Heard that countries should 'compete' on tax? Wrong

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A myth we're repeatedly told is that a country must be "tax competitive" in order to support a successful economy. It sounds so reasonable. We're taught that competition between companies keeps them on their toes and pressures them to produce better products and services, at better prices.

But here's the problem: competition between companies in a market bears no economic resemblance whatsoever to "competition" between countries on tax. They are utterly different economic beasts.

Theoretical arguments used to support tax "competition" between countries were first made in a 1956 paper by the economist Charles Tiebout. He argued that in a globalised world, people would naturally migrate to the countries with the most efficiently run public services for the least amount of tax possible. This would lead to countries "competing" with one another by running public services better and with less money, and everything would organically improve. But how many people do you know who will rip their kids out of school and flee to a foreign country as soon as it tweaks its tax code? It doesn't take a tax expert to see how silly this theory is.

Tax "competition", it turns out, is always harmful. First, while people rarely move in response to tax changes – flighty financial capital does move. Governments "compete" for it by cutting tax rates on mobile capital (which means, in effect, cutting taxes on the rich.) And if you're not taxing the rich, you've got to make that up elsewhere. How do you do that? You tax people who can't afford to move, and can't afford to complain. The poor end up paying more.

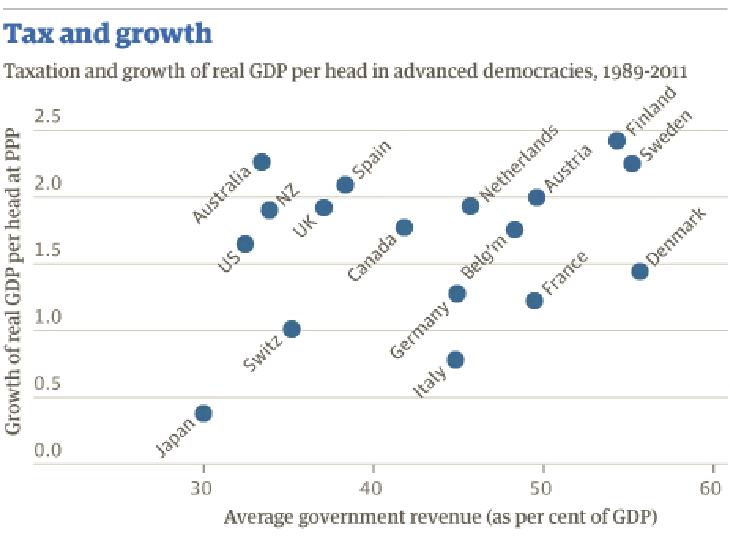
Second, tax "competition" gives big business an unfair, unproductive advantage. Every "competitive" tax system has tax avoidance built into it – whether through low taxes, or by allowing the use of tax loopholes, and so on. Usually it's only larger multinationals that can afford the expensive tax lawyers and accountants necessary to harvest these tax subsidies. So they can use the offshore system to drive smaller, more locally based competitors to the wall – on a factor that has nothing to do with genuine business productivity or true innovation.

Tax "competition" is economic warfare, where countries fight over businesses by lowering taxes. In the United States, for example, an in-depth New York Times report provides an example of how bad the problem has become:

"A recent bidding war [between US states] for United Airlines ... drew more than 90 cities. The airline had set up negotiations in a hotel, and its representatives ran floor to floor comparing bids. Jim Edgar, then the governor of Illinois, called for a truce, but many states would not sign on, he said."

A recent study found that the two US states of Kansas and Missouri alone had spent at least $192m (£125m) in tax subsidies to poach jobs from one another – despite an "anti-poaching" agreement between them. The net result was a tiny net jobs migration to Kansas – at very high cost to both.

The end result of all this is, as another recent report explains: "All [US] states have regressive tax systems that ask more from low- and middle-income families than from the wealthiest."



Still, it is often asserted that high taxes stifle investment and growth. But is this even this true? The figure below plots GDP growth against the tax take for prosperous democracies. Dramatic differences in taxes as a share of the economy – from 29% in Japan to over 55% in Denmark – have no obvious impact on growth.As the FT's Martin Wolf concludes (paywalled link): "Such a spread seems to have no effect on economic performance."

There's a similar story to tell on countries' top income tax rates. A non-partisan report on the US tax system found that "The top tax rates appear to have little or no relation to the size of the economic pie ... However, the top tax rate reductions appear to be associated with the increasing concentration of income at the top of the income distribution."

So much for income tax. What of tax rates on capital? Does tax-cutting here make a country more competitive? Again, the evidence says no. Which makes complete sense: if you tax capital less, you must make up the difference by taxing labour more, or by increasing government borrowing. As Professor Chris Sanchirico of the University of Pennsylvania notes in a new research paper:

"Attempting to spur economic growth with tax preferences for capital income may be like trying to repair one side of the roof with shingles from the other."

Finally, how do individual investors react to "competitive" tax cuts on capital?Warren Buffett puts it neatly:

"I have worked with investors for 60 years and I have yet to see anyone – not even when capital gains rates were 39.9% in 1976-77 – shy away from a sensible investment because of the tax rate on the potential gain."

Above all, investors want good roads, a healthy and educated workforce, and the rule of law. All of which mean tax. And let's not forget what else taxes are used for: to care for the sick, to educate our children, and to look after the vulnerable. Whenever you hear a politician utter the words "competitive tax system", it's probably an indication they have no idea what they're talking about. Tax "competition" is economic warfare: a beggar-my-neighbour race to the bottom, worse than a zero-sum game. It is always harmful.

• This is part of a series co-ordinated by the New Economics Foundation and the Tax Justice Network.