

# CORPORATE TAX COMPETITION IN UE

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*Abstract: The taxation of corporate income creates huge difficulties in an open economy; each government tries to take advantage by undercutting the tax levels of other governments or offering superior levels of public services. The existence of a strong interrelation implies that competition between countries, interested in capturing the tax base of the whole market, becomes more significant because capital will follow the maximisation of profits in the global market. The most competitive countries will have an advantage in terms of total revenue in the short run and a greater rate of economic growth in the medium-long term.*

*Key words :tax policy ,corporate income tax, CCCTB*

## **Introduction**

Fiscal degradation occurs through the erosion of the tax base resulting both from tax competition (the relocation of taxable bases to other countries) and from the development of the underground economy (the relocation of taxable bases towards the black market). The former depends on the differential between effective rates of taxation, the latter on their absolute level. Firms in Europe countries increasingly adopt global strategies and establish overseas sales, marketing, production and research units to cope with new competitive pressures. The notion of control allows all of a company's activities to be attributed to the controlling investor. This means that variables such as a company's turnover, staff or exports are all attributed to the controlling investor and the country from which he or she comes.

Elaborating the tax policy of a state is a very complex act of decision that should be based on the efficiency criterion. Thus, they have in view the reduction of fluctuations, of economic instability, the protection of incomes and the stimulation of economic development. Taxes and the other levies to the state budget modify the initial distribution of incomes, influencing the economic activity, the investments and the consumption. Fiscal degradation affects every major source of taxation (consumption taxes, business taxation, capital income taxation, social contributions), its effects differ greatly according to the nature of the tax concerned. Even consumption taxes, which are harmonized to a much greater extent than direct taxes, are not immune from the risk of fiscal degradation

As foreign investments stimulate the economic growth, the degree of unemployment, the transfer of technology and know-how, the increase of competition and the increase of revenues from taxes and duties, the countries strive to attract investors through their adopted tax policy. The tax policy is essential for all Member States, and the actions of a country can have an influence not only on that country, but also on the neighbouring countries. Therefore, on the European Union unique market, the Member States should cooperate and should not perform actions in different directions. The tax competition can be materialized also in measures considered as non acceptable at the EU level, such as:

- Attracting some funds from abroad and protection at the same time the funds of their own residents;
- The existence of some tax measures that can be considered isolated within the specific of the national economy;
- Granting some tax benefits if there is no effective economic activities, and others.

Using criteria like those mentioned above, the 1999 Primarolo report identified 66 harmful tax measures at the level of the European continent, such as: the regime of distribution centres in Belgium, the regime of coordination centres in the Basque country, the regime of the Luxembourg holdings established pursuant to law in 1929, the regime of the international financial services centre in Dublin, the regime of the Portuguese free areas in Madeira and Azore, the regime of the financial and insurance services centre in Trieste, the rules applicable to foreign insurance companies in Sweden, the tax treatment of the naval companies in Germany, Greece, France, Italy, Netherlands, the regime of the insurance companies in Gibraltar, the deductions for investments in mineral processing in Greenland etc.

The relation between the tