PAPER VII:
International tax competition and corporate taxation in the wake of Brexit
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Since the British public voted to leave the European Union, there has been widespread conjecture as governments across Europe and beyond try to assess the political and social ramifications of the result. There is no question that Brexit has the potential to impact on all aspects of our day-to-day lives, from education to the economy, health and housing, trade and travel, and much more besides.

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1. Summary

In recent decades, increasing mobility of firms and capital has led to fierce international tax competition and brought down corporate taxes. International tax coordination can, in principle, prevent a race to the bottom, and the EU has set out various policy initiatives to limit wasteful tax competition. Brexit could sound the bell for a new round of intensified international tax competition for two reasons. Firstly, Brexit could cause downward pressure on corporate taxes in the UK and in some remaining EU member states, as exporters would be hit if trade barriers were erected between the UK and the EU. Secondly, Brexit makes European tax coordination a more difficult task. Fiercer tax competition negatively affects public finances, potentially undermining spending on vital infrastructure projects, education, etc. To limit the negative effects of Brexit, this paper recommends that

- the UK and the EU maintain the current level of economic integration as far as possible;
- the UK and the EU continue to coordinate tax policies in general and corporate taxation in particular;
- any attempts to maintain competitiveness should focus on measures that make the UK a more productive place, such as improving infrastructure and skills, rather than on cutting corporate taxes.

2. Purpose of Paper

This paper explores some implications of Brexit for international tax competition and corporate taxation in the UK and the EU. To this end, it first briefly discusses the effects of tax competition on tax rates and revenues and outlines some EU tax initiatives. The paper concludes with some recommendations.

3. Issues

1. **International tax competition** – In the 1990s, the EU (and other organisations, such as the OECD) became increasingly worried about the extent to which ‘harmful’ international tax competition could lead to a ruinous race to the bottom which drastically erodes national tax revenues. The background of these fears is that, in the course of world-wide economic integration, businesses and capital had become increasingly mobile, with footloose companies and capital chasing around the world for the best locations. If anything, this process has accelerated in this millennium. In response, competing countries have reduced their taxes more and more to attract new businesses and capital and to prevent old businesses and capital from moving away. For instance, median statutory corporate tax rates in high-income countries have plummeted from about 50% in the 1980s to less than 30% in recent years. Similar downward trends hold for middle-income and low-income countries. Typically, smaller countries, such as the Republic of Ireland, levy lower taxes on corporations than larger countries, such as the UK, since a
smaller country can simply gain more from undercutting a larger country than vice versa. Indeed, data from the OECD shows that the correlation between country size and statutory corporate tax rate has significantly increased since the 1980s. The key normative conclusion of basic economic models is that international tax competition leads to inefficiently low taxation of mobile businesses and capital. Governments are thus left with insufficient revenues and fail to maintain an efficient level of public spending, with all the negative implications for public infrastructure, education systems, etc.

2. **International tax coordination** – Imposing the same tax rates across countries is certainly not a way forward to prevent wasteful tax competition. Smaller countries, such as the Republic of Ireland, would oppose such a step, since they would be left worse off. However, there are potentially suitable measures of limited international coordination, targeting the tax levels or the structure under which tax competition takes place. Four of them are briefly mentioned:

- **Introducing a minimum tax rate.** This measure ultimately increases the overall tax levels but allows countries still to undercut their competitors, thereby respecting the interests of smaller jurisdictions. It can soften international tax competition in a way that makes all countries better off.

- **Limiting preferential tax regimes.** Preferential tax regimes refer to tax practices that aim at attracting foreign direct investment (FDI) by levying a lower tax on the income of foreign investors than on that of domestic ones. While completely banning such regimes is not necessarily to the benefit of all countries, restricting the extent to which national tax systems can discriminate in favour of foreign investors can increase tax revenues in all countries.

- **Taxing corporations on the basis of formula apportionment.** Multinational enterprises (MNEs) face huge incentives to shift ‘bookkeeping’ profits from high-tax countries to low-tax ones by means of transfer pricing and other tax planning devices, thereby reducing the overall tax burden. Formula apportionment prevents such ‘bookkeeping’ activities, as it attributes a share of an MNE’s total profits to individual countries according to the ‘true’ economic activities in each of these countries. These ‘true’ economic activities can be approximated by using shares of sales, capital or payroll in each country. While this formula apportionment is not a silver bullet and involves some problems, it can be superior to other solutions under certain circumstances.

