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*Corporate Tax Policy in the Global Economy: A Race to the Bottom, or  
Limited Convergence?*

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Capital is now more mobile than ever before thanks in part to technology and in part to a relaxation of barriers to trade and financial transactions across the globe. This aspect of globalization has allowed multinational corporations to choose where to do business, which has led many to speculate that states will and have been forced to lower corporate taxes to attract this increasingly mobile capital. Indeed, there has been a clear trend over the last two decades toward lower corporate tax rates. In 1980 the average marginal corporate rate was almost 48 percent; by 2003 that rate had fallen to 34 percent.

With states competitively lowering taxes, some have worried of a “race to the bottom” to attract capital. This scenario would involve a complete abandonment of taxing mobile capital, shifting the tax burden to labor, consumption, and non-mobile capital. In this paper I seek to find whether tax competition has led to a convergence toward lower corporate tax rates. Secondly, I consider whether the recent trend toward lower corporate taxes represents a true race to the bottom, which would cause a shift in the tax burden away from mobile capital and toward less mobile forms of taxation like labor and consumption and have grave implications for the welfare state.

The basic argument is that tax competition does indeed affect the tax policies of advanced industrial democracies by pressuring them to lower taxes on corporations, particularly those most able to relocate to competing states. Furthermore, evidence of this study suggests that the argument that domestic politics are still the most important factor is false, at least in the area of corporate tax policy. However, I argue tax competition is not the sole determining factor in tax policy. Structural differences between states affect corporate tax policy as do domestic economic pressures like unemployment rates and public sector debt. Because there are so many variables that go

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into any given state's corporate tax code, it seems unlikely that the recent trend toward lower corporate taxes is evidence of the beginning of a "race to the bottom." Rather, this trend is likely simply the result of the addition of one more pressure to the mix of factors that go into the policy-making process. Therefore, this paper largely agrees with the skeptics, even though it disagrees with some of their specific arguments. I do not argue that tax competition is irrelevant, but it is certainly not the sole factor that determines a state's tax policy.

### **Race to the Bottom or Limited Convergence?**

Current literature on corporate tax reform essentially falls into two opposing camps. The first group of scholars, including Yoo,<sup>1</sup> Deveroux,<sup>2</sup> Mintz,<sup>3</sup> and Scharpf,<sup>4</sup> among others, follows a race to the bottom logic toward corporate tax reform. This logic sees tax reform as merely one aspect of a much larger process of reforming corporate governance in general to better attract capital that is now vastly more mobile than ever before. The second group of scholars consists of people like Garrett,<sup>5</sup> Krugman and Baldwin,<sup>6</sup> and Steinmo and Swank<sup>7</sup> and has a more skeptical view of the extent to which tax competition limits a given state's freedom to choose from a variety of tax systems.

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<sup>1</sup> Yoo, Kwang-Yeol. 2004. "Corporate Taxation of Foreign Direct Investment Income 1991-2001." OECD Economics Department Working Papers, No. 365.

<sup>2</sup> Deveroux, Michael, Rachel Griffith, and Alexander Klemm. 2004 "Corporate Income Tax: Reforms and Tax Competition." In *Economic Policy* October.

<sup>3</sup> Mintz, Jack. 1992. "Is There a Future for Capital Income Taxation?" *OECD Department Working Papers*, No. 108, OECD Publishing.

<sup>4</sup> Scharpf, Fritz. 2004 "Globalization and The Political Economy of Capitalist Democracy." In *The Global Transformation Reader*. Ed. David Held and Anthony McGrew. Polity Press, Cambridge.

<sup>5</sup> Garrett, Geoffrey. 2004. "Global Markets and National Politics." In *The Global Transformation Reader*. Ed. David Held and Anthony McGrew. Polity Press, Cambridge.

<sup>6</sup> Baldwin, Richard E. and Paul Krugman. 2004. "Agglomeration, Integration, and Tax Harmonisation." *European Economic Review* 48.

<sup>7</sup> Swank, Duane and Sven Steinmo. 2002. "The New Political Economy of Taxation in Advanced Capitalist Democracies." *American Journal of Political Science* 46, 3 (Jul.): 642-655.

This group tends to emphasize that while globalization may have significant effects on the policy choices of governments, domestic factors are still the most important causes in determining policy.

Admittedly, this categorization of the literature is not nearly as nuanced as the literature itself. There is substantial variation even with the two basic groups of scholars that I have labeled race to the bottom and skeptic. That said, almost all the literature does clearly fall more within one of these two ideal types than the other. With this overarching division in the literature in mind, I now turn to an examination of the arguments that each group makes in order to see how my work contributes to this scholarly debate.

The central premise of race to the bottom scholars is that, assuming other factors are equal, multinational corporations will choose to do business in the state with the lowest tax on capital.<sup>8</sup> From this premise it follows that states will competitively cut taxes to attract investment. In the more extreme forms of the theory this competition results in a race to the bottom, where states abandon taxation of mobile capital and shift the burden entirely to labor, consumption, and less mobile capital. Aside from the consequences this development would have for the less mobile forms of capital that will bear a greater share of the tax burden, the strongest versions of race to the bottom theory argue that this competition will likely result in less government revenue in general, which would have grave consequences for some of the more generous welfare states.<sup>9</sup> In this way, the race to the bottom would not merely affect tax policy, but would have ripple

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<sup>8</sup> Mintz 1992.

<sup>9</sup> Yoo 2004.

effects through all government, as it would cause a substantial decline in the government's revenue, which would mean less money to go around for all government programs.<sup>10</sup> This effect would have especially important consequences for states with especially generous welfare policies.

