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# Smart Tax Competition and the UK's Withdrawal from the EU*

Britain's upcoming exit from the EU has led to a debate on the strategy British economic policy could take after Brexit. Politicians from other EU countries are concerned that the UK could establish itself as a tax and regulation haven at the EU's doorstep. Using tax incentives the UK could attract companies as well as wealthy EU citizens to the country, with a negative impact on the economic development and tax revenues of the remaining EU member states.

With regard to tax competition, countries face a trade-off. For example, if they reduce the tax rate on company profits, they lose revenues from the taxation of companies that are already active within their borders. This is the cost of tax cuts. The benefit is that additional investment is attracted to the country because of the low taxes. For small countries, existing domestic economic activity tends to be less significant in comparison to what can be gained from abroad. Therefore, they are more likely to position themselves as low-tax countries than large economies. Ireland is a good example. In addition, low taxes can help compensate for locational disadvantages, such as a peripheral geographic location. This can explain why many countries in Eastern Europe have low taxes on corporate profits.

Britain, however, is not a small country, nor does it suffer from locational disadvantages due to geographical position or to economic back-wardness. Certainly the withdrawal from the European single market will make the island less attractive for some investors. However, the UK government reacting with massive tax cuts is unlikely for two reasons. Firstly, UK corporate taxation is already the lowest among large industrialised countries. At present, company profits in the UK are taxed at 19 percent, which is the lowest tax rate among the G20 countries. In the spring of this year, the UK government announced plans to reduce the profit tax rate to 17 percent by 2020. For companies, the UK is already very attractive in terms of taxes. Since very low corporate tax rates lead taxpayers to shift income from the personal income tax sphere to corporate profits, where tax rates are lower, there are limits to further corporate tax cuts. Secondly, Theresa May has repeatedly stated that she wants to tackle the problem of high income inequality in Britain.

Nevertheless, it is to be expected that tax competition will intensify. However, this competition is not likely to result in a general reduction in headline tax rates but in the creation of targeted tax incentives aimed at specific activities. This could be called a very differentiated "smart" form of tax competition. In this area, Britain would gain considerable leeway by leaving the EU, mainly for the following two reasons.

Firstly, the country will no longer be subject to EU state aid control. State aid control has increasingly restricted the scope of tax policy in recent years. A current example is Apple. With attractive tax arrangements, Ireland allowed Apple to export a significant portion of its PCs and iPhones to Europe via Ireland while paying very low profit taxes. The European Commission considers this to be illegal state aid and has presented Apple a massive bill for tax arrears. Such EU interventions in national tax policies are no longer to be feared in Britain in future. It is quite possible that companies like Apple will move their activities to the UK, as long as they need not be based in the EU.

Secondly, EU directives will no longer be binding on Britain. The recently adopted EU directive on measures to prevent tax avoidance, for example, stipulates that all member states restrict the allowable deduction of interest. Since Britain can avoid this in future and will be able to selectively choose other regulations, it will be more attractive for companies to move activities to the UK. The EU is currently planning – under the so-called Country by Country Reporting – to force multinational corporations to publish their tax payments and other information about their business instead of just making this information available to the tax authorities. This is meant to put companies whose tax payments appear to be low under public pressure. Many companies see a competitive disadvantage in this publication requirement and may choose to relocate to UK.

We can expect British tax policy to take advantage of this room for manoeuvre and that the UK will seek to gain competitive locational advantages through targeted and tailor-made tax incentives for internationally mobile activities. If this competitive pressure causes the EU to focus not solely on a tightening of corporate taxation but also on the EU's international competitiveness, it need not be a disadvantage.

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**Clemens Fuest**
Professor of Public Economics and Finance
President of the ifo Institute