- **Fortress building.** In a world in which tax coordination at the global level is not possible, the members of a group of countries, say the EU, can still improve their plight by coordinating tax policies among them. In this sense, fortress building pays off.

3. **EU initiatives** – In response to international tax competition, the EU has set out various policy initiatives. Early strategies focused on indirect taxes, such as VAT and excise taxes. In 1992, minimum VAT and excises rates were introduced. Attention then shifted to the more important fields of interest income and corporate taxation. In 1997, the EU adopted a Code of Conduct for business taxation to eliminate ‘harmful’ tax practices. As a result, the Republic of Ireland, for instance, abandoned its preferential tax regime, which effectively levied a lower corporation tax on foreign investors than on domestic
In 2003, the EU Savings Directive implemented the exchange of bank information and a withholding tax, effectively imposing a minimum tax on interest income. More recently, in 2015, the EU relaunched its initiative on the Common Consolidated Corporate Tax Base (CCCTB) as part of an action plan for fair and efficient corporate taxation. This initiative explores options of formula apportionment to combat profit shifting between countries. Further projects have focused on international information exchange.

**4. Assessment of EU initiatives** – The EU fairly successfully harmonised VAT and excise taxes and regulated taxes on interest income. In the key area of corporate taxation, the outcome is more mixed. It successfully induced member states to phase out harmful tax practices. In the case of preferential tax regimes, however, this policy is contentious, with some economists criticising and others defending the stance of the EU. The future will show how successful the CCCTB initiative is.

However, two points are worth mentioning: First, the EU is the only international organisation that has achieved some meaningful degree of tax coordination and some progress in terms of beneficial fortress building. Second, while measures of tax coordination have benefitted all EU members, they were particularly to the advantage of larger countries, such as the UK, which are vulnerable to ‘tax raids’ of smaller low-tax neighbours, such as the Republic of Ireland.

**4. Potential Outcomes from Brexit for the UK and the EU**

1. **Brexit and corporate taxation in the UK** – The single market is the most important export market for British businesses and currently takes up 44% of all British exports. If the UK leaves not only the EU but also the single market, the competitiveness of British exporters will suffer, as they will be put at a distinct disadvantage to their EU and EFTA competitors in the single market. This will also reduce the attractiveness of the UK as a destination for FDI, particularly since many of the foreign investors have specifically chosen the UK as a port of entry to the single market. As a result, FDI inflows, which have added up to a FDI stock of over £1 trillion in the UK, are likely to drop by more than 20% according to current estimates, and British businesses are more likely to relocate at least partly to one of the remaining EU member states. In the case of the financial sector, specific regulations (for instance, passporting rights) can effectively force financial institutions to increase operations in the EU unless a comprehensive trade agreement reinstates the current market integration.

If UK businesses lose ground in the EU market and foreign direct investments into the UK decline, the economic framework for corporate tax policy will change. The British corporate tax base will erode and, most likely, become more sensitive to changes in taxation. A likely policy response to such a development is to reduce the tax burden of UK companies to regain some of the lost competitiveness. Indeed, Philip Hammond stressed that the UK could drastically slash corporate taxes if British exporters lost their current access to the single market. This would in turn put pressure on the remaining EU member states to follow suit and cut their taxes too. As a result, lower taxes in the UK can sound the bell for a new round of fierce international tax competition, reinforcing a
fall in tax revenues. Alternatively, intensified international competition could manifest itself in an upward spiral of subsidies and compensation payments to exporters which suffer from higher trade costs and tariffs, putting strain on public finances in very much the same way as a downward spiral of tax rates.

2. **Brexit and corporate taxation in the EU** – The impact of Brexit on corporate taxation in the EU is ambiguous, as there are opposing effects at work. On the one hand, EU businesses will also lose access to an important export market if the UK leaves the single market without a trade deal. The EU will be a less attractive market place without the UK. This will hurt FDI into the EU and could lead to relocations of businesses to places outside Europe. As a result of the ensuing strain on EU exporters to the UK, EU member states also face incentives to lower the tax burden of their businesses.

