Introduction to *Tax Notes International* 34, no. 13 (2004)

James R. Hines Jr.
University of Michigan Law School, jrhines@umich.edu

Special Supplement

Introduction

by James R. Hines Jr.

James R. Hines Jr. is a professor of economics, public policy, and business economics at the University of Michigan and a research associate at the National Bureau of Economic Research.

There is now considerable interest in the state of international tax competition, its implications for economic performance, and appropriate policy stances for governments to adopt. That interest has a public side and a research side. The public side is reflected in pronouncements by public figures of all political stripes, informing listeners of what are deemed to be good and bad developments in tax policy around the world, and what might be favorable new courses for governments to chart. The research side looks different: It is characterized by the gradual accumulation of theories and evidence of international tax practice, and while there is much left to learn about the formation and impact of international tax policies, consensus views on some important issues, informed by the latest research, have already emerged. Despite the research advances of the last 20 years and their clear implications for tax policy, there is often little connection between the research and public sides of international tax policy. Consequently, little of the public discussion of international tax policy issues has been informed by up-to-date thinking on the likely implications of tax policies for taxpayers, treasuries, and economies.

In the hope of stimulating new research and discussion of issues regarding international tax competition and cooperation, the International Tax Policy Forum and the American Enterprise Institute sponsored a conference that was held at the American Enterprise Institute in Washington on 9 December 2003. The topic of the conference was "Competition Versus Cooperation in Global Tax Policy." The conference included policy discussion as well as original research findings on the impact and determinants of international taxation. Four of the conference papers are included in this special supplement to *Tax Notes International*. Following is a synopsis of the research as it relates to the state of thinking on the formation and effect of international taxation.

I. Recent Tax Policy Developments Around the World

Countries are largely free to design their own tax systems and set their own tax rates, subject only to internal political considerations, anticipated effects of taxation on economic activity and the distribution of income, and the need to raise revenue to finance government operations. Because national tax policies are formed independently, countries' setting competitive tax rates could drive rates of taxation of mobile activities ever lower, the downward spiral ending only when tax rates reach zero. This race to the bottom in the taxation of mobile economic activity is thought to be much more likely to characterize corporate income taxes and other capital income taxes than labor or consumption taxes. A race to the bottom in taxing capital income, should it materialize, carries implications for all other government tax and spending decisions.

There is much controversy over the likelihood and desirability of that race to the bottom. From a theoretical standpoint, it is not at all clear that competitive pressures need push down tax rates on capital income.

The standard thinking is that the international mobility of capital could increase the elasticity of the tax base from the standpoint of any country acting in isolation, thereby giving governments incentives to reduce tax rates. However, it need not be that globalization of business operations increases the mobility of the tax base. The international nature of modern business operations makes activities in one country increasingly dependent on operations of the same firm elsewhere in the world, which can carry the implication that heavier tax burdens in one jurisdiction raise the cost of doing business everywhere. In that setting the total volume of multinational business activity might be less responsive to national taxation than is typical domestic investment, and the globalization of the economy might tempt governments to impose higher tax rates than they would otherwise. Consequently, the direction of any effect of global economic developments on tax policies around the world is unclear as a theoretical matter, which is why researchers are at pains to consider what the data say about government reactions.

Economic theory is generally favorably disposed toward competition of all kinds, following on the efficient properties of competitive markets, but it need not necessarily follow that tax competition produces desirable outcomes.

A similar ambiguity attends the desirability of unbridled tax competition. Economic theory is generally favorably disposed toward competition of all kinds, following on the efficient properties of competitive markets, but it need not necessarily follow that tax competition produces desirable outcomes. It is relatively simple to concoct scenarios in which uncoordinated action by competing governments drives tax rates too low or too high from the standpoint of global efficiency. That is sometimes taken as a reason to prefer international tax coordination, except that it is also easy to produce models in which competition between governments serves an important disciplining function that reduces inefficiency, and improves citizen welfare, compared to fully coordinated outcomes. Without better information on the behavior of governments, it is difficult to distinguish between those scenarios, and therefore to evaluate the desirability of different forms of competition and coordination among governments. The task before researchers and policymakers is to better understand the determinants of tax policy developments, as an important first step in considering what kinds of policy reforms would be most desirable.

The paper "What Has Been the Tax Competition Experience of the Last 20 Years?" by Rachel Griffith and Alexander Klemm considers the evolution of tax policy developments in high-income OECD countries since 1980. The first and most important observation that the authors make is that corporate income taxation has not been driven to zero, or anywhere near zero, over that period in that sample of countries. Statutory corporate tax rates have fallen over the last 25 years, but those reductions have been accompanied by an equivalent broadening of tax bases, leaving corporate tax collections roughly unchanged as fractions of national income and as fractions of government revenues. It would appear that the most extreme fears of those concerned by the possibility of unbridled international tax competition — the possibility of corporate tax rates being driven to zero — are unfounded. That point is clear in the data that they present, but has received insufficient attention in discussions of international tax developments.

