Session 11
The Global Tax Conflict
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Whether tax competition is desirable or undesirable, and whether it should be regulated by agreement or by federations such as the European Union, has been debated a very long time. Partly this is an issue of efficiency and distribution, and partly this is an issue of sovereignty and self-determination.

Our models of tax competition suggest that, in the absence of international agreement, tax competition can lead to tax rates being too low ("race to the bottom") or too high (when countries levy taxes intended to impose burdens on foreigners). There is no presumption that uncoordinated tax rates will be too low from an efficiency standpoint, and not really any evidence that they are currently either too high or too low.

One of the difficulties of coordinated responses to tax competition is that they tend to set common rates for all participants. There is no reason for tax rates to be the same everywhere. Whatever the efficient corporate tax rate is for Germany, it is very unlikely to be the efficient corporate tax rate for Malta, since they have such different economies. Part of the apparent appeal of equal taxation is that if tax rates were the same everywhere then taxation would not influence the location of economic activity. This is nonetheless inefficient, because taxation inevitably creates inefficiency by discouraging income production – and it is better, from an efficiency standpoint, to have differentiated tax rates that impose lighter taxes on activities in some places and heavier taxes elsewhere, despite the locational distortions this may cause.

Left to their own devices, countries adjust their tax rates in part to reflect their economic needs, so that a country that wants more investment, and is willing to give up tax revenue to get it, will set a lower corporate tax rate. It is efficient to have a lower tax rate if additional investment is actually worth more to that country than it is to another. In concept, an international agreement could provide for higher tax rates in some places and lower taxes elsewhere, but tax coordination efforts usually envision something much closer to common harmonized tax rates.

One of the concerns about tax competition is that tax differences create opportunities for base erosion and profit shifting by multinational firms. The G-20 and the OECD promise guidance on these issues shortly. All of the careful analysis suggests that base erosion and profit shifting by multinational firms is a problem of quite modest size, much smaller than ordinary tax evasion by individuals. One of the potential concerns in the present environment is that governments will take actions that cause significant economic distortions in order to combat a problem that is actually of very modest size.

In addition to the available statistical work, there are three facts that strongly suggest that the problem of base erosion and profit shifting has been much overstated in popular discussion. First, the fact that governments of high-tax rate counties collect considerable revenue from taxing the profits of their resident multinational corporations itself indicates that tax avoidance is not as easy or cost-effective as some fear that it is. If firms were able to arrange their affairs in ways that would easily reallocate pretax income earned in high-tax locations to zero or very low-tax alternative locations, then most would surely do so, and even those corporations without international business presence would quickly establish operations in low-tax foreign locations in order to reduce their tax obligations. That corporations persist

in paying taxes to governments of high-tax countries does not reflect lack of imagination or insufficient profit motive; it reflects that enforcement makes tax avoidance difficult and costly.

Second, studies consistently find that multinational firms locate more employment, property, plant, and equipment in low-tax locations, and less in high-tax locations, than the structures of these economies would ordinarily warrant. From the standpoint of profit shifting, this pattern makes it clear that firms are unable to reallocate pretax income with impunity. If it were easy to reallocate taxable income there would be no benefit to locating real business activity in a low-tax country. The profit-maximizing strategy instead would be to locate business activity wherever it generates the highest pretax profits, and use financial or other means to reallocate taxable income to an affiliate located in a zero-tax location. In fact, this is not what firms do, which is consistent with maximizing after-tax profits only if it is difficult to shift pretax income.

Third, there is evidence from the use of operations in tax havens (low tax countries). Among large U.S. multinational firms from 1982-1999, only 38 percent had tax haven affiliates, and in the universe of German multinational firms from 2002-2008, only 20 percent had tax haven affiliates. The majority of U.S. and German firms obviously do not reallocate taxable income to tax havens. The most noteworthy feature of this evidence is that there is nothing that prevents a U.S. or German multinational firm from establishing a tax haven affiliate. The reason not to do so is that it is not worth it –and the reason it is not worth it is that it is too difficult or costly to reallocate taxable income from high-tax countries to tax haven countries.