What is a Competitive Tax System?

Statements about the importance of tax systems being ‘competitive’ are often made by business, politicians, lobbyists and other commentators, but what does this term mean?

Introduction

In everyday usage ‘competitive’ is a relative concept. When applied to a business, it would mean that the firm in question is able to produce its output at the same or lower cost than other firms in the same line of business, or that it has some other advantage over them such as the quality of its product. In most industries a competitive firm would (as a result of its cost or other advantages over its rivals) be able to earn returns in excess of its cost of capital.

It is more difficult conceptually to apply the term ‘competitive’ to an economy as a whole rather than a particular business. An economy is made up of many different firms (plus extensive public sector provision of services). Moreover the structure of its production and the pattern of its trade will depend on its comparative advantage relative to other economies. Specialisation in line with comparative advantage increases production efficiency and raises living standards.

For a typical advanced economy (where natural resources and primary products make up a relatively small part of domestic output) there are likely to be strong links between the competitiveness of its firms and the overall levels of productivity and living standards that the country is able to sustain. Individual firms may then be ‘competitive’ internationally (in the sense of having a cost or other advantage relative to their foreign rivals, given the exchange rate, etc); and if a firm is not competitive, then national output and income are likely to be higher if the resources it would have used are redeployed to another line of business where profit opportunities are better.

Most of the drivers of the competitiveness of firms lie within the domestic economy. Thus the World Economic Forum, for instance, in its Global Competitiveness Report defines ‘competitiveness’ as ‘the set of institutions, policies and factors that determine the level of productivity of a country’. The level of productivity in turn sets the sustainable level of living standards. The Global Competitiveness Report weights together data pertinent to 12 ‘pillars of competitiveness’: institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication and innovation.

There are likely to be significant overlaps and interactions between these ‘pillars’ and views may differ on precisely how they translate into increased production efficiency and growth potential. However, one approach to examining the impact of tax on ‘competitiveness’ is to...
consider how tax policy and administration impact on the various ‘pillars’ and hence productivity, etc. In practice, most taxes (not just the corporate income tax) can have an impact on competitiveness, as Section B below indicates. In practice, the underlying themes arising from taking a ‘competitiveness’ perspective are very similar to those explored in OECD work on Tax and Economic Growth (OECD 2010a) and the Tax Policy Brief on Tax Policy Reform and Fiscal Consolidation (OECD 2010b).

However, in considering how tax policy can help to generate economic growth and prosperity, each country’s tax system cannot be considered in isolation. In open economies where capital is mobile across boundaries and multinational enterprises play an increasing role in international trade and investment, tax regimes and tax rates can potentially have a significant influence on decisions about the location of production and investment. Section C accordingly explores notions of ‘international tax competitiveness’ and how they interact with other desiderata for tax regimes: raising sufficient revenues, fairness, economic efficiency, etc. Section D discusses further some of the problems of measuring international tax ‘competitiveness’.

Section E then sets out a few concluding observations on the implications for tax policy and the role that common principles (e.g. the OECD Model) and economic cooperation can potentially play.

Pillars of competitiveness: The Impact of Tax Policy and Administration

The following paragraphs focus on the ‘pillars’ identified in the Global Competitiveness Report that are most likely to be directly affected by tax policy and/or administration.

Institutions

A sound and fair legal and administrative framework (within which individuals, firms and governments interact to generate income and wealth in the economy) has a strong bearing on competitiveness and growth. Investment decisions for instance will be influenced by property rights, attitudes to markets and levels of trust. Tax policy and administration can contribute to a competitive economy in a number of ways under this pillar, including:

- Raising tax revenues in a way that is broadly accepted as fair is more likely to achieve high levels of (largely) voluntary compliance
- Good administration that is effective in deterring evasion reinforces social cohesion and ensures no unfair advantage accrues to businesses that evade tax
- Similarly, tax administration that is not open to corruption and that implements tax law consistently and impartially make the tax regime predictable and reduce the extent to which it might discourage investment
- Efficiency in tax administration reduces the amount of an economy’s resources that have to be devoted to revenue collection
- Low compliance costs and burdens on business reduce the time that taxpayers have to spend on tax compliance – time and effort that could otherwise be spent on creating income and wealth
- Tax policy making that is evidence-based and transparent, with publication of the revenue forgone from tax expenditures and periodic reviews of their cost-effectiveness, estimates of the revenue effects of tax measures proposed in the budget, etc.