Race to the bottom theorists tend to concentrate on "hard" data to prove their point. Thus, for this type of scholar the most important variable is usually how tax rates change over time with considerably less emphasis on the political process by which the reforms are enacted.<sup>11</sup> These scholars tend to look at long time periods to comprehend a country's long-term corporate tax trend. This examination of tax reform generally stops at examining the change in marginal or effective average tax rates on corporations rather than getting into the details of the reforms. Because almost all advanced industrial democracies have substantially cut corporate tax rates in the past two decades, these scholars determine that this phenomenon must be the result of tax competition among countries to attract foreign investment.<sup>12</sup> Race to the bottom scholars argue that countries can be expected to continue competitively lowering tax rates for corporations indefinitely. Furthermore, Scharpf argues that these governments will attempt to make up the revenue they lose through these tax reforms by shifting the tax burden from mobile capital that is free to choose the cheapest place to do business to less mobile capital that is not as affected by tax competition.<sup>13</sup> Therefore, for these scholars, the race to the bottom is not merely a trend toward lower taxes for corporations but a shift of the tax

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<sup>10</sup> Scharpf 2004.

<sup>11</sup> Yoo 2004 p. 17-29.

<sup>12</sup> Deveroux et al. 2004. p. 487-8.

<sup>13</sup> Scharpf. 2004. p. 376.

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burden from the mobile capital of multinational corporations to the less mobile capital of labor and consumption.

The skeptic group of scholars largely contends that race to the bottom scholars overstate their case. Globalization pressures may be important, and the numbers do seem to suggest that there is a systematic pattern of governments cutting corporate tax rates.<sup>14</sup> Still, these scholars argue that this trend is not nearly as constraining as race to the bottom theorists would have us believe. For one thing, there is still a substantial deviation of corporate tax rates among advanced industrial democracies. Furthermore, there does not seem to be a clear relationship between lower taxes and more foreign investment across advanced industrial democracies.<sup>15</sup> Indeed, the logic that tax competition forces countries to lower corporate taxes may be flawed, as tax rates are only one of several factors that corporations and investors take into account when deciding where to do business. Countries with high taxes tend to be states that have long been wealthy, which means that they may offer companies other advantages (in infrastructure, experienced workforce, etc.) that offset their high tax rates.<sup>16</sup> Also, Swank and Steinmo note that while tax competition is important and has led to changes in tax policy, domestic economic pressures will not allow a true race to the bottom because these economic problems pressure policymakers to keep both labor and capital tax burdens low.<sup>17</sup> In short, skeptics argue that, while tax competition pressures are significant, they

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<sup>14</sup> Yoo. 2004. p. 18 and Deveroux et al. 2004 p. 462.

<sup>15</sup> Garrett. 1998. p. 394.

<sup>16</sup> Baldwin and Krugman. 2004. p. 2.

<sup>17</sup> Swank, Duane and Sven Steinmo. 2003.

do not solely determine national corporate tax policies nor are they generally the determining factor in what type of policy a given state enacts.

Skeptic scholars generally make two arguments to refute race to the bottom theorists. The first argument is that it is wrong to simply assume that all states experience the pressures of globalization equally. Garrett powerfully argues that some states are more integrated into the global market than others.<sup>18</sup> Tax competition and other globalization pressures are not uniform throughout the globe. Rather, some states are more integrated in the world market than others. Secondly, skeptics claim that individual states are capable of enacting widely differing policies even when they face similar pressures. The responses to similar pressures differ because domestic institutions and interests shape the responses of individual governments. Domestic variables like the balance of political power, labor market institutions, and domestic economic variables are important to both Garrett and Swank and Steinmo.<sup>19</sup> For example, a state with a corporatist political economy will be more likely to be able to sustain higher taxes because it possesses the institutional capacity to do so.<sup>20</sup> Likewise, states with left-center governments will be less likely to lower taxes on corporations.<sup>21</sup> Finally, domestic economic variables that have little to do with tax competition, like growth and unemployment rates, also affect a state's corporate tax policy. In short, both domestic politics and domestic institutions still matter.

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<sup>18</sup> Garrett, Geoffrey. 1998. *Partisan Politics in the Global Economy*. New York: Cambridge University Press. p. 53.

<sup>19</sup> Garrett, 1998 p. 59-62 and Swank and Steinmo p. 653-5.

<sup>20</sup> Garret, 2004 p. 397.

<sup>21</sup> Radaelli, Claudio. 1997. "How Does Europeanization Produce Domestic Policy Change: Corporate Tax Policy in Italy and the United Kingdom." *Comparative Political Studies*. Vol. 30, no. 5; October, p. 564-5.

In making their arguments, skeptic scholars tend to rely on case studies to a much greater degree than race to the bottom theorists. These scholars argue there are substantial differences in domestic policies when one looks beyond the numbers that seem to show convergence around lower corporate taxes. Skeptics argue that national differences still matter, but one often has to look deeper into national tax reform policies to understand how these national differences shape actual policy responses.

To add to the established body of literature, this paper will attempt to test the claims of both groups of scholars. Through a quantitative study of thirteen advanced industrial democracies, I will examine what effect, if any, tax competition has on corporate tax policy. This study will also consider the role that domestic politics and institutions play in corporate tax policy as well as the effect of short term domestic economic variables. In this way, this study tests race to the bottom theory as well as the skeptic critiques of this theory. Following this quantitative section is a comparative case study of British and German corporate tax reforms in the late 1990s that will allow for the examination of details of the reforms and the reform process that are impossible to consider in the much larger quantitative section. These two sections should give the paper both the breadth and depth necessary to fully investigate the claims of both groups in the literature.