On the other hand, the EU is a relatively more attractive market place in terms of size and purchasing power than a post-Brexit UK. This should attract FDI and businesses that would have otherwise ended up in the UK. As a result, the EU member states might see less need to lower their taxes. However, as stated above, once the UK cuts its taxes, the EU comes under pressure to react similarly. Overall, the impact of Brexit on the corporate taxation in the EU will be mixed.

In any case, the effect of Brexit on exporters should be relatively less severe in the ‘average’ remaining EU member state than in the UK. After all, exports from the UK to the EU amount to roughly 14% of the British gross domestic product (GDP) while exports from the EU to the UK account only for approximately 3.5% of the EU GDP. But focusing on the ‘average’ EU member state disguises significant regional variations, with some regions and sectors, such as German car manufacturers, much more affected than others. Hence, the policy response might well vary across the EU member states.

3. **Brexit and international tax competition** – As Brexit causes downward pressure on taxes in the UK and ambiguous effects on taxes in the EU, tax competition in Europe may become fiercer in the aftermath of Brexit, with negative implications for public finances. Such an outcome would reinforce the need for some further tax coordination. Also, competing countries outside Europe will not stay idle either if the UK cuts its corporate tax.

4. **Brexit and tax coordination in Europe** – Beneficial tax arrangements between the UK and the EU will be, in principle, still possible in the post-Brexit era, but they will certainly be more difficult to be negotiated. One reason is that, within the EU, different policy issues can be fairly easily linked with each other, and concessions of a member state in one area can be compensated by concessions to this member state in other areas. Such issue linkages can facilitate beneficial agreements and are easier to arrange within the EU with its multitude of political projects than between the EU and third parties.

Overall, tax coordination between the UK and the remaining EU members will become more difficult, at the expense of public revenues in both the UK and the EU and to the advantage of multinational enterprises. However, a decline in cooperation might damage the EU more than the UK. The UK, as a small country compared to the EU, could gain from free-riding on EU initiatives. For instance, any future agreement on limiting tax competition within the EU would also benefit the UK without imposing any obligations on
the British government. By contrast, the EU cannot free-ride on UK policies to the same extent.

5. Recommendations

To summarise the discussion above, Brexit could lead to fiercer international tax competition and a further decline in taxes and tax revenues, potentially jeopardising vital public spending and leaving the UK and the remaining EU member states worse off. To avoid such an outcome, this paper makes the following recommendations:

1. **Post-Brexit arrangements** – To limit the negative effect of Brexit on tax competition and tax revenues, the UK and the EU should maintain the current level of economic integration as far as possible. A comprehensive agreement between the UK and the EU could ensure that the market position and competitiveness of British businesses remains largely unaffected. This would curb the downward pressure on corporate taxes and tax revenues in the UK and prevent an accelerating tax race to the bottom at the expense of both the UK and the EU.

2. **Coordination of tax policies** – The UK and the EU should maintain a strong partnership and should continue to coordinate their tax policies and initiatives. This is key to avoiding wasteful tax competition between the UK and the remaining EU member states that would undermine public revenues. After all, the mismatch between the limited geographical reach of individual countries and the global activities of multinational enterprises prevents an efficient and fair taxation of businesses. Coordination at the European level is therefore necessary even if it alone is insufficient to generate efficient policies and needs to be accompanied by coordination at a more global level.

3. **Competitiveness** – To safeguard the competitiveness of the UK in the post-Brexit era, the British government should focus on productivity enhancing measures (such as improving infrastructure and skills) rather than on cutting corporate taxes or paying compensation payments to companies for higher trade costs and tariffs. The latter strategies are at best a short-term fix, while productivity enhancing measures generate long-lasting GDP gains.
6. Key Sources


Dhingra, S., Ottaviano, G., Sampson, T., and Van Reenen, J. (2016), The impact of Brexit on foreign investment in the UK, CEP Brexit Analysis 3, Centre for Economic Performance, LSE.


ABOUT THE AUTHOR

Dr Alexander Haupt is Associate Professor (Reader) in Economics. In his research, he analyses key challenges that societies face in the presence of increasing economic integration and global environmental problems. His publication topics range from international environmental agreements and energy efficiency to international tax competition and skilled labour mobility. He is also a Research Fellow of CESifo and leads the iSPER Research Group Markets, Innovation and Competition (MIC).

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