, laying out many of the pros and cons of tax harmonization, not directly advocating any policies, all the while subtly tilting the intellectual playing field in support of European efforts to limit "harmful" competition. Schön struggles with how to distinguish acceptable tax competition from "harmful" competition, a problem he shares with other contributors to the volume, and indeed, all who feel there is an important distinction between the two.

What is the case for a harmonized high rate of capital taxation among European nations with significantly different economies? Schön sees two primary benefits of harmonization, first that it promotes efficient resource allocation, and second that tax harmonization counters market forces that put downward pressure on tax rates and tax bases. He is skeptical of the standard microeconomic case for tax competition (p.2):

> "When we read mainstream US economic literature about the advantages of tax competition we have to bear in mind that in the United States both the labour market and the financial market are fully integrated, with high mobility for all production factors. Contrary to this, in Europe we have to distinguish between a highly integrated financial market, a pretty advanced market for goods and services and a labour market that still faces many non-legal impediments such as the different languages or cultural backgrounds of European citizens."

Unfortunately, the book does not develop this point further, so that, by the end, it is anything but clear how the European-American differences cut. If tax competition is good for the United States, with its high rate of economic growth, low unemployment rate, and rather free markets, does it follow that tax competition is bad for the much more regulated European economies? Isn't it possible that tax competition would benefit European economies by permitting countries to tailor their tax systems to local needs and circumstances, in the process providing a force that mitigates against some of the institutional constraints that prevent economies from achieving their potential? There is a presumption in much of the Schön volume, made explicit by the Pinto book, that

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tax competition, in reducing capital taxes, leads to high labour income taxes and thereby contributes to the European unemployment problem.

Is that right? Do lower capital taxes and higher labour taxes lead to greater unemployment? Economic theory says otherwise: lower capital taxes encourage saving and investment, which improves labour productivity and increases wages, thereby working against the regulatory and expectational rigidities that cause unemployment. This is more than an academic curiosum: decades ago Ireland slashed its taxes on foreign investment to the subsequent enormous benefit of its labour market. The Irish problem, from the standpoint of those who would like to maintain high capital tax rates, is that now other European countries are thinking that maybe they too would like to enjoy some prosperity.

The Schön chapter is followed by a spirited and cogent defense of tax competition by Alain Steichen. Steichen argues that tax competition disciplines governments otherwise inclined to overtax capital income, and he worries—clearly, he is distraught—that contemporary Europe displays an insufficient degree of tax competition. A short chapter by Augusto Fantozzi considers the application of state aid rules to tax competition issues, expressing considerable skepticism about the actions of the European Commission in promoting tax harmonization in the absence of explicit legal mandate to do so. Matthias Mors counters with his own chapter defending the Commission and what he describes (p.151) as its "fairly prudent approach, leaving Member States' prerogatives in defining their tax systems and tax rates largely intact." This chapter leaves the reader in no doubt whatsoever that, on some future day when the restraints of prudence are lifted, some in Brussels will try to orchestrate European tax policy.

This is stuff to stir adrenaline, so an unwary reader who starts the book in the early evening might have trouble falling asleep later on. Fortunately, the remaining 366 pages consist of 16 dreary chapters reporting on the tax systems of Austria, Belgium, Denmark, Finland, France, Germany, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland, and the UK. The chapters are presented in alphabetical order of country names, and, while they have separate authors, they have virtually (in some cases, exactly) identical structures, section headers, and content. This part of the book may have been intended to give the reader a taste of what life would offer in a more harmonized Europe. A couple of the chapters, notably including that by Ian Roxan on the UK, break from this mould, and perhaps more would have done but for the apparent agreement not to compete for the reader's interest.

Carlo Pinto's *Tax Competition and EU Law* is a treatise rather than a contributed collection; its provocative arguments are tightly wrapped around central themes, so the book seems considerably shorter than its 437 pages. Pinto is unabashedly opposed to "harmful" tax competition, with which he associates the erosion of the welfare state, high unemployment rates, skewed distributions of income, unfair reallocation of tax base between countries, and other maladies. The problem, we are told (p.12), is that "national jurisdictions outbidding each other surrender themselves to the market." This, by implication, is bad.

Lest one be tempted to despair (your reviewer was not), Pinto has a solution, which is a pan-European agreement to avoid "harmful" tax competition. The art in the proposal lies in its definition of "harmful" competition. A country's tax practices are "harmful" if they meet two tests, the first of which is that they offer tax reductions that are targeted to specific activities or industries. The second test is that tax provisions are designed not to encourage domestic industries but instead to steal activities or tax base from other countries. Put these two together, and you have harmful tax competition, something that Pinto would have European countries agree to abolish.

In a nod to reality, Pinto acknowledges the difficulty of actually enforcing such an agreement. Every tax system in the world favours some industries or activities, and identifying tax provisions designed to poach tax base from other countries is a challenging, if not impossible, task. To be sure, there is little danger that European governments will actually embrace this proposal, but as a device to prompt thinking about the consequences of tax competition, the proposal is excellent.

Abstracting from the specifics, tax competition is "harmful" in Pinto's framework when it impedes the ability of countries to pursue policies that they would adopt in the absence of competition. Should this be a cause of concern? Or does having vital and progressive public policies entail being willing to modify the compromises of the past in the light of changing conditions? Using this standard it is not hard to name dozens of policies that countries would do well to jettison, and if, over time, competition has this effect, then hooray for competition.

The Schön and Pinto books share certain features. Both went to press a couple of years ago, prior to the discovery by the European Court of Justice of what fun it is to wreak havoc on national tax systems, so aspects of the institutional setting have since changed significantly. Both books have what might be called a European focus. There is no discussion of tax considerations in the US, Japan, Canada, China, India, Brazil and other countries, and certainly no serious proposal that these places be drawn into any European agreement to limit tax competition. Under what circumstances would there be benefits from limiting competition within Europe when most of the world economy is free to compete with abandon? Are there any such circumstances?

There is something just a little bit sad about the case for European tax harmonization as it appears in these books. The desire to harmonize taxes stems from a deep concern that the increasingly competitive world is changing Europe. In order to forestall this, in order to keep things as they have been, the advocates urge policymakers to ignore the rest of the world and forge binding agreements among Europeans. This is yesterday's method of preserving yesterday's policies. The world of tomorrows offers unprecedented economic opportunities to those who are open to them, and it will be a great shame if Europe is not included.

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