**Method:**

The paper consists of two sections. The first quantitatively analyzes the effects of tax competition on the tax policies of thirteen advanced industrial economies. This section uses a data set that is essentially an updated version of the data set used by Swank and Steinmo in their 2002 study of tax policy, with a few modifications that are described

in detail later. I pooled this data into averages from all thirteen countries for each year.

Because most states only change their corporate tax rates every four or five years, pooling this data gives much more variation in the dependent variable, though it does limit the cases to the relatively small number of twenty-three. The small number of cases forces me to use fairly small models of three to four independent variables at a time.

Because of this limitation, I have employed a series of models to fully explore what has precipitated the recent decline in corporate tax rates.

In addition to the effects of tax competition, I examine the effects of three main groups of independent variables on marginal corporate tax rates. The first of these is domestic economic factors, operationalized as unemployment rates and growth rates. One would predict, following countercyclical logic, that high unemployment would cause tax rates to decline while high growth would cause them to rise. The second group is the balance of political power and is operationalized as the percentage of seats in the legislature and of cabinet posts held by parties of the left. The third set of factors is structural. Following Garrett, who argues that labor-market structures affect how a state responds to globalization pressures,<sup>22</sup> I include labor-market institution variables in the model. An index measuring the government's involvement in wage bargaining measures this variable. One would predict that states with more government involvement would also have higher corporate tax rates.<sup>23</sup> Finally, I measure tax competition through lagging the change of corporate tax rates five years of all other states in the study and

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<sup>22</sup> Garrett 1998.

<sup>23</sup> This index is from: Golden, Miriam; Peter Lange; and Michael Wallerstein. 2002. "Union Centralization among Advanced Industrial Societies: An Empirical Study." Dataset available at <http://www.shelley.polisci.ucla.edu/data>. Version dated July 28, 2004.

averaging them to create an average change in global tax rate. Through the use of three models that will be discussed in detail later, I am able to show the effects of all these variables on my dependent variable, which enables me to test both the race to the bottom theorists and the skeptics.

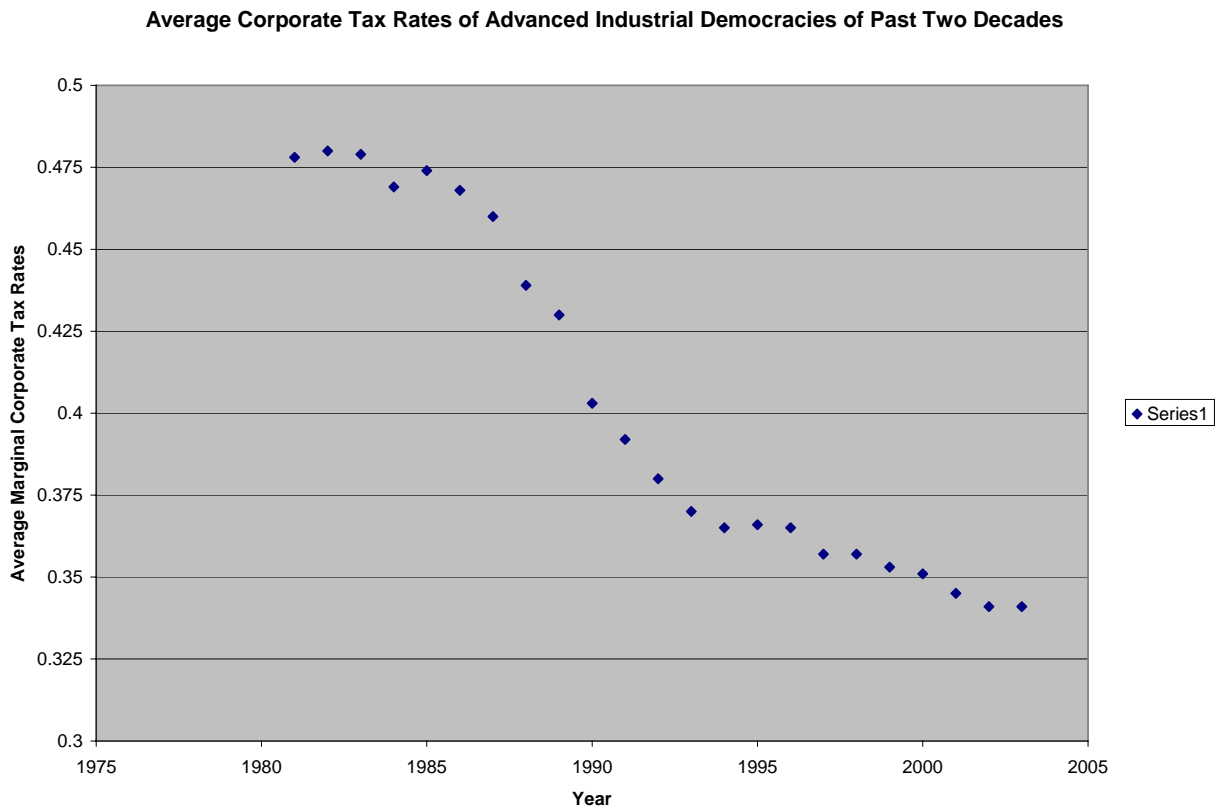
The second section is a qualitative comparison of the reforms to the tax code in the United Kingdom and Germany throughout the 1990s. These two states make for a good case study because they are both large states with large economies. Both states also compete with one another for capital investment and therefore would presumably both feel the pressures of tax competition, which makes this case study a good test of the race to the bottom argument that tax competition between states will continuously pressure states to lower corporate tax rates and shift the tax burden to less mobile forms of capital. Furthermore, corporatist Germany has historically had much higher corporate tax rates than the far more liberal United Kingdom. This case therefore is also a good test for the skeptic argument that different varieties of capitalism will respond differently to globalization pressures. Lastly, both states have undergone shifts in the balance of political power in the 1990s, with Labour's victory over the conservatives in the UK and the social democrats' victory over the Christian Democrats in Germany.

