Are small economies doomed to be tax havens ?

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Presentation prepared for the Conference:
Competitiveness Strategies for the EU Small States
Chambre de Commerce Luxembourg, Kirchberg
19-20 April 2018

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1. Small country size in the tax competition literature

1.1. Does small country size involve tax dumping ?

- Small states are highly dependent on foreign direct investments
- They have to attract resources to be viable
- How ? By adopting tax dumping ? ⟶ View shared by prominent specialists.

➢ Wilson (1999), Bucovetsky (1991)

When two countries of different size compete in taxes then the ***small country chooses the lower*** *rate*.

- Bucovetsky, S. , Asymmetric Tax Competition, ***Journal of Urban Economics***
- Wilson, J.D., Tax competition with interregional differences in factor endowments, ***Regional Science and Urban Economics***

- Kanbur and Keen (1993) argue that small states **specialize in international tax dumping**. The model they develop is rather simple but they claim that

  *" (it) seems likely to **extend to models more general** than that used here. It captures what seems in practice to be a common characteristic of tax havens: their smallness."*

  Kanbur, R., and M. Keen, Jeux sans Frontières: Tax Competition and Tax Coordination when Countries Differ in Size, ***American Economic Review***

- Smallness and tax dumping? Is this supported by evidence and consistent with recent theory?

a) **What does casual evidence show?**

- Basing on capital tax rates in the European Union for 1991), Marceau et al. (2007) claim that

  *"the correlation between the size-population of a country and its tax rate is not clear. For example, some large countries like France and Germany have below average tax rates. (…) [T]he predictions of the asymmetric tax competition literature **do not appear to be realized in the real world equilibrium**."*

  Marceau, N., S. Mongrain, J.D. Wilson, Why do most countries set high tax rates on capital ?, CIRPEE Working Paper No. 07-11. Published in the ***Journal of International Economics (2010)***

b) What does recent theory tell ?

Preliminary question: Do jurisdictions **only** compete in **taxes** ?

- Hauptmeier et al. (2012) use a data set of local jurisdictions in Germany.

  Estimations suggest that jurisdictions use **independently** and **strategically** business tax rates and **public inputs** to compete for capital.

Hauptmeier F., S. Mittermaier , and J. Rincke , Fiscal Competition over Taxes and Public Inputs, ***Regional Science and Urban Economics***

This justifies *modeling* tax **and** public infrastructure competition between jurisdictions of uneven size (Pieretti and Zanaj, 2011)

Pieretti P. and S. Zanaj, On tax competition, public goods provision and jurisdictions' size, ***Journal of International Economics***

- Infrastructure provision
  - Infrastructure → input in firms' production function → **enhance private productivity**
  - Infrastructure → **public goods** (services) → **non rivalrous**
  - **Costly** to provide
  - **Tangible** and/or **intangible** goods (services)
  - **Tangible** infrastructure: roads, railways, technological and communications investments…
  - **Intangible** infrastructure : education, the enforcement of property rights, the provision of capital market, labor and environmental **regulations** …
- Major result
  - A small jurisdiction **does not need to lower taxes** to be attractive to foreign investments.
  - For a certain **range of mobility costs**, it attracts foreign capital by supplying a **higher level of public goods** than its larger rival does **without levying lower taxes**.
  - This can occur independently of other specific features **apart from their size**.

1.2. The smaller a state, the more it hurts global welfare ?

- Kanbur and Keen (1992)

  *"Even more strikingly, **differences in size have been seen to exacerbate** the inefficiencies of noncooperative behavior. Tax competition between countries that are identical in size leads to an inefficient outcome. But when countries differ in size, the outcome is even worse."*

  - In other words, when small countries compete with larger countries for mobile tax bases, the source of inefficiency is **increasing with their smallness**.

- However, jurisdictional competition **with tax and nontax instruments** may change this classical view.
- If capital is internationally mobile enough, **smallness lowers the inefficiency** of tax competition (with infrastructure competition) (Han, Pieretti and Zou., 2014).

*Han, Y., P. Pieretti, P., B. Zou, Does size asymmetry exacerbate the inefficiency of tax competition?, **Economics Letters***

- Why ?

  - Bigger size asymmetry increases tax aggressiveness. This results in **higher** capital outflows (**negative** effect) but **increases** aggregate (**positive effect)** output.

  - The sum of both effects depends eventually on the degree of (international integration) capital mobility.

  - When capital mobility is **high**, the **net effect** is **positive**. Wasteful relocation of capital is compensated by **output creation**.

2. Survival of a small state in a competing world for mobile resources.

Can small states ensure their sustainability over the long term if they have to attract foreign firms (capital) ?

- Issue analyzed by a model based on differential game theory

  ⟶ dynamic **tax and infrastructure** competition between a small and bigger states

  Han Y., P. Pieretti , S. Zanaj and B. Zou, 2014, *Asymmetric Competition among Nation States: A Differential Game Approach,* ***Journal of Public Economics***

➢ **Growth determinants** in the small economy ⟶ **Inflow of foreign firms** + **enhanced productivity** resulting **from infrastructure** expenditures

➢ The dynamics weaken gradually and output converges towards a **steady state**.

