Tax Competition Helps the Global Economy

by Daniel J. Mitchell & Jason Clemens

Tax competition exists when people can reduce their tax burdens by shifting capital and/or labour from high-tax to low-tax jurisdictions. This migration disciplines profligate governments and rewards nations that engage in pro-growth tax reform. This process is good for the global economy since lower tax rates increase incentives to work, save, and invest.

Not surprisingly, some high-tax governments despise tax competition and would like to see it reduced or eliminated. They have even convinced the Organization for Economic Cooperation and Development (OECD), an international bureaucracy representing developed nations, to launch an anti-tax competition initiative. As part of this project, the OECD created a "tax haven" blacklist, and has threatened these jurisdictions with sanctions unless they agree to help high-tax nations track—and tax—flight capital. The latest development was the OECD global forum held in Ottawa on October 14 to 15, which was designed to pressure low-tax jurisdictions into surrendering their fiscal sovereignty.

Tax competition should be celebrated, not persecuted. It is a powerful force for economic liberalization, one that has helped promote good tax policy around the world. Indeed, even OECD economists have admitted that "the ability to choose the location of economic activity offsets shortcomings in government budgeting processes, limiting a tendency to spend and tax excessively." Fiscal rivalry among governments has produced an amazingly desirable impact on fiscal policy in the last 25 years. Examples abound, but below are some of the more outstanding.

1. The Thatcher/Reagan tax rate reductions

Margaret Thatcher and Ronald Reagan inherited weak economies but managed to restore growth and vitality with free market reforms. Sweeping tax rate reductions were a significant component of both the Thatcher and Reagan agendas. The top tax rate in Britain was 83 percent when Margaret Thatcher took office; she reduced the tax rate to 40 percent. The top tax rate in the United States was 70 percent when Ronald Reagan was inaugurated; he lowered it to 28 percent. Britain and the United States both benefited from tax rate reductions,[1] but other nations also profited because they were compelled to lower their own tax rates—and this shift to better tax policy is an ongoing process. Even the OECD, which is hardly sympathetic to pro-growth tax policy, estimated that economies grow half a percent faster for every 10-percentage point reduction in marginal tax rates.

2. Corporate rate reduction in Europe

The "Irish Miracle" is perhaps the most impressive evidence of how tax competition advances good tax policy. Less than 20 years ago, Ireland was the "sick man of Europe"—an economic basket case with double-digit unemployment and an anemic economy. This weak performance was caused, at least in part, by an onerous tax burden. As recently as 1991, the top tax rate on personal income was 52 percent, on capital gains was 50 percent, and on corporate income was 43 percent. Over the following 10 years, tax rates were slashed dramatically, especially on capital gains and corporate income. Today, the personal income tax rate is 42 percent, the capital gains tax rate is just 20 percent, and the corporate income tax rate is only 12.5 percent. These aggressive tax reductions have yielded enormous benefits. The Irish economy experienced the strongest growth of all industrialized nations, expanding at an average annual rate of 7.7 percent in the 1990s. In a remarkably short time, the "sick man of Europe" became the "Celtic Tiger." Thanks to tax competition, Ireland's tax rate reductions have also had a positive effect on the rest of Europe. The Irish Miracle has motivated other EU nations to significantly reduce their tax rates in

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recent years, bringing the average corporate tax rate down to about 30 percent.

3. Tax reform in Eastern Europe

One of the most amazing fiscal policy developments is the adoption of flat taxes in former Soviet Bloc nations. The three Baltic nations—Estonia, Lithuania, and Latvia—adopted flat tax systems in the 1990s. Tax reform in the Baltics triggered a virtuous cycle of tax competition. Russia followed with a 13 percent flat tax that took effect in 2001. Ukraine has just approved a 13 percent flat tax, and Slovakia is implementing a 19 percent flat tax. Even Serbia has a variant of a flat tax. The evidence already shows that good tax policy is having a desirable impact. The Baltic nations, for instance, are the most prosperous of the former Soviet Union. The Russian Federation is the next most prosperous of the former Soviet Republics. The evidence from Russia is particularly striking. The Russian economy has expanded by about 10 percent since it adopted a flat tax. That may not sound like much, but the slowdown in the global economy makes it particularly noteworthy. The Russian economy certainly performed better than the US economy, and easily outpaced the anemic growth rates elsewhere in Europe.

4. Canadian tax reductions: Alberta and Ontario lead the way

Canada has not been immune to tax competition. Tax rates on personal and corporate income have generally been falling since the early-to-mid 1990s with provinces like Alberta and Ontario acting as catalysts for the rest of the country. Even more socialist-leaning provinces like Saskatchewan have reduced tax rates to remain competitive. The combination of fiscal restraint coupled with moderate tax relief ushered in a five-year period (1997 to 2001) of tremendous prosperity for the country as a whole.

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Unfortunately, the tax harmonization agenda threatens nations that want to reform their tax codes and enact single-rate, consumption-based tax systems. Once implemented, the agenda would certainly mean that tax reform would be very unlikely. The flat tax, for instance, is a territorial system. Yet the OECD and other international bureaucracies believe that territorial taxation is a form of "harmful" competition. The flat tax eliminates double taxation, but the OECD initiative is designed to help governments discriminate against income that is saved and invested.

Several Nobel laureates have commented on tax competition. James Buchanan points out that "tax competition among separate units… is an objective to be sought in its own right" (Brennan and Buchanan, 1980). Milton Friedman writes, "Competition among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or enterprises in the goods and services they offer for sale and the prices at which they offer them" (Friedman, 2001). And Gary Becker observed that "competition among nations tends to produce a race to the top rather than to the bottom by limiting the ability of powerful and voracious groups and politicians in each nation to impose their will at the expense of the interests of the vast majority of their populations" (Becker, 1998).

Note

[1] Interestingly, in 1981 Canada predated the United States in dropping its top marginal tax rate.

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