Several types of evidence are important to this qualitative study. First, I consider the reasons given by the policymakers themselves for their reforms to their corporate tax codes. I also look at the domestic political balance of power and the actors involved in some depth to try to better understand what considerations went into the policy. Finally I engage in counterfactual analysis to attempt to explain these reforms absent tax competition pressures to see if this factor is truly essential to the reforms that the

governments eventually apply. This case study of the United Kingdom and Germany therefore allows me to see if my conclusions based on my understanding of the literature and my own statistical analysis apply in the policies of these two states.

### Macro Level Analysis

As the graph below clearly shows, there has been an undeniable decline in corporate tax rates across these thirteen advanced industrial democracies. My study therefore seeks to find what factors cause this decline. As mentioned earlier, I run a pooled time series to examine the effects of several independent variables on the dependent variable of corporate tax rates. The models here clearly show that tax competition does create downward pressure on corporate tax rates. The first



model includes the average global tax rate lagged five years, the growth rate, the

percentage of cabinet posts held by governments of the left, and the amount of government involvement in wage bargaining. As shown in the table, all these independent variables have significant effects on the marginal corporate tax rates. In the second model, I remove the government involvement variable. With this removal, growth rates no longer have a significant relationship. Of course it's notable that the global tax rate, lagged five years is significant at the .001 level in both models. This strong relationship shows that tax competition plays a role in tax policy even when taking countercyclical pressures for tax reform into account.

The above table shows the powerful predictive value of this model with an adjusted r square value of .85. The table below provides information on the coefficients of each of the four independent variables. All four variables are significant at the .1 level and the measures of tax competition and the domestic political balance of power are significant at the .001 level. Surprisingly, the percentage of cabinet posts held by left-center parties is negatively correlated with corporate tax rates. Conventionally, scholars argue that governments controlled by the left are less likely to lower tax rates for corporations. In fact, Garrett argues that left-controlled governments are one of the factors that mitigate any race to the bottom effects.<sup>24</sup> In my model, however, cabinets controlled by the left seem to be speeding this race to the bottom.

It seems counterintuitive that parties of the left lower corporate tax rates in greater numbers than parties of the right. Of course it's possible that this very strong correlation is not causal. The past two decades have seen a rise in the power of left-center parties

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<sup>24</sup> Garrett. 1998

**Table of First and Second Models**

	FIRST MODEL	SECOND MODEL
Tax Competition		
Standardized Coefficient	.651	.625
Significance	.001	.001
Percentage of Left Cabinet Posts		
Standardized Coefficient	-.731	-.621
Significance	.000	.001
Growth Rate		
Standardized Coefficient	-.247	-.228
Significance	.08	.134
Government Involvement		
Standardized Coefficient	.234	
Significance	.094	
Adjusted R Square	.848	.81
Durbin-Watson	2.324	1.958
Number of Cases	18	18
Dependent Variable	Corporate Tax Rates	Corporate Tax Rates

and a decline in marginal corporate tax rates in advanced industrial democracies. There could, of course, be numerous explanations for the recent rise of left-center parties that are completely independent of corporate tax rates. Still, this result is important because it clearly refutes the argument that these parties will find it difficult to sell corporate tax cuts to their constituency,<sup>25</sup> for the data clearly shows that left governments have no trouble lowering corporate tax rates. Therefore, tax competition largely overwhelms the ideological debate over corporate tax policy, as even those on the left seem eager to cut corporate tax rates.

The coefficients to the other independent variables of this model are more or less as expected; the lagged tax rate variable is positive, which means that prior reductions in corporate tax rates will cause future reductions. This makes sense, because it means that reductions in other states' tax rates will cause a given state lower its tax rates to attract investment. Government involvement is also positive, which means that more government involvement in wage bargaining and therefore a presumably more corporatist state will result in higher taxes, which seems to follow Garrett's basic logic that labor-market institutions affect tax policy.<sup>26</sup> As I will show, however, the relationship between government involvement and high growth rates makes the effect of this variable somewhat more complicated.

Growth rates have a negative effect on corporate tax rates, as shown in the above table. This means that higher growth leads to lower tax rates. From a revenue standpoint, this relationship seems natural, as governments tend to have more revenue

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<sup>25</sup> See Swank and Steinmo 2003. or Garrett 1998.

<sup>26</sup> Garrett, 1998. p. 62-9.

during periods of high growth, which makes these periods prime times tax cuts.

Conversely, it is difficult to cut tax rates in times of low growth because tax receipts are lower during periods of slow growth even without reductions in tax rates.

Interestingly, however, this relationship between growth rates and corporate tax rates is not significant when government involvement is not in the model, as the summary of the second model in the table above clearly shows. This suggests an intriguing phenomenon. High growth rates likely lead to a trade off of sorts when the government is involved in wage bargaining. When the government plays a central role in this process, it likely often offers a tradeoff of lower taxes for corporations in return for labor concessions. Tradeoffs of this kind are likely quite difficult to negotiate without substantial government involvement in wage bargaining. This arrangement would explain why growth rates need the government involvement in the model for the relationship to be significant. While more study would clearly be needed to fully understand this relationship, it is clear from the model that labor market institutions can affect corporate tax policy in unexpected and perhaps more complicated and problematic ways than skeptic scholars generally argue.

