Tax Competition: How Does It Affect the Developing World?

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What is tax competition?

- Tax competition exists when governments are encouraged to lower fiscal burdens to either encourage the inflow of productive resources or to discourage the exodus of those resources from their domain.

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The artificial factor of production

- Tax is used to induce relocation of resources
- As anyone who knows market economics will understand - this is a market distortion
- Market distortions harm well being
- Market distortions result in inefficient allocation of resources
- By definition tax competition is a bad thing
- The question then is who wins and who loses

How does it work?

- Tax holidays
- Non-standard tax regimes
- Effective subsidies for those investing in a country
- A guarantee of future stability
- Usually ignore the standard framework of international tax agreements

What are the mechanisms that facilitate tax competition?

- IMF and World Bank imposed
- Usually involve high degree of secrecy
- Frequently, in fact almost always associated with highly artificial investment structures using opaque tax haven structures
- Often linked to corruption - made much easier due to the secrecy involved in the arrangements

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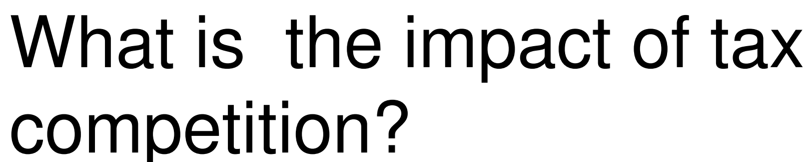

What is the impact of tax competition?

- Very low or no payment of tax by companies on profit - largely because it is very easy to record no local profit
- Goods are exported at too low a price
- Goods are imported at too high a price
- Transfer pricing abuse is a normal part of tax competition in developing countries

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What are the side effects?

- Disrespect for tax systems
- Promotion of secrecy
- Increased risk of corruption
- Over dependence on tax havens

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What is the cost?

- Very low or no tax revenues
- Exploitation of limited local natural resources with insufficient return to the local community
- Corruption
- Debasement of governance

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What's the evidence?

- Tax concessions have been employed as a central component of the development strategy in the small island states comprising the Eastern Caribbean Currency Union. This paper compares the costs of concessions in terms of revenues forgone with the benefits in terms of increased foreign direct investment. The costs are very large, while the benefits appear to be marginal at best. Forgone tax revenues range between 9½ and 16 percent of GDP per year, whereas total foreign direct investment does not appear to depend on concessions. A rethinking of the use of concessions in the region is needed urgently.
- http://www.imf.org/external/pubs/ft/wp/2008/wp08257.pdf

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What can be done about it?

- Stop the Breton Woods support for undermining tax revenues
- Create openness and transparency
- Renegotiate the bad contracts: some are now doing it
- Create country by country accounting which would require investing companies to report what their local sales, costs, employment data, profits and taxes paid are: the information we need to know if they are acting responsibly and paying their way in the communities that provide them with the opportunity to earn their profits

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Summary

- Tax competition is a process of reallocating of the resources of developing countries to the shareholders of companies in the developed world
- This is unacceptable
- It has to stop, now

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