Are small economies doomed to be tax havens?

Patrice PIERETTI

Center for Research in Economic Analysis
University of Luxembourg

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


> 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.”

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


➢ 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*)
   - Difficulty 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.