In light of that evidence it is important to consider why relatively heavy corporate taxation exhibits such persistence, and the paper by Griffith and Klemm does that. The paper reviews multilateral initiatives, including those by the OECD and the European Union, that could have accounted for observed tax rate patterns but appear to have had little impact. As the paper notes, however, the limited scope for future multilateral European legislative tax developments need not be mirrored in practice, given the recent active entry of the European Court of Justice into tax matters. The paper discusses the findings of applicable analytical research, including theoretical models of international tax setting, some of which carry implications similar to observed tax patterns. The paper also reviews recent empirical research on the determinants of national tax decisions. The finding that tax setting exhibits interdependencies (admittedly of unknown origin), in the sense that a country's tax actions affect the actions of its neighbors, may offer an important window into understanding why tax competition takes the form that is recently observed.

The paper by Michael Keen and Alejandro Simone, "Is Tax Competition Harming Developing Countries More Than Developed?" considers many of the same tax trends from the standpoint of the developing world (countries with per capita incomes below US $7,000). As the paper reports, statutory corporate tax rates have been falling sharply in the developing world to the same extent that they have fallen in OECD countries, the difference being that rate reductions in the developing world have not been accompanied by tax base expansions. As a result, corporate tax collections have fallen markedly.

Because the tax systems of developing countries often resemble those of high-income countries, it is important to consider why there has been such a recent divergence in tax base trends between those two parts of the world. The Keen and Simone paper draws attention to the proliferation of special incentives offered to foreign investors by developing countries, such as tax holidays, special corporate tax rate reductions, free trade zones, and tax breaks for exporters. Those incentives are not unknown in the high-income part of the world, but have been much more commonly granted by developing countries in recent years. Whether the provision of those incentives is a wise move on the part of governments of developing countries depends on any trade-off between their effect on local economic activity and their implications for government finance. Because developing countries usually need greater economic activity and government tax revenue, drawing appropriate conclusions for their tax policies may turn on what alternatives the governments face, and how responsive local business investment is to favorable tax treatment.

II. European Tax Reforms

The European Union includes a significant fraction of world economic output and world government activity, so any tax coordination efforts among European governments would be likely to have significant effects on economic performance not only in Europe but also in the United States and elsewhere. Sijbren Cnossen's paper, "Reform and Coordination of Corporation Taxes in the European Union: An Alternative Agenda," considers recent European tax developments and promising directions for future developments. One of the important features of European tax policy that the paper explores is that there is nothing resembling a unitary European tax-setting body, for any kind of taxation. As a result, European tax coordination efforts have taken the form of multilateral agreement on some aspects of taxation far removed from the broad issues of tax rates and most aspects of tax bases. Periodically there are proposals floated to coordinate more central aspects of European tax systems, but as Cnossen's paper notes, those proposals have problematic elements and have not been greeted with the kind of widespread support necessary to translate them into the realm of actual tax policy.

Is there a realistic scenario in which European governments might find it in their interests to coordinate their tax policies in some way? The Cnossen paper offers a blueprint for one such possibility, a plan that proceeds in five steps outlined in the paper. Doubtless it is a long walk from where European countries are now to where the Cnossen plan would take them, and it would be remarkable if any such journey were not accompanied by repeated stumbling along the way. However, it is important to consider plans like those, because their features illustrate important aspects of other tax systems, and because they illustrate the difficulties that governments face in trying to reconcile the needs of differing interests both within and between countries.

III. Taxpayer Behavior

Much of the thinking about tax competition between governments, and proposals for multilateral tax coordination or other reforms, are predicated on views of the likely impact of taxation on the economic activities of taxpayers. In considering those issues, it is understandably important to incorporate the most reliable information on what has been the effects of international taxation on business activity. The paper by Rosanne Altshuler and Harry Grubert, "Taxpayer Responses to Competitive Tax Policies and Tax Policy Responses to Competitive Taxpayers: Recent Evidence," provides an up-to-date analysis using data drawn from tax filings of U.S. multinational firms.

The paper by Altshuler and Grubert notes that the location of foreign business activity by U.S. multinational firms is highly responsive to tax rate differences, and offers evidence that location decisions appear to be growing more responsive. There is by now an extensive empirical literature, to which Altshuler and Grubert have been major contributors, that points strongly to the increased tax responsiveness of foreign investment decisions, but what is notable about the paper is that it offers suggestive evidence that that trend is, if anything, accelerating in recent years. That sensitivity then carries important implications for host governments seeking to tax U.S. investors as well as investors from other countries who are presumably no less responsive to tax differences.

The Altshuler and Grubert paper goes on to consider recent changes in the effective rates of taxation facing U.S. firms investing abroad. Average foreign tax rates have been falling, driven by foreign tax developments and possibly by avoidance on the part of taxpayers. The paper presents evidence on the extent to which tax rate changes are associated with country and taxpayer attributes, offering informed speculation on what might lie behind the decisions of some countries to change their taxation of U.S. firms, and what might account for recent changes in the tax obligations of some taxpayers. The evidence presented in the paper is intriguing, and though it is open to many possible interpretations, it offers a valuable input to thinking about the likely future direction and implications of international tax competition.

IV. Conclusion

Taken together, the papers in this issue offer an instructive guide to up-to-date thinking and research findings on international tax competition. Given the salience of taxation in everything that governments do, and the need to incorporate international considerations in any reform of what used to be thought of as domestic tax policies, it is hoped that the findings will stimulate more discussion and further rounds of investigation of these important international tax issues. ✦