Another important institutional factor for a country’s competitiveness is corporate governance: having businesses that are run honestly and follow strong ethical practices in their dealings with government on tax matters.

Macroeconomic environment

A core objective of tax policy must be to raise sufficient tax revenues to finance public expenditure while maintaining sustainable budget deficits and public debt ratios. Correspondingly, any tax cuts have to be ‘paid for’. The overall economic impact of a tax reform package and of

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its financing hence need to be considered together.

In addition, the macroeconomic environment influences the extent to which the tax regime reduces economic efficiency and growth prospects. Low and stable inflation rates for instance reduce the distortionary effects on saving and investment of conventional income taxes based on historic cost accounting. Stability of the macroeconomic environment also enables stability in tax rates and regimes; and where the tax consequences of business decisions and/or household savings’ choices are predictable the tax regime should lead to less distortion of the market signals to businesses and households that guide their saving and investment decisions.

**Higher education and training**

While primary and secondary education is generally compulsory and state funded, higher education, vocational and on-the-job training usually involve more private sector choice and finance. Tax regimes thus need to be designed so that they do not distort such choices and, moreover, take account of the various market imperfections and spillovers that often arise in this area.

**Good market efficiency**

Growth-oriented tax regimes distort market signals as little as possible, and avoid discouraging the supply of entrepreneurship, investment and skills. Tax policies need to go with the grain of competition in ensuring that it is the most efficient firms, producing the goods and services demanded by the market, which thrive; and at the same time support the redeployment of resources into firms and industries where the reward they can earn is higher.

Tax systems will in general be less distortive if they use a broad base, e.g. by applying the standard VAT/GST rate to all consumption expenditure, as this reduces the extent that tax distorts choices and enables tax rates to be lower than otherwise, so disincentive effects are reduced. Similarly broadening Personal (and Corporate) Income Tax bases by reducing tax expenditures would allow lower marginal tax rates; and the distortionary effects of these taxes depends primarily on marginal rates. (The international dimension to government decisions about what to tax and the design of tax regimes is discussed further in Section C.)

A significant exception to the general rule that taxes should distort market prices as little as possible can arise where those prices do not reflect costs (such as environmental damage) or benefits (such as spillovers from one firm’s R&D to other firms). In such cases a well-designed tax to ‘correct externalities’ would improve economic efficiency and incentives.

**Labour market efficiency**

On average in OECD countries revenues from personal income tax (PIT) and social security contributions (SSCs) make up about half of total revenues. This implies that tax rates can be high and have potentially significant disincentive effects. The PIT is also the tax that is most closely tailored to reflect ability to pay and it plays a significant role in the redistribution of gross (pre-tax) incomes. Governments thus have to make important judgments about the trade-offs between efficiency and fairness. Both can be important for competitiveness. Social cohesion associated with widely-held views that the tax regime is fair can for instance improve the functioning of institutions, goods and labour markets.

Empirical evidence suggests that some labour supply decisions are more responsive to tax (dis)incentives than others, e.g. those of second earners, the low-skilled/ low paid, older workers. Tax reforms that promote their labour market participation could thus increase labour supply and promote inclusiveness – another rider to focusing on productivity/ competitiveness per se.

Labour market efficiency also involves the cost and speed with which labour can be shifted from one economic activity to another, as economies adjust to the opportunities and challenges of globalisation, new technologies and the aftermath of (macro) economic shocks. There can be
significant interactions between labour market regulations, minimum wage rates and the tax/benefit regime impacting on this flexibility.

**Financial market development**

A sound financial sector that intermediates efficiently between savers and investors is important in ensuring that businesses and entrepreneurs (especially those developing new products and technologies) have adequate access to funds and that the investment opportunities that yield the highest expected (pre-tax) returns are undertaken. It is correspondingly desirable that tax should not distort decisions on how to finance investment, including the choice between debt and equity.

