

TAX COMPETITION AND CAPITAL MOBILITY BETWEEN OLD AND NEW EU MEMBERS STATES

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Abstract: Accession of new member states with lower corporate taxation has raised fears on tax competition within enlarged Europe. The fiscal systems can contribute to the intensification of capital mobility the development of financial markets, competition intensification, and the better allocation of resources having positive effects on the economy. The flow of capital worldwide, including Foreign Direct Investments (FDI), is subject to diferent conditions and determinants of the host countries. Beside the comparative or competitive advantages given by the economical environment, the labour costs, the financial market developments, etc. fiscal policy is ready to contribute to the attraction of foreign direct investments.

Keywords: tax competition, foreign direct investments (FDI), corporate taxation

1. Tax competition in the European Union: theory and empirical evidence

1.1. Theories of Tax Competition

The literature on the topic of tax competition could be distinguished into two main ways. The first one, beginning by Tiebout, assesses tax competition in positive way because it leads to more effective using of public funds and limits non-productive activities such as rent seeking. The second one, beginning by Oates, professes the tax competition as a harmful because the decline of tax revenues leads to the decrease of providing public services below optimal welfare level. Oates says that the result of tax competition could be a tendency to lower volume to and lower efficiency of public services providing. If governments decrease the taxes to attract mobile capital, public expenditures are below the level when the marginal benefits of these expenditures equal their marginal costs. The expenditures cuts concern especially on programmes which don't provide enough benefits to business environment. Oates's conclusion, that such a governments behaviour is not effective, is based on the presumption that no government gets competitive advantage in the struggle. The result is a welfare decline in all communities or countries. Sinn emphasises the characteristics of services provided by public sector and not efficiently provided by private sector. Competition amongst government leads to a decline of providing such services. Sim adds that tax competition doesn't have to lead to the under-dimension of public services but it has strong redistribution effects.

Following Oates's discussion of tax competition, it was not until the mid-1980s that economists began to build formal models based on his ideas. Zodrow and Mieszkowski and Wilson have derived in a formal way the dynamics and the consequences of tax competition in what are known today as the basic models of tax competition. In their models, tax competition for mobile tax bases will lead to a "race to the bottom" in tax rates and leave the competing jurisdictions with too little revenues to be able to provide public services at a socially-optimal level. This basic result has also led to the fundamental question whether capital taxation – and for what matters corporate taxation – can survive in the long-run. Wildasin notes that the tendency toward under-provision of public services attributable to tax competition can be offset with a subsidy to each of the local governments, provided by a higher level of government.

A rather different perspective is taken by the public choice literature. Brennan and Buchanan argue that tax competition improves welfare, because the size of government would be excessive in the absence of this competition. Edwards and Keen examine this view formally in various "Leviathan models," where governments are concerned in part with maximizing the size of the public sector.

New considerations arise when regions differ in size. Bucovetsky and Wilson analyze "asymmetric tax competition" between a "large" region and a "small" region, as distinguished by the number of residents, each possessing the same endowments of capital and labor. Assuming that they are large enough to affect the after-tax rate of return to capital in the union, the larger jurisdictions tend to have higher equilibrium tax rates than the smaller jurisdictions, since the former are less concerned about tax-induced capital

outflows. The resulting tax differentials cause an inefficient reallocation of capital from larger to smaller jurisdictions and thus potentially strengthen the case for tax harmonization. However, such differentials can also create political opposition to tax coordination, as small jurisdictions may benefit from the capital inflows (and higher service levels) attributable to tax competition.

Over the last twenty years, economic research has attempted to remove the strict assumptions of the basic models of tax competition and has come with a more contrasted picture. The consequences of tax competition are indeed rather complex, do not necessarily lead to a “race to the bottom”, need to take into account the public expenditure side of the problem, and depend on various characteristics.

The degree of (a)symmetry in the size of countries or the asymmetries in endowment of factors between jurisdictions will also influence the outcome of the tax competition. The geographical location and the concentration production, such as the existence of a core-periphery model may lead to different optimal levels of taxation between regions. In addition, the existence of trade between the members of a union or with the rest of the world may lead to specialization and hence different equilibrium levels of taxation. The availability of multiple tax instruments besides capital taxation, the existence of economies of scale in the provision of the public service international spillovers in public goods , the possibility for the public sector to provide public input goods that will reduce the private cost of production , or that will reduce income uncertainty via redistribution are also elements that will influence the effects of tax competition. The degree of mobility of the factor(s) of production, the complementarities between mobile and immobile factors a possible home bias in investment, the degree of citizens demand for social insurance , the presence of cross-border loss offset , and the possibility to export the tax burden on foreigners are further features that will determine the equilibrium effect of tax competition.