The removal of government involvement from the first model has other effects as well. The predictive value of the model declines, as shown in the tables above, as the new adjusted r-square value is .81. This is still a very high value, however. It is also notable that both the lagged change in tax rates and the political balance of power retain their powerful and very significant effects on marginal corporate tax rates. This means that while there is likely a relationship between the effects of growth rates and of labor-

market institutions, both tax competition and the political balance of power exercise independent effects on marginal corporate tax rates.

These two models show the importance of tax competition as a predictor of corporate tax policy. Furthermore, they show that some skeptic critiques of the race to the bottom theorists may be unfounded. In this study, at least, it is quite clear that the rise of center-left parties has not slowed, much less stopped, states from engaging in tax competition. Indeed, as the next section will reveal, these parties often have no qualms about publicly using tax competition as a rationale for their tax cuts. The skeptic arguments that partisan politics still determine a nation's corporate tax policy therefore are incorrect. Still, the results of these two models clearly show that corporate tax rates are not the only factor in determining tax policy. Growth rates and labor market institutions both clearly affect corporate tax rates. Therefore, there will continue to be some national divergence in tax policy, as these two variables vary widely from one state to the next. Furthermore, there is more evidence in the comparative case study against a true race to the bottom.

### **Comparative Case Studies: UK and Germany in the 1990s**

I now examine the tax policies of two states in depth. This comparative case study of the United Kingdom and Germany allows me to go beyond the simple statutory corporate tax rates studied in the pooled time series to look examine the details of the tax reforms of these two states to see if both reform their tax codes in similar ways. Further, if the reforms are similar, I seek to discover the underlying reasons for these reforms. I first examine the reforms of the German tax code, with a focus on the changes of the

1990s and the landmark 2000 tax reform. Following this analysis is an examination of the tax reforms of the United Kingdom under Blair's Labour party in the 1990s.

### **Germany**

The course and substance of German corporate tax reform clearly shows the pressure, or at least perceived pressure, on the government to lower corporate taxes in order to attract investment. The government's justifications for their tax reforms clearly show the strong effect of tax competition on these reforms. Chancellor Schröder specifically cited globalization pressures as a reason for the country's need for tax reform that will "strengthen the ability of companies to make investments."<sup>27</sup> There are other examples of this use of globalization as a rationale for tax cuts as well. The day the reform finally passed in the Bundesrat, the Chancellor said it was a good day for Germany not only for the economic effects the reforms would have but also for the effect the reform would have on Germany's reputation in the world, calling the reform a "breakthrough for Germany as a business location."<sup>28</sup> Clearly, the Chancellor and the government felt pressured to reform German tax policy in order to attract mobile capital, or at least that is what the government tells the public. While it could be argued that the government simply used tax competition as an excuse to implement neo-liberal reforms, it will be shown later that German officials do not seem to be converts to neo-liberal ideology.

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<sup>27</sup> The Press and Information Office of the (German) Federal Government. 2004. "Speech by Chancellor Gerhard Schröder at the conference The Federal Armed Forces and Industry – a Strategic Partnership on the Path towards a Modern Government Sector held in Berlin on Thursday, 4 May 2000." Press Release No. 201.

<sup>28</sup> The Press and Information Office of the (German) Federal Government. 2000 "Modernizing Germany: The Reform Package." press release 24 July.

Mere words from the German government are not enough evidence to show that tax competition pressures are the main motivation for tax reform. We therefore must look at their actions as well. If tax competition and globalization pressures are truly responsible for the government's effort to reform the corporate tax system, it follows that the reforms they enact would be aimed at attracting foreign direct investment (FDI) that is exactly what these reforms do.

The concern with attracting investment from abroad is exemplified by the weakening of the capital gains tax in 1997<sup>29</sup> and its eventual abolition in the 2000 tax reform.<sup>30</sup> The removal of this tax, levied at 50% before its abolition, is especially significant to the kind of capital that is most mobile: capital from multi-national corporations (MNC's). Changing this aspect of tax law was significant because it allowed German firms much greater flexibility in dealing their holdings, an especially important development for German banks that often hold large stakes in corporations but are unable to deal such holdings because of the huge capital gains tax.<sup>31</sup> Therefore, the elimination of this tax created a more favorable environment for international investment. In particular, the abolition of this tax had a positive impact for companies considering mergers and acquisitions, bringing the German tax system closer to those of the UK and the rest of the world that experience mergers and acquisitions at much greater rates than Germany.<sup>32</sup> Clearly, the 2000 Tax Reform appeals to foreign investors and MNC's in

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<sup>29</sup> *World Tax Report*. 1997. "German Tax Reform: Will it please anyone?" Informa Publishing Group: February 1.

<sup>30</sup> *The Economist*. 2000. "Business: Germany Unlocked." Jan 8. Vol. 354, Iss. 8152; p. 62.

<sup>31</sup> *Financial Times* (London, England). 1999. "World News: Christmas Comes Early for German Boardrooms." December 24; World News p. 1.

<sup>32</sup> Burkert, Manfred. 2000. "Impact of the German Tax Reform on Foreign Investors." *Corporate Finance*. London: Nov, p. 30

particular by encouraging a corporate restructuring of the economy through the elimination of the capital gains tax.