**Market size**

Trade generally has a positive effect on growth, especially for countries with small domestic markets. Tax policies can support wider markets by removing tax obstacles to trade, e.g. the OECD International VAT Guidelines that are being developed to prevent double taxation (or non-taxation).

**Business sophistication**

This includes the quality of individual firms’ production, innovation and marketing strategies, as well as the growth of ‘clusters’ and other networks. An associated challenge for the tax authorities can be that firms’ (particularly MNEs) tax planning strategies also develop in sophistication and frequently exploit mismatches between national tax systems.

**Technological readiness and innovation**

Technological readiness refers to the ability of economies to adapt existing technologies and innovation to the development and application of new technologies and products. Successful R&D is clearly crucial. There is some evidence that a favourable tax regime for R&D increases the amount of such expenditure, but less clear evidence on the best design of any tax relief or the appropriate degree of tax privilege.

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**International Tax Competitiveness**

Liberalisation of trade and capital markets has been an important component of ‘globalisation’. This process has embraced both OECD countries (which have taken further steps in this direction) and emerging economies (notably the BRICs). The resulting increased competition and pressures to produce where profitability is greatest have been accompanied (on the supply of funds side) by much greater mobility of capital. Both foreign direct investment (FDI) and portfolio investment have grown massively in relation to GDP. In the OECD area the stock of outward FDI in relation to GDP increased from 10% in 1990 to 39% in 2009; and the corresponding figures for inward FDI were a rise from 8% to 31% of GDP. Inward and outward portfolio equity investment grew from around 1% of GDP in 1990 to around 7%.

These trends have had significant implications for tax policy, as cross-border investors will generally be looking to maximise their post-tax not their pre-tax returns. Countries may feel that they are increasingly in a position of competing as a location for FDI and, as a result, under pressure to reduce taxes on the return on investment, particularly their corporate income tax rate. Even an investment with an expected return comfortably in excess of a firm’s cost of capital may not go ahead if an even larger return could be achieved in another country through tax rates being lower. In practice, the range of empirical estimates of the responsiveness of FDI to corporate tax rates is quite wide and this makes clear cut conclusions difficult. Nevertheless, this elasticity appears to have increased over time and international competition for FDI thus reinforces the wider ‘competitiveness’ arguments discussed in the previous section for a tax regime that fosters a good climate for investment and innovation.

A second, but related, challenge for tax policy from globalisation is the greater ease with which business (especially MNEs) can engage
in aggressive tax planning activities, including by:

- moving (‘stripping’) earnings from one (higher tax) country to another (lower tax) country through e.g. internal group leverage such as financing subsidiaries in high tax countries primarily with debt;
- profit shifting through transfer mis-pricing, i.e. by setting prices for intra-group transactions which are inconsistent with what unrelated parties would do; and
- taking advantage of differences between tax regimes, e.g. through the use of ‘hybrid’ instruments (which may lead to a deduction in one jurisdiction without corresponding taxation in another jurisdiction).

Countries may thus feel that they are competing not only for investment, but also for taxable profits. The tax base of a MNE’s home country and that of host countries can be at risk. Especially if the home country is a relatively high tax country, its taxable profits may be reduced dramatically through aggressive tax planning techniques, particularly in the area of intangibles.

In deciding how to respond, governments have to take a systemic view of the tax regime and of how, in particular, they want to tax capital income. Corporate income taxes potentially fulfil a number of valuable functions such as taxing profits on an accruals basis, so that individuals cannot use corporations as a tax shelter; providing a way of taxing source country profits accruing to overseas investors; and implementing a form of withholding tax on the capital income from equities held by resident investors. Collecting tax on profits at the corporate level is likely to be much less cumbersome than taxing individual shareholders and, when domestic companies were owned almost entirely by resident investors, such a regime was likely to be administratively both fair and efficient. This is arguably still the case in a large country like the US where nearly 90% of equity in US corporations is US-owned, but is much less likely to be the case in small open economies.

In lobbying governments about taxes, businesses tend to focus on the CIT regime, as this is generally a tax burden on all their shareholders whether domestic or foreign, exempt or taxpaying. And for MNEs a ‘competitive’ CIT regime appears to be seen as one under which the tax rate that they face in a country is no less favourable than that facing both domestic companies in the host country and the subsidiaries of MNEs from other home countries.

