

# Where will tax competition end?

Governments around the world are engaged in increasingly aggressive tax competition. This is most clearly seen in headline rates of corporation tax. Four years ago, in 2003, the UK had the fourth lowest rate in the EU. Today, despite an unchanged rate of 30%, it has the 21st lowest rate in the EU.

This dramatic decline in the rankings has come about for two reasons. One is the accession of new EU member states in 2004 and 2007 (of the 12 new members, all but one have a tax rate lower than that of the UK). Also, six of the pre-2004 members have reduced their rates from 30% or more to less than 30%.

Where is this process leading? Policy makers have for many years been concerned about a 'race to the bottom' in tax rates. But, until recently (and perhaps even now) that has seemed more of a theoretical hypothesis than a real possibility. How likely is it that some tax rates might reach zero?

An important feature of the recent performance of corporation taxes is that tax revenues have not fallen in line with rate reductions. For example, UK corporation tax revenues have increased substantially in recent years: up from £28bn in 2003-04 to a forecast £47bn in 2006-07. Part of that rise is due to higher North Sea oil profits but, even excluding those, there has been a remarkable rise in business, consistent with increased UK profit, rather than an exodus in response to the UK's fall in the tax competitiveness league.

## Competition versus revenue

Governments cannot rely on ever-higher rates of profit to protect their tax revenue in the face of tax rate reductions, though. So where will this spate of tax competition end? Some argue that competition will halt as governments resist the pressure to give up all their revenue. Perhaps there might be a convergence at, say, 15%. Why stop at 15%, though? There will always be countries that see an advantage in undercutting their neighbours. In the early 1980s, the average Organisation for Economic Co-operation and Development corporation tax rate was about 50%. The rates now would have been scarcely believable then.

The real issues here are more fundamental. In a competitive environment, tax policy is an important tool for governments that seek to attract and maintain investment and



Will corporate tax continue to fall until the rate is zero? Michael Devereux looks at what is fuelling the competition

profits. The tax rate on profit cannot be too much higher than that in other countries. Although it has not happened yet, falling tax rates must eventually reduce corporation tax revenues.

Can governments then raise the revenue they require from other sources? From an economic perspective, yes. Based on 2006-07 forecast tax revenues, the UK government, for instance, could replace revenue from corporation tax by raising the value-added tax rate by about 10 percentage points (up from seven percentage points in 2003-04). Such a switch would have the advantage of making the UK extremely competitive as an investment location – at least until other countries responded. But it is more likely that the UK government will eventually be forced into such a move in defence against aggressive competition from abroad.

The real constraint on governments in this competitive process is political. Do they dare to continue reducing the rate of corporation tax, at least in its current form, ultimately to zero?

## Fairness should be debated

The most important objection is based on a concern for fairness, but the fairness of corporation tax needs to be debated. Corporations cannot pay their fair share of taxes because, ultimately, they do not bear any tax: it can be passed on to shareholders, consumers, suppliers and workers. Whether corporation tax contributes to a fair tax system depends on who bears the tax burden – and that depends on economic conditions, which vary across companies and sectors.

There are almost certainly better ways of achieving a fair distribution from the tax system. If that were generally believed, then the political objections to cutting corporation tax rates would diminish, and the powerful forces of competition would meet with less resistance. **TB**

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The Bracken column is named after Brendan Bracken, the founding editor of **The Banker** in 1926 and chairman of the modern-day Financial Times from 1945 to 1958. This column reflects his enormous contribution to the open discussion and understanding of international finance and banking. It focuses on providing views and perspectives on how to improve the global financial system.