Business leaders themselves seem to agree with the analysis above, as CEOs of large multinational corporations were quick to sing the praises of the German reforms. Leaders of BASF and the German Automobile Industry both voiced their support for the tax reforms and for Schröder's reform agenda more broadly.<sup>33</sup> Heads of similar large corporations also expressed their satisfaction with the reforms. Beyond simply broad approval of the reforms, business leaders also recognized that the biggest winners of the whole process may indeed be foreign investors. As the chief economist of Deutsche Bank put it, "Now foreign firms have will have a fairer chance to buy things in Germany that fit their portfolios."<sup>34</sup>

A brief analysis of the tax reforms of 2000 has exemplified three important facts about tax reform in Germany. First, the Chancellor and his government used globalization arguments as a rationale for their tax reform proposals. Second, the reforms that Germany eventually enacted are especially aimed at creating an attractive environment for foreign investment. Third, business itself sees these reforms to the corporate tax code as especially beneficial to large multinational corporations. There is, therefore, ample evidence of globalization shaping the course of German reform to the corporate tax system. The question, as always, is to what extent are these reforms a response to globalization pressures as opposed to a response to domestic politics or some other pressure independent of the process of globalization. In the German case there is

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<sup>33</sup> The Press and Information Office of the (German) Federal Government. 2004. "Industry Praises Agenda 2010 Reforms." March 16.

<sup>34</sup> *The Economist*. 2000. "Business: Germany Unlocked." Jan 8. Vol. 354, Iss. 8152; p. 62.

substantial reason to believe that without globalization pressures Schröder's Red-Green coalition would be unlikely to enact the type of corporate tax reforms that they passed in 2000.

It is difficult to understand the rationale for corporate tax reform in Germany under a coalition between the Social Democrats and the greens without globalization pressures. The corporate aspect of the 2000 tax reforms is certainly not a great move politically. Indeed, the government was so unexcited about popular response to the abolition of the capital gains tax that they buried the hugely significant change to corporate tax law in a single sentence in a long press release outlining a number of technical changes to the tax code.<sup>35</sup> Not only are corporate tax cuts not generally politically popular, they are also not in line with the preferences of social democratic or green parties. Indeed, the irony of such sweeping reform coming from the left was well noted at the time.<sup>36</sup> Because it is so difficult to understand the government's efforts to reform the tax code without considering the pressures caused by tax competition, it seems reasonable to conclude that the German tax reforms of 2000 do represent a case of tax competition significantly constraining the policy choices of a government.

An argument could be made that the German government was not responding to market pressures but to the global spread of neo-liberal ideas. While this spread of ideas could still be considered an aspect of globalization, it is certainly a much different type of pressure than the market pressure created by international tax competition. It seems unlikely, however, that the spread of the neo-liberal ideology is a significant causal factor

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<sup>35</sup> *The Economist*. 2000. "Business: Germany Unlocked." Jan 8. Vol. 354, Iss. 8152; p. 62.

<sup>36</sup> *Financial Times* (London, England). 1999. "World News: Christmas Comes Early for German Boardrooms." December 24; World News p. 1.

in explaining German corporate tax cuts. The rhetoric of the German government is inconsistent with neo-liberal ideas, as evidenced by its hostility toward unfair tax competition.<sup>37</sup> Also the rest of the Red-Green agenda seems out of line with neo-liberal principles; it appears the government is responding to market pressures rather than the spread of some global ideology.

German politics may be constrained in the sense that Schröder's government had to enact some type of corporate tax reform, but the extent of this reform is still largely decided by domestic factors that have little to do with tax competition or international factors whatsoever. The fact that policy choices are constrained in Germany does not imply that it is only a matter of time until Germany adopts a political economy or even a tax system identical to the UK or US. Rather, the domestic institutions still matter in determining tax policy. These institutions are, in fact, a significant reason that German tax reform tends to be slow. Unlike most other advanced industrial democracies, Germany has a federal system, with regional governments represented in the Bundesrat, the upper house. Recently, this house of parliament has essentially been in the power of the opposition, forcing the government to reach consensus with CDU-CSU on any tax reform.<sup>38</sup> Furthermore, Germany's constitutional court also has the power to outlaw tax reforms, and it is thought that any reform that does not tax labor and corporations at approximately the same rate would be illegal in the eyes of this court.<sup>39</sup> It is clear, therefore, that German institutions affect both the timing and the extent of German tax reform. These institutions will likely stop the German state from engaging in a true race

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<sup>37</sup> *The Economist*. 2004. "Cheap Allure; Central Europe's Economies." October 2.

<sup>38</sup> *The Economist*. 1999. "Europe: Germany's Reform Battle." Sep 18. Vol. 352, Iss. 8137; p. 53.

<sup>39</sup> *The Economist*. 2004 "Europe: Systematic Chaos; German Tax Reform" *The Economist*. Jan 24. Vol. 370, Iss. 8359; p. 35.

to the bottom, as it would be very difficult for Germany to lower their corporate tax rates below some minimum level.

There are also signs that the government is seeking alternative solutions to the problem of tax competition. Germany's numerous attempts to use the international system to stop "unfair tax competition" show that the German state is willing to try to use its position in the world to try to mitigate the effects of tax competition. Of particular interest are the attempts by the Germans and French to achieve some degree of tax harmonization within the EU to combat the low corporate tax rates of new Eastern European members.<sup>40</sup> While it is uncertain at this point how effective these attempts will ultimately prove, it is worth noting that both states have threatened to take away structural funds from countries with excessively low tax rates.<sup>41</sup>

The threat of taking away EU subsidies may never be realized, but the mere presence of it shows that there is a certain amount of international pressure against lowering corporate taxes too low. Chancellor Schröder has also used the bully pulpit, explicitly chastising low tax member-states in speeches.<sup>42</sup> Germany has also sought to end unfair tax competition through extensive involvement with the OECD's Project on Harmful Tax Practices, though it is still unclear how much progress this project has made.<sup>43</sup>

The effort by Germany to combat tax competition through the EU and OECD combined with the effect of German institutions mitigate concerns of a true race to the

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<sup>40</sup> *The Independent*. 2004. "Brown on Collision Course with EU Over Corporate Tax." September 11. Business p. 54.

