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Does recent empirical evidence support the existence of international corporate tax competition?

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Abstract

Recent reductions in institutional barriers to international investment have meant that the existence of international corporate tax differentials is now one of the most significant remaining causes of distortion to the optimum global allocation of resources, and hence to international trade. In the debate as to how to reduce such distortion, two main schools of thought have emerged. The first believes that this result can be achieved primarily through the international co-ordination of corporate taxes. To date, efforts in this direction have not made significant progress. The second contends that market forces, through tax competition, will spontaneously reduce international corporate tax differentials. In this article, an analysis of recent trends in corporate tax rates supports this second contention: statutory and effective corporate tax rates are continuing to decline and converge. However, recent tax revenue data give little support for the existence of tax competition; the expected shift in the tax burden from corporate profits onto less mobile factors such as labor has largely failed to materialize. Several explanations for these contrasting findings are outlined and analyzed.

Keywords: Tax competition; Tax co-ordination; FDI

1. Introduction

The world economy is becoming more integrated, with capital being transferred seamlessly and instantaneously over national borders. Institutional barriers to international investment, such as capital controls, are being dismantled. An important effect of these recent developments is that potential distortions to the optimal allocation of investment have been reduced.[1] This has turned the spotlight on those few distortions that remain. One of these is caused by the differing extent

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[1] The free flow of global capital results in other benefits. Increased international competition forces domestic companies to become more efficient in order to survive. Also, investors benefit in that they can more easily diversify country-specific risks, and thus can achieve higher risk-adjusted rates of return.

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to which countries tax income from capital. Indeed, corporate tax differentials are widely seen as the last government-induced impediment to the complete liberalization of world capital flows (see, for example, Owens, 1993).[2]

Under the assumption of perfect mobility of capital, resources will continue to be shifted between sectors of the world economy until the marginal productivity of capital in each sector is equal to the world return. At equilibrium, the international allocation of the world stock of capital is efficient: the maximum volume of world output is obtainable from a given stock of capital, since resources are directed towards the location where they can be put to their most productive use. However, if tax differentials exist between countries, resources will continue to be shifted only to the point where *post-tax* rates of return are equalized to the world return. *Pre-tax* rates of return will remain unequalized, and thus so too will the marginal productivity of capital in different sectors of the world economy. Tax differentials thus disrupt the optimum allocation of resources, and reduce economic efficiency.[3] This misallocation of resources is at the expense of the comparative advantage of countries in production and trade (see Ricardo, 1819), and thus reduces world capital productivity and levels of total output.

Two main schools of thought have emerged as to how this situation can be improved.[4] The first of these believes that tax-induced distortions to global investment can only be effectively removed through co-ordinated inter-governmental action. Some attempts have indeed already been made with regards to corporate tax co-ordination within groups of countries, in particular the European Union (EU). There, various co-ordination approaches have been put forward, but without significant progress so far (for a discussion of the many difficulties involved, see, for example, James, 2000).

The second school of thought, which adopts what could be called a “free market” approach, holds that, as countries compete for foreign investment, the process of so doing will reduce tax differentials amongst nations. Countries’ tax rates will spontaneously converge downwards through the process of “international tax competition”, which occurs when two or more nations manipulate their tax policies in order to attract scarce resources from overseas. By narrowing international tax differentials, tax competition reduces the possibility that firms will choose tax-efficient over economically efficient locations for their investment. Resources will thus be shifted to a point where pre-tax rates of return and the marginal productivity of capital in different sectors of the world economy are closer to equality than previously was the case, enhancing world productivity and output.

Tax competition therefore represents a possible means by which tax-induced distortions to the optimum global allocation of capital can be spontaneously reduced. As a “market-based” solution, it is free from the inherent difficulties (and costs) associated with negotiating and implementing international tax co-ordination. However, if it is to constitute a persuasive solution to the problem of resource misallocation, then, given the increased level of capital mobility and integration of the world economy in recent years, some empirical evidence of its existence should already be apparent. However, evidence for international tax competition has not to date been convincing.

[2] Corporate taxes are used here as a proxy for taxes on capital income, the justification for this being that nowadays foreign direct investment (FDI) is overwhelmingly undertaken by the corporate sector, especially multinational corporations.

[3] A considerable amount of empirical evidence suggests that investment location decisions are significantly influenced by corporate taxation, although there are other factors to consider. See, for example, Hartman (1984), Slemrod (1990) and Grubert and Mutti (2000).

[4] On the assumption that the existence of international tax differentials do indeed constitute a problem. For a discussion of the benefits of tax diversity, see, for example, Cnossen (1990).