1.2. Tax competition in EU: Do European Members States compete over tax rates?

A important question is whether EU Members States compete over corporate tax at all. Over the last 25 years, Europe has experienced declining statutory tax rates both for mobile bases and less mobile ones. In the analysis of the evolution of statutory tax rates on corporate income in 1995-2007, at the level of the EU-15 countries, we notice a decrease for all the countries . For instance, the corporate tax rate decreased in Ireland from 40% to 12.5%, Portugal from 39.60% to 26.5%, Greece from 40% to 25%, Luxembourg from 40.9% to 29.6%, Italy from 52.2% to 37.3%, Germany from 56.8% to 38.7%. At the level of the countries NMS-12, we notice a more considerable reduction of statutory tax rates on corporate income in 1995-2007. For instance, the corporate tax rates decreased in Cyprus from 25% to 10%, Latvia from 25% to 15%, Lithuania from 29% to 18%, Poland from 40% to 19%, Slovakia from 40% to 19%, the Czech Republic from 41% to 24%, Slovenia from 25% to 23%, Bulgaria from 40% to 10%. On the other hand, Malta (35%) preserved their rates as such. And in Romania the statutory tax rate on corporate income tax decreased from 38% in 1995 to 25% in 2002, then to 16% in 2005.

Over the last decade both old and new member states decreased statutory corporate income tax rates and broadened the tax bases, but while this was associated with declining tax revenues in the NMS, they remained broadly stable as proportion of GDP in EU-15. For old member states effective tax rates fell for profitable projects but remained fairly stable for projects that just break even or make low profits. In 2007, average nominal tax rate in the NMS is by nine percentage points lower than in the old member states, with the difference growing over the last decade. During 1995-2007 the average statutory rate in old member states fell by 5.8 percentage points and in NMS by 13.9 percentage points. One of the reasons was the motivation of NMS to adjust their tax systems and cancel these tax incentives which were in conflict with the European Law. The NMS pattern of capital allowances and treatment of losses was converging to EU practices. There were some differences in valuation of inventories for tax purposes, although they have also decreased. NMS granted various tax incentives to foreign investors, but as far as most of them were in conflict with the European law, they had to be abandoned. With this remark in mind, the fall in statutory rates to some extension had to compensate for broadening of the tax base.

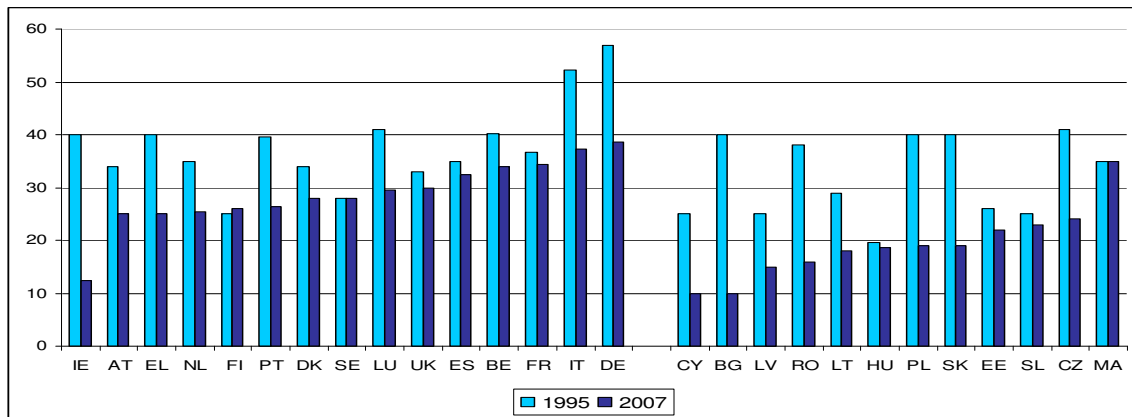


Figure 1 Statutory tax rates on corporate income 1995-2007 in EU (%)

Source: European Commission, 2007

The trend to decrease statutory rates continues. In 2007 some old MS lowered their corporate taxation level, specifically Greece, Spain, Netherlands and Portugal cut their rates. Moreover, Estonia reduces its rate by 1 pp annually to achieve 20% in 2009. Slovenia, which resisted the pressure for tax cuts for decade in 2007 decreased it by 2 pp. Judging by numbers one could note that we observe some kind of “race to the bottom” in corporate taxation. The dynamics of this process accelerates. Accession of Romania and Bulgaria in 2007 increases the competition for investments and jobs as the corporate taxation rates in these countries are below the EU level: in Bulgaria the government reduced the corporate tax rate from 15% in 2006 to 10% in 2007 and in Romania a flat rate of 16% for income and corporate taxes was introduced in 2005. Although the cuts in statutory corporate rates are significant it is not clear if result in higher capital inflow.

