



Tax Competition

How tax havens help the poor

By Richard Teather

Tax competition brings great benefits, to all society and not just to those who directly take advantage of it.

The above quotation, from my book *The Benefits of Tax Competition*, turned out to be extremely controversial. Not only do opponents of tax competition refuse to acknowledge its truth, but also some supporters of low-tax jurisdictions are surprised by its claim. And yet in reality tax competition not only benefits people who have nothing to do with low tax jurisdictions, but indeed also gives its greatest benefits to them.

What are the effects of tax competition?

Tax competition is the use by governments of low effective tax rates to attract capital and business activity to their country.

Tax competition appears to operate through a two-stage process: first some pioneer countries (not just 'tax havens') will reduce their tax rates, or offer low effective tax rates through tax exemptions or reliefs; then other countries will lower their own taxes in response to this competition.

Encouraging economic growth

So the most important effect of tax competition is to reduce taxes in developed countries. And the main effect of reduced tax rates in developed countries is to increase their GDP. As taxes are lowered there will be more savings, more investment in productive plant, and more entrepreneurship.

Perhaps the most obvious way in which this works is by encouraging saving. High taxes (particularly high taxes on investment returns) tend to act as a disincentive to savings,

and so reduce the pool of available investment capital and therefore slow growth and lead to fewer jobs being created.

But taxes also damage economic growth in other ways. Work or entrepreneurship creates a combination of costs and benefits: the difficulty of doing a job, the time and money spent in gaining skills, the effort and risk of setting up a new business, and the leisure time that is sacrificed, are all set against the salary and other rewards. If taxes are increased, the rewards are reduced and so work becomes less attractive.

This effect is perhaps most obvious for entrepreneurs, but for all workers this drives a 'tax wedge' between the benefits that flow from work for the employer/client and those that can be transmitted to the worker, reducing work incentives (for a highly readable exposition of this see Arthur, 2003). Although few people would take such an extreme position as giving up work, many more will be affected at the margins. Working overtime, trying for a promotion, or even working full-time rather than part-time, all involve a balancing of pain and gain, and taxes reduce the value of the gain.

So high taxes reduce wealth, and therefore if tax competition can keep tax rates down, and so increase savings, entrepreneurship and effort, then it will boost overall wealth.

A remarkable example of this is Hong Kong – long a British colony but with a high level of self-rule, including the right to set its own tax levels. As a result the UK reached a basic rate tax of 35% and a top rate of 98% in the 1970s, Hong Kong kept a single rate of 15% (and high thresholds). The table below shows the relative economic growth of the two jurisdictions, measured by GDP per capita in constant 1990 US dollars. The disparity is remarkable:

	1950	1973	1999
UK	6,907	12,022	19,030
Hong Kong	2,218	7,104	20,352

Source: Maddison (2003) via Bartholomew (2004)

Hong Kong's growth over the period was a remarkable 800% (even after allowing for inflation), as opposed to the UK's 175%.

Efficient capital markets

Low tax jurisdictions also make international capital markets more effective. By providing tax-free vehicles, they can minimise the problems of double taxation that can occur with cross-border investment.

Tax havens do not 'poach' international capital; they merely act as conduits for investment back into the industrialised countries.

This conduit action is necessary because tax systems do not cope very well with international investment. Where investors, fund managers, holding companies and operating companies are all within the same country, the tax system usually has rules to make sure that the money is only taxed once. But if they are in different countries, the different countries can have very different tax systems, so the same profits can effectively be taxed more than once as they are passed up the chain.

By providing a low-tax environment for investment funds, tax havens make international capital markets more efficient and allow international pooling of capital possible where it would otherwise be prevented by a lack of co-ordination of cross-border tax and investment regulations. By doing this they increase the amount of available international investment capital, most of which is going to flow back to the large industrialised nations, and enable it to be invested without the distortions caused by the need to avoid double taxation.

The benefits of tax havens

Tax havens therefore promote economic growth in other countries directly, (a) by allowing capital markets to flow more freely and (b) by enabling companies to reduce their overall tax bill, and therefore have more funds available for reinvestment. Tax havens also promote economic growth indirectly by encouraging large, developed countries to

keep their own tax rates low and so boosting their own growth.

Although quantifying the detrimental effect of high taxes is difficult, various economists have studied it and the overwhelming result is that there is a significant effect. Bassanini & Scarpetta (2001) for the OECD found that an extra 1% of GDP taken in taxes would reduce economic growth by around 0.6%, and although other studies show lower amounts (and some higher), they tend to agree on the principle that higher taxes reduce growth. For a summary of recent studies, see Leach (2003).

With this damage to the economy, and the cost of collection and administration of taxes, the true cost of an extra £1 of government spending is therefore not £1 but probably more like £1.75.

Although small, the cumulative effect of this reduction in growth over a few years can be significant.

In Europe, employment protection for those already in work means that a large part of the burden of this stagnation has fallen on the young, who are trying to enter the job market but are finding that work is not available. Several EU countries, including France, Italy, Spain and even Sweden, had youth unemployment rates of around 20% – a scandalously high level – even at the height of the economic boom in 2007. With the current recession, those rates are now over 25%, and over 35% in Spain. These are the people who are suffering from higher taxes.

Who benefits from economic growth?

Even though tax havens increase economic growth in high-tax countries, it is still frequently argued that they only benefit the rich, since they are the ones who keep their investments offshore or own the businesses that benefit from this economic growth.

However, this is to misunderstand the result of economic growth, which is primarily to generate new jobs, and – by investing in plant to make work more profitable – make those jobs better paid and more secure.

Indeed, it seems that the vast majority of the fruits of growth fall not to the capitalists, the shareholders and lenders, but to the workers. It is impossible to give a precise figure, but

a recent study by the Oxford University Centre for Business Tax estimated that when corporate taxes are cut, 75% of the benefit goes directly to the workers rather than the owners.

Moreover, the main beneficiaries will tend to be the least well off – the unemployed, those who are most at risk of unemployment, and those on very low incomes whose jobs can be made more valuable by investment.

Reduced public spending

So the main beneficiaries of reduced taxes are, indirectly, the less well off. The unemployed who find jobs, and those in unstable or low paid jobs that are made more productive (and therefore more valuable) by investment in more productive plant.

But don't the less well also bear most of the cost of reduced taxes, through reduced government programmes? Not necessarily.

By stopping governments from increasing taxes, tax competition should make them think more carefully about what they spend money on, to ensure that they only spend on what will give the greatest benefit to the people, and do so in the most efficient manner. The interaction between tax competition (keeping taxes lower) and public opinion (demanding better public services) should lead to desperately needed improvements in government efficiency.

Conclusion

Tax havens are not sucking investment away from Europe. Nor is tax competition impoverishing public services. Instead, tax competition is a beneficial force, which creates jobs and boosts wages. Thus the greatest beneficiaries will not be the wealthy capitalists, but rather the workers.

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