

Tax competition: a literature review

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Abstract

This article reviews the social science literature on tax competition in three steps. The first step is to look at the baseline model of tax competition on which most of the literature implicitly or explicitly builds. The key feature is that governments in a context of open borders will engage in wasteful competition for mobile economic assets and activities through tax reductions. The second step is to focus more closely on tax-induced cross-border mobility. Do tax payers actually shift assets and activities across borders in response to differences in taxation? The main message of the literature is that the scope for tax arbitrage depends crucially on the legal rules governing the taxation of cross-border activities and that the intensity of tax arbitrage varies greatly across different taxes. The final step is to analyze government reactions to tax arbitrage. Do they engage in competitive tax cutting as predicted by the baseline model? The literature discusses various strategies of tax competition and demonstrates that different governments use them to different degrees across different taxes. It also shows, however, that governments increasingly engage in tax cooperation to reign in tax arbitrage and competition. While off to a slow start in the 1960s, tax cooperation has gained momentum in recent years, especially after the financial crisis in 2008.

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