<sup>41</sup> *The Economist*. 2004. "Cheap Allure; Central Europe's Economies." October 2.

<sup>42</sup> *The Times (London)*. "Schoröder rails at new low-tax kids on block" May 5; Business 24.

<sup>43</sup> *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report*. 2004. OECD Committee on Fiscal Affairs; 4 February.

bottom. These factors clearly act as upward pressures on corporate tax policy.

Furthermore, many of these factors are impossible to see larger quantitative sections similar to the first section of this paper. Of course, Germany still significantly lowered its corporate tax rate over the course of the past two decades largely as a result of tax competition, so this competition clearly affects German tax policy. This involvement in the international community and the effects of these domestic institutions are important, however, because they create upward pressure and will likely prevent Germany from engaging in the true race to the bottom some scholars fear.

### **United Kingdom**

Like Germany, the United Kingdom has also sought to lower corporate taxes in the hope of attracting international investment. While the United Kingdom has a long history of cutting corporate taxes that starts in earnest during Thatcher's reign, the analysis here focuses on the Blair government's tax cuts. The reasoning for this limit is that the Tories likely cut tax rates for largely ideological reasons, while Blair's Labour party seems to be responding to market pressures resulting from international tax competition.

Also similar to the German case, British officials use globalization and tax competition to justify their corporate tax reforms. In the 1997 budget the Labour party, in its first budget, cut the statutory corporate tax rate from 33 to 31 percent, while leaving income taxes unchanged and establishing a one-time windfall tax on recently privatized corporations.<sup>44</sup> Gordon Brown, Chancellor of the Exchequer, explicitly stated that the

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<sup>44</sup> *Chicago Sun-Times*. 1997. "New British Budget Taxes 'Excess Profit.'" Dick Beveridge. July 3, News p. 26.

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tax reform would make the UK more appealing to foreign investors, a claim he would

repeat on numerous other occasions, including his unveiling of the 2000 budget that

lowered the capital gains tax.<sup>45</sup> This justification for the 1997 tax cut is important

because it came in a budget that actually increased taxes overall, meaning that the

decision to cut corporate taxes was not simply part of a larger tax-cutting package.

Furthermore, the Labour party trumpets, “corporation tax levels have been cut to their

lowest levels ever” in a press release explaining the country’s attractiveness to

investors.<sup>46</sup> Therefore, the British government explicitly stated that they were lowering

their competitively lowering corporate taxes in the hope of attracting foreign investment.

The reforms the Labour government instituted do indeed seem to make the UK a more attractive destination for mobile capital. The reduction of the corporate tax rate to 31 percent in 1997 and then down to 30 percent the next year effectively gave Britain the lowest headline corporate tax rate of any of its main competitors.<sup>47</sup> Like the German reforms, the British tax cuts tend to favor bigger, more profitable companies. This aspect of the tax code supports the contentions of many scholars that states will seek to lower taxes for the most mobile forms of capital while broadening the base by shifting the tax burden toward less mobile forms of production like labor.<sup>48</sup> While there has been much dissatisfaction about the complexity that has resulted from Labour’s efforts at tax

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<sup>45</sup> *Financial Times*. 2000 “Budget 2000.” Simon London. March 22. Front Page.

<sup>46</sup> Labour Party. 2004. “Our Approach to Trade and Industry” Press Release, June 21.

<sup>47</sup> *The Scotsman*. 1997. “Business Leaders Happy at corporate tax reform.” November 26, p. 4.

<sup>48</sup> Jourmand, Isabelle. 2001 *Tax Systems in European Countries*. OECD Economic Studies working paper no. 34, p. 95-6.

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reforms,<sup>49</sup> it appears clear that their intent was to create a more favorable environment for investment, and there is evidence that the reforms have been at least moderately successful despite the complexity of the law, at least in the eyes of the people doing the investing.<sup>50</sup>

Like the German tax reforms, it is almost impossible to understand the British reforms to the corporate tax code without tax competition. The 1997 cuts are particularly difficult to rationalize without seeing the attraction of investment as the prime motivation for the reform. Because the tax cuts came out of a Labour government that left income taxes alone and increased taxes overall in the same budget, it seems clear that the government was constrained, or at least felt constrained, by tax competition. After all, this is a government that raised taxes overall in its 1997 budget, and one that followed a long period of conservative rule that held tax cuts and liberalization of the economy at its core. Furthermore, the government imposed a windfall tax on the recently privatized, and almost completely immobile, industries.<sup>51</sup> Therefore, it is not as if the Labour government is especially pro-business. Rather, it seems the government felt they had to cut corporate taxes to better compete for international investment.

Unlike the German case, there is considerably less evidence of British efforts to use international institutions to actively stop tax competition from going too far. While the UK does take part in the OECD project against unfair tax competition,<sup>52</sup> the British

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<sup>49</sup> See "Principled but not practical" in *Financial Times* by Edward Trou. April 20, 2000, Comment and Analysis p. 21. Or "Tax Reform Promises Weigh Upon Chancellor" *The Times (London)*. By Gabriel Rozenberg and Gary Duncan, November 29, 2004, Business p. 40.