- Two **opposing features** of very small economies are accounted for in the model

  a) **Higher flexibility** in the decision taking of the small state

  → Periodical policy updating within a changing environment

  → Policy in the large economy constrained by longer term commitments.

  b) **Limited *institutional capacity*** of the small states

  - **Fixed costs and indivisibilities in the provision of public services** (Briguglio L., B. Persaud, and R. Stern, 2006, ***World Bank***)
  - **D**ifficulty to recruit **high quality staff** given the limited pool of potential candidates (Streeten P., 1993, ***World Development***)

- Model takes into consideration the **degree of international openness** (capital mobility)

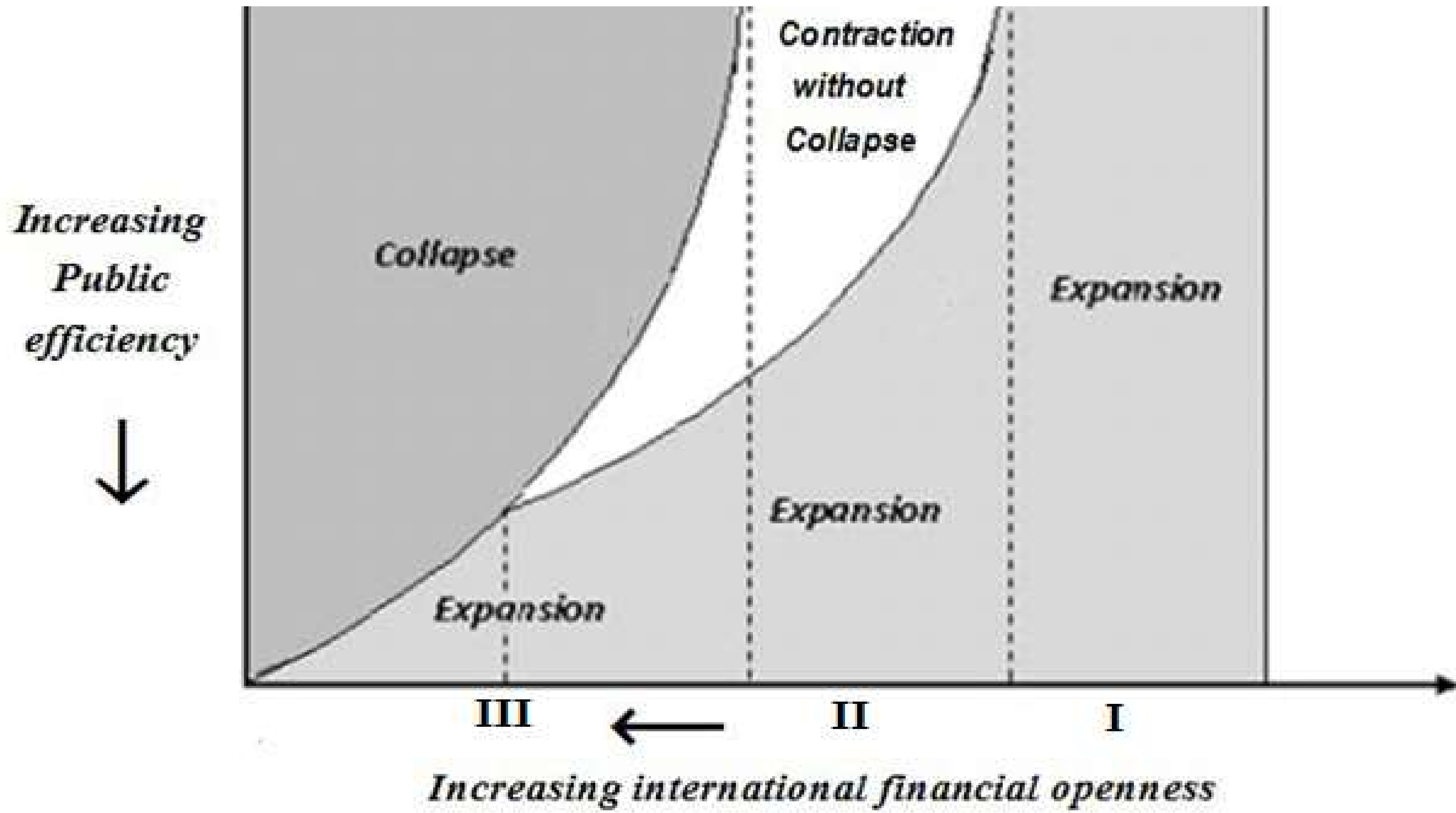
Results (See Figure)

I. If ***capital mobility is relatively low***, the small country can lower its tax rate without strong reaction of the bigger rival → country is attractive to foreign business **independently of institutional efficiency** → GDP increases steadily.

II. If ***capital mobility is intermediate,*** *the level of institutional efficiency matters for growth.* If efficiency too low → loss of international attractiveness → economic potential **decreases**

III. When capital ***mobility is relatively*** *high*, international competition can be harmful to the small economy.

- **Low taxation** is **no compensation** for poor institutional efficiency. Due to low revenue, a sufficient amount of public spending on infrastructure is no more affordable.
- **Flexibility** in decision making does **not compensate** for relative weakness in institutional resources.



Contraction
without
Collapse
Increasing
Public
efficiency
Collapse
Expansion
Expansion
Expansion
III
II
I
Increasing international financial openness