There is no clear link between statutory corporate income tax rates and revenues raised from corporate taxes, what indicates the role of effective taxation. The good example is Germany with high tax rates and limited revenues and on the opposite Ireland with low rates and relatively high revenue level. It indicates the potential role of effective taxation in generating budgetary revenues. However, the effective tax rates are not observed and therefore do not influence the common perception of the real tax burden.

Statutory rate is only one factor among all determining tax burden. Regulations concerning the tax base are even more important as they provide instruments to differentiate between types of activity and operations. To capture real effects of corporate taxation one should apply the nominal rates to real tax base. The purpose of computing taxable profits, income may be subject to adjustment for exemptions (income excluded from the tax base), allowances (amount deducted from the gross income to arrive at taxable income), rate relief (a reduced rate of tax applied to a class of taxpayers or activities), tax credits (amount deducted from tax liability), and tax deferral (a relief which taxes the form of a delay in paying taxes). It is common to apply all above mentioned measures. As a result the tax base is influenced by depreciation schemes, treatment of losses and valuation of inventories among others. Another factor determining real tax burden is efficiency of tax revenue office. Thus, effective corporate tax rates differ from announced statutory rates.

2. The impact on tax competition on foreign direct investments

Companies are affected differently by the taxation in each country. Thus, the small companies are more sensitive to the fiscal policy than the bigger ones because the levies are significant in their cost structure and they do not have the possibilities to envisage tax avoidance strategies. Big companies are able to negotiate fiscal treatments and the funds they pay to the budget. Under these circumstances, multinationals have several alternatives to structure and finance the investments, considering the host country's characteristics. A very important aspect concerning taxation is that multinationals are able to locate branches in countries with low taxation setting up strategies to avoid taxation. Companies are tempted to declare a higher profit in countries with low taxation or adjust the repatriation of dividends according to the tax legislation in the country of origin. Given these behaviour agreements concerning double taxation avoidance are very important for each country's tax regime.

The governments have several fiscal instruments at their disposals useful in influencing the actual tax rates and the local orientation of multinationals. Traditionally the literature sums up the following instruments useful in attracting the FDI: the reduction of corporate taxation to competitive level, deferral of taxes or exemptions from corporate taxation, exemptions from duty or local taxation. These instruments are used on a large scale though their applicability was restricted by international conventions.

The FDI can be appreciated by using several indicators: net FDI inflows, and as ratio of the GDP. FDI have reached historical levels due to their effort to create a competitive framework designed to attract FDI. Though there are significant differences, all CEE countries have managed to implement sufficiently attractive measures for the foreign capital. The major determinants were: a stable economic environment, without major crisis or convulsions, the privatisation of state companies, a positive evolution of financial markets, bank intermediation, relatively good infrastructure and communication systems, modern payment systems.

2.1. FDI inflows into new member states

The issue of tax competition can be examined indirectly by looking for the responsiveness of foreign investment to corporate tax rates. The empirical literature on the effects of taxes on FDI focuses almost exclusively on the US and the EU-15 data. There are only a few studies on FDI determinants in the NMS. Carstensen and Toubal apply difference between statutory rates of two countries as variable determining FDI flows for the sample of 1993-1999 and CEECs and conclude that estimated parameter value is small and not significant at the 5% level. The potential explanation was that they did not take into account special tax regimes designed to attract FDI. application of effective tax rates would address these shortcomings. Tax rates were also examined as FDI determinant by Edmiston who apply two variables: number of special tax rates and the highest statutory profit tax rate. The results indicate that imposition of an additional special tax rate reduces FDI as a percent of GDP and higher tax rates lead to lower inflows of FDI in FSU and CEECs. Again, the variable applied is statutory rate Lahreche-Revil adds data on some of the current new members to their EU15 sample, and tries to separate the effects of corporate taxation in the new members for the sample 1990-2002. Tax measure determines the sample: statutory rate, implicit tax rates (Czech, Hungary and Poland) and EATR (Czech, Hungary, Poland and Slovakia). The only strong and general conclusion of the Lahreche-Revil paper is that taxation may drive relocation, but only within EU15. This factor is rather irrelevant when outflow of FDI from old to new members are considered. Anyway, the approach seems to be very useful in analyzing capital flows from old to new member states.