This ‘tax rate’ depends in practice on a range of factors including the statutory CIT rate, the tax base (notably depreciation of assets for tax purposes), the type of double taxation relief operated by the home country, the opportunities for aggressive tax planning and the extent to which a business exploits them. The last factor means that the effective tax rate faced by a business does not just depend on the host country’s tax legislation – it is to some extent linked to the tax legislation of the other countries in which the business operates and the degree to which the business chooses to exploit differences between the regimes.

Thus even if the narrow business lobby interpretation of a ‘competitive’ tax regime were accepted, a country that wanted to compare its regime with that of other jurisdictions would need to look not just at statutory tax rates, but also at effective tax rates that allow also for differences in the tax base such as the rates of depreciation of assets permitted for tax purposes. But even this estimated effective tax rate might not be the actual effective tax rate when aggressive tax planning is not effectively countered. Ideally, international comparisons of effective tax rates ought therefore to take account of tax planning and avoidance.

Business lobbies seek to put pressure on governments for support in the name of ‘competitiveness’ in many areas of international trade and investment. As a general rule, though, resources devoted to providing export subsidies or other support mean that an economy ends up producing less than otherwise, given the exception. Exception may be some forms of imputation regime.
additional (distortionary) taxes that have to be levied on the rest of the economy to finance the support. Similar arguments can be made in relation to any implicit support for FDI (whether inward or outward) through lower effective tax rates on the return on such investment than a purely domestic investment. The forgone revenues have to be made up through higher taxes on the rest of the economy.

On the other hand, where capital is highly mobile internationally and an economy is small in relation to international capital markets, it is arguable that, while the formal incidence of the corporate income tax may be on the owners of capital, its effective incidence is likely to be on less mobile factors such as labour. At the limit, source taxation of capital income could mean investors would choose to invest in another country (where taxes were lower) and the host country would have a lower capital stock, a lower capital/labour ratio and lower real wages. In practice capital is generally not quite that mobile (except perhaps money and bond markets), but governments still face difficult choices about how far they should tax corporate earnings (especially given the uncertainty already noted above about how responsive FDI is to tax rates) and about whether to accept MNEs being able to achieve a lower effective tax rate than domestic firms by exploiting differences among tax systems.

These choices involve making judgements about what are the most significant distortions that will mean output is lower than it could be and how far additional investment will mean that domestic incomes are higher than they would otherwise be. At the same time the principle of ‘ability to pay’ would point to taxing capital as well as labour incomes, posing the question of how is this to be achieved if CIT rates are cut (or MNEs are tacitly allowed to reduce the effective tax rate they face through tax planning).

Although tax policy decisions about rates of CIT and approaches to aggressive tax planning are central to the impact that tax has on the competitiveness of an economy, the way the tax system is administered matters as well. In making decisions about future investment, businesses value certainty about the tax regime that will apply to the returns they expect to earn. Tax systems that are not administered in a consistent and even handed way, or that impose high compliance costs, are likely to impede competitiveness. Instability in the tax system, resulting from frequent changes in policy or design, will also increase levels of uncertainty in the minds of investors. For a country to be regarded as a ‘good place to do business’ many aspects of its tax systems are likely to be pertinent, not just its business tax regime.

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**Can international tax competitiveness be measured?**

The discussion in Section B above of how tax policies and administration influence the ‘pillars’ of competitiveness used in constructing the Global Competitiveness Indices of the World Economic Forum was largely descriptive and it is tempting therefore to look for more quantitative measures of how one country’s tax regime compares with others’. As already discussed, though, statutory tax rates are only part of the story. Account should also be taken of not only differences in the tax bases, but also the impact of (aggressive) tax planning. Measures of the tax wedge between the pre- and post-tax returns on hypothetical investment projects can capture such effects and provide a useful indicator of the extent to which taxation raises the cost capital and distorts investment choices. Such figuring can also take account of other taxes (as well as CIT) that impact on business investment decisions such as recurrent taxes on business property and capital. However, it is inevitably somewhat stylised. It also does not take account of administrative and compliance costs.

