Cutting taxes is a largely ineffective strategy for attracting foreign investment.

by Blog Admin

Closer co-operation between eurozone members on tax policies might undermine the attempts of some European states to use tax competition as a method for attracting investment. Taking the case of Ireland and the Netherlands, **Aidan Regan** *assesses the link between low corporate taxes and investment, arguing that the impact of tax cuts has largely been overstated. In some cases high tax rates might actually increase the potential for investment if the revenue is used to improve infrastructure, or produce a more educated workforce.*

The eurozone crisis has hastened the move toward increased fiscal integration among member-states, reflected in the fiscal stability pact, and the proposed measures for a centralised authority to monitor national budgetary decisions. This move toward a fiscal union is widely accepted as necessary to embed and stabilise the monetary union. The politics of this integration process, however, are deeply contested, particularly in relation to the proposed European financial transaction tax. Countries such as Ireland, the Netherlands and the UK have used tax competition as a strategy to increase foreign direct investment (FDI), which has become a lynchpin of their economic development models. The UK is unlikely to become part of any fiscal union. It is probably safe to assume that the Conservative government would be more likely to pull out of the European Union than accept increased 'interference' in national budgetary decisions. They are not members of the eurozone, will never accept a Federal Europe, and will continue to pursue tax competition as a strategy to lure corporate financiers and investment to the City of London.

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This is not the case for the Dutch and Irish governments. They must accept increased fiscal centralisation, enhanced fiscal co-ordination, and potentially a financial transaction tax across the single European market if they are to remain members of the eurozone. This will put increased pressure on their traditional strategy of using tax competition as a mechanism for economic development. Or what Wolfgang Streeck once described as a crude combination of nationalism and neoliberalism. The Irish, in particular, given their proximity to the UK, and their shared liberal market institutions, are publicly opposed to a financial transaction tax and aggressively defend their low corporate tax regime (12.5 per cent) in European negotiations. This defence of the low corporate tax regime unites all the mainstream political parties, business lobby groups, trade unions, policy-makers and mass media because it is assumed that low taxes attract foreign direct investment, which is crucial for economic and employment growth. But do low taxes really affect the FDI decisions made by multinational corporations (MNCs)?

According to the OECD, corporate and income tax reforms are crucial to maintaining inward investment in

an era of capital mobility and globalisation. National governments must lower taxes to attract capital investment, ensure job creation and attract human capital. This assumption has underpinned the tax reforms of the United States since the 1980s and the European Union since the 1990s. It is a policy discourse that is particularly strong in liberal market economies such as Ireland, the UK, US, New Zealand and Eastern and Central Europe. But a recent paper by Prof Jensen, from Washington University, titled 'Fiscal Policy and the Firm: Do Low Corporate Tax Rates Attract Multinational Corporations?' directly challenges these assumptions. Using a variety of methods to compare 19 OECD countries, he concludes that tax policy has no discernible impact on FDI flows. Sweeping tax reforms are not associated with substantial changes in FDI flows, and the impact of globalisation is significantly over-estimated. This is not to say that domestic tax reforms do not matter for investment, but the priority accorded to them by politicians is radically over stated.

This conclusion builds upon a comparative political economy literature in political science that specifically examines the strategy of corporate firms in making investment decisions, and the interactive effect of institutions and politics on fiscal policy outcomes. This research illustrates that tax decisions are predominately the result of domestic politics, not functional pressures associated with capital mobility and globalisation. The implication is that governments can pursue alternative strategies to attract inward investment. For example, if high tax rates provide for an educated workforce, high wages, a well-developed infrastructure, or other public goods, multinational corporations may choose high tax countries rather than low tax countries as an investment location (or at least not threaten to leave if corporate tax rates are increased). This high-value added strategy is something that member-states of the eurozone could pursue. But it would require countries such as Ireland to stop marketing themselves as a low-tax country to foreign investors (i.e. using tax competition as a strategy for economic development).

Although low taxes may have less impact on investment decisions than we assume, they certainly shape where firms declare profits. This is the real problem facing Ireland. The Irish have the second best trade surplus in the eurozone, and productivity per worker is three times higher than Germany. Multinational corporations in Ireland make four times as much profit per employee than the European average (US MNCs make €240,000 per employee compared to €32,100 in other EU countries). Pre-tax profits of the manufacturing sector are ten times higher than other European countries. This is what underpins the perception that Ireland is bouncing back from the crisis, and that austerity and export led growth are complementary. The truth of this fairy-tale is that US multinational corporations are engaged in transfer pricing. They locate profits in Ireland to take advantage of the low corporate tax regime. The Irish government is stuck in a path dependent strategy of using tax policy as a mechanism for taking credit for new investment in the country. In reality, they have constructed a tax haven for US MNCs, not a strategy for employment creation. This is simply not sustainable in a future political union of eurozone member-states.

Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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