Along with progress in development, foreign investment flows into NMS boosted in 2005, in some countries reaching over EUR10 billion a year. UNCTAD reports that even in 2000-2002, when overall FDI flows were shrinking each year reflecting slowdown in world largest economies, inflows to NMS increased. Indeed, these inflows have been steadily increasing year after year. In the euro terms, the average annual dynamics during 1995-2004 was 9%.

EU-15 countries have been very active in acquiring assets in NMS until 2001, often winning large privatization tenders. New inflows have been declining from that year. However, it seems that the accession of the new members in 2004 boosted FDI from the EU-15. What more, it seems that the increased flows into NMS in 2004 were at the expense of other FDI outflows from "old Europe". FDI flows into the NMS increased even more dynamically in the following year. Nevertheless, the significance of direct investment flows to the NMS was negligible for all outward FDI of Western European economies. Even the high results of 1995-2001 and 2004-2005 were only about 3-5% of total outward FDI investment into equity capital and loans of the EU-15. In 2002-2003, EU-15 investment into equity capital and loans in NMS were only around 1% of total outward EU-15 FDI.

Germany is the largest EU investor in the group of old members states, with reported FDI outward stock in 2003 of nearly EUR37 billion in 2004, followed by the France (EUR25 in 2004), the Netherlands (EUR18 billion in 2005), Austria (EUR13 billion in 2003), United Kingdom (EUR8 billion) and Sweden (EUR7 billion). Inflows of direct investment from Western Europe constituted around 75% of total incoming FDI to EU in 2001-2002, and in the case of smaller countries have been significant part of overall investment outlays. FDI flows among new member countries are still small (3% of total FDI stock in the CEE region in 2005), yet increased in recent years.

2.2. The evolution FDI in Romania

In Romania, during the last 10 years since market liberalisation, several changes went on, the FDI encountering ups and downs. During 1996-2000 the FDI volume barely raised to 6 billion USD (2 billion USD from privatisation of state companies). Compared to the capital inflows into Poland (39 billion USD), Hungary (21,5 billion USD), Czech rep. (12,5 billion USD) the investments were incomparable low because of the political instability, unfavourable laws, small scale of privatisation and the reluctance to create the legislative framework favourable to foreign investments. Obviously, analysing the investments flow in the mentioned countries, the main determinants for FDI entry were: the host countries political willingness to attract FDI, a payment system adapted to modern needs and connected to the real time payment system already existing in developed countries, a flexible foreign exchange system, a friendly business environment, stable tax system, possibilities to withdraw profits, etc. The trend of FDI flows were reversed in 2000 when economic growth resumed, Romania being regarded as an attractive country for the foreign capital. The evolution of FDI indicators shown in the table below:

mill. Euros

Indicator	1996/2000	2001	2002	2003	2004	2005
Net FDI	5695	1312	1194	1910	4153	5213
Gross FDI	5857	1457	1448	2782	4561	5957
Net FDI/capita EUR	264	61	55	88	192	236
Net FDI/GDP (%)	3,3	3,3	3	5,5	7,0	8,34
Gross FDI/GDP (%)	3,4	3,3	3,0	5,5	7,7	9,53

Figure 2 Foreign direct investment indicators in Romania

Source: NBR

The FDI inflows during 2005 mounted to 5213 mill euros consisting of: foreign capital participation to equity formation (51,6%), reinvested profits (22,3%), net loans (26,1%). The FDI were directed towards manufacturing industries (37,3%), food industry (26,1%), transportation (5,1%), trade and commerce (15%), banking and insurance (14,5%), communication (10,9%). A rather low contribution was brought to the textile industry, despite its' great potential (2,6%), hotels and restaurants (0,2%). From the point of view of FDI types Greenfield investments represent 42,2% of the total FDI at the end of 2005, the difference being acquisitions (brownfield investments). The spread of investments the largest amount was directed toward the Bucharest region (60,6%), the South Eastern part of the country (8,4%), the central regions (7,4%), the western regions (6,8%). The most important part of FDI come from The Netherlands (19,5%), Austria (15,4%) Greece (8,5%), France (8,4%), Switzerland (7,1%), Italy (6,9%).

This brief study attempts to analyse the effect of fiscal rates on foreign direct investments. Considering the old, more developed members of the EU as well as the countries that have recently acceded to the EU. We find that the fiscal rates are important, but not the most important determinant in attracting FDI. In spite of the speed up of investments flow in the newly acceding countries the more developed, stable economies are the favoured destinations. Besides the economic growth characterising the new member states, the financial market development, the low inflation, loans availability and economic perspectives are among the most important determinants.

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