Some limited international comparisons can be made of the size of the compliance cost burdens imposed on firms in meeting their tax obligations (including those arising from deducting at source personal income tax liabilities and employee social security contribution on earnings and then remitting them to the tax authorities). However, ensuring that like is compared with like is problematic.
This is a fortiori the case for measures that seek to combine both tax and administrative burdens based on a 'standard' firm in different countries (as with the Doing Business reports prepared by the World Bank). The chosen hypothetical firm and business scenario are unlikely to be representative of the actual situation in different countries. Methodological difficulties can include assuming that responsibility for remitting a tax is the same as effective incidence and ignoring all tax planning which (as already noted) is rife and reduces effective tax rates. Measurement of administrative burdens, being based on generalisations from particular cases and activities, does not give a complete picture of the end to end process of tax administration and compliance. As a result of such methodological problems ‘Doing Business’ and similar indicators can be very difficult to interpret; and changes to tax policy or administration that look to be cost effective ways of improving a country’s ranking in such league tables may not actually be desirable, viewed from a wider tax policy perspective.

In addition, to the extent that the provision of public services which enhance the business climate and competitiveness (in the broader sense used by the Global Economic Forum) is positively correlated with tax revenue, one cannot argue that lower taxes increase competitiveness. In any case, it is desirable to take a systemic approach to tax policy and administration. There may well be scope, for instance, to characterise income as corporate or personal (depending on which is the more favourable regime). Thus the statutory corporate income tax rate cannot simply be set at low levels that are judged to be ‘competitive’: it has to have a coherent relationship with the rest of the regime so that significant arbitrage and distortions are prevented.

**Some concluding observations**

As discussed above, notably in Section B, an economy’s ‘competitiveness’ and its ability to achieve high and growing productivity and economic prosperity are likely to be driven primarily by domestic factors. If these mean that it is able to generate plentiful investment opportunities with high (pre-tax) returns, then its tax rate (if broadly in line with other similar economies) may not have much effect on levels of investment. In other words, if the competitive pillars of an economy are strong, it is generally more able to impose corporate income tax without discouraging investment. This highlights the importance of governments spending their tax revenues efficiently in areas that strengthen the fundamentals of competitiveness.

Conversely, low CIT rates may not be able to compensate for weaknesses in the competitiveness ‘pillars’. (A small country with a low CIT rate and weak anti-avoidance regime could, though, attract sufficient additional taxable profits to its jurisdiction to offset the loss of CIT revenues on profits from domestic investment, even if this advantage might prove precarious if other countries were to adopt more effective measures against profit shifting and other avoidance.)

Tax policy and administration to promote ‘competitiveness’ thus need primarily to be directed at strengthening the pillars outlined in Section B. This points to pursuing the sort of policy recommendations that emerged from OECD work on Tax and Growth: shifting the balance of taxation more toward broad based taxes on consumption and recurrent taxes on residential property, broadening tax bases, improving compliance, etc.

Nevertheless, in a world with high levels of capital mobility, countries cannot ignore the potential effects on investment of how their tax rates compare with other countries’. However, as discussed above, the relevant tax rate is not just the statutory CIT rate but effective rates that also take account of other aspects of the tax base and the likely nature and scale of aggressive tax planning. In addition, other taxes (e.g. on business property), compliance costs, quality of infrastructure, etc are likely to be important elements of a country’s ability to provide a business friendly tax administration.

At the same time, countries will want to protect their tax bases. They can do this unilaterally to some degree, *e.g.* by the regime they operate for
the passive income of controlled foreign companies, for the deduction of interest and other expenses or for double taxation relief. The effectiveness of such measures would be strengthened if international cooperation is enhanced, e.g. through exchange of details of aggressive tax planning trends and patterns, the detection and the response strategies used (from both a policy and compliance perspective), the use of joint audits, and the development of additional guidance such as on the application of the arm’s length principle to intangibles. This will ensure that taxpayers engaging in aggressive tax planning are no longer able to shift the burden of taxation onto more compliant taxpayers through other (distortive) taxes having to be higher than otherwise, and at the same time will help to provide much needed certainty to taxpayers.

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