<sup>50</sup> *The Scotsman*. 1997. "Business Leaders Happy at corporate tax reform." November 26, p. 4.

<sup>51</sup> *Chicago Sun-Times*. 1997. "New British Budget Taxes 'Excess Profit.'" Dick Beveridge. July 3, News p. 26.

<sup>52</sup> *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report*

are against German and French efforts to harmonize taxes to some degree at the EU level.

In fact, the British government has a long history of support for tax competition and has been cold to any effort to harmonize the base from which states tax corporations. British officials are on the record supporting “tax competition as the best way forward” for Europe.<sup>53</sup> Furthermore, Chancellor Brown himself has articulated his support for tax competition throughout Europe in an op-ed piece in 2003.<sup>54</sup> Clearly the UK’s wholehearted embrace of tax competition in contrast to Germany’s efforts to use its position in the international system to slow tax competition is a case of divergence rather than policy convergence. This divergence is likely the result of differing ideologies within the two states. While Germany’s leaders seem almost explicitly hostile to the neo-liberal ideology, British elites even on the left side of the British political spectrum do subscribe to this ideology to a certain extent. Furthermore, British politicians operate with the legacy of Thatcher, who embraced the neo-liberal ideology. This legacy likely gives neo-liberal ideas more currency among both elites and the general populace of Britain. National factors clearly still matter, even in a relatively clear case of policy convergence.

In summary both the United Kingdom and Germany significantly lessen the tax burden facing the most mobile forms of capital in order to better compete for and retain investment in their respective countries. This simple fact implies a certain degree of policy convergence, as both states unequivocally have cut corporate tax rates.

Furthermore, the kind of reform each country pursues also implies policy convergence.

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<sup>53</sup> *The Independent*. 2004. “Brown on Collision Course with EU over Corporate Tax” September 11; Business p. 54.

<sup>54</sup> Brown, Gordon. 2003. “Europe Must Change.” *Financial Post*. October 17; Comment p. FP11.

Both states focus on cutting rates for the biggest, most profitable, most mobile firms while broadening the tax rate to at least partly make up the lost revenue. Both states substantially reduce the effective marginal tax rate and also significantly lessen the capital gains tax (eliminating it in the German case) to allow for more flexibility for MNC's. Also, both states explain these tax cuts are the result of tax competition. Finally, both states cut taxes from the left, which means that these reforms are not really in line with the policy preferences of those that pass them through the legislature. Clearly, both states are constrained in their policy choices concerning corporate tax rates, but that does not imply that these states retain no freedom in corporate tax policy.

While it is clear that Germany and the UK converged in the sense that both states did cut the same types of taxes and both actively try to attract investment through corporate tax reforms, it is not as if the two states have adopted a common tax code. Nor is there sufficient evidence to show that the trend toward lower corporate taxes will result in a race to the bottom. There remains substantial variation in the two tax systems, with Germany's effective marginal rate some 9 points higher than the British rate.<sup>55</sup> Furthermore, while there has been a broad trend of tax cuts throughout advanced industrial economies, Germany is still at the top in terms of tax rates and the UK is still near the bottom of the list.<sup>56</sup> Germany also has several institutional quirks that likely will prevent any race to the bottom, which suggests that institutional differences do still cause substantial variation in tax policies. Therefore, it does not appear that states are systematically undercutting each other's tax rates. Also recent international efforts by

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<sup>55</sup> Yoo 20048.

<sup>56</sup> Deveroux et al 2004 p. 7-8 and Yoo 2004.

Germany to end harmful tax competition have made some progress and do provide some upward pressure against any race to the bottom in terms of corporate tax rates. This backlash against tax competition will likely only increase if a true race to the bottom scenario involving a substantial shift of the tax burden to labor seemed imminent.

### **Conclusion**

My findings, both in the pooled time series and in the qualitative case study, largely support the skeptic argument that tax competition is but one of several factors that determine changes in the corporate tax rates of advanced industrial economies. That said, this study unequivocally finds that tax competition does powerfully affect the corporate tax policies of advanced industrial democracies. Further, certain claims of the skeptics seem false. Most notably of these is the effect of partisan politics. Many skeptics have argued that there remains a great deal of difference between parties in tax policy. This claim seems false, as evidence in the quantitative section suggest that left government have no problem at all with cutting corporate tax rates. The case study corroborates this finding, as both the United Kingdom and Germany engaged in significant reductions in corporate tax rates under left-controlled government.

The key finding of this study is that the most extreme versions of both theories seem misguided. Tax competition is not the only factor, but it is not simply one of many equal factors either. Tax competition clearly does seem to have erased the ideological differences in corporate tax policy, as both parties are now constrained by a set of factors, with tax competition arguably as the most important of these. While, the power of tax competition is quite clear in this study, there is not evidence that we are in the midst of a true race to the bottom. The fact that several other variables, including institutions and

domestic economic variables still matter a great deal in the quantitative analysis means that there are factors that likely prevent corporate tax rates from falling below some minimum level. Again, the qualitative study reinforces this claim, as the institutions of Germany coupled with its pushback against tax competition in the international arena likely will prevent German tax policy from ever engaging in a true race to the bottom. Therefore, this study comes down somewhere in the middle of the two groups outlined in the literature. Tax competition does not obliterate all other factors that go into a state's tax policy, nor does it leave these factors alone, as domestic politics is clearly no longer as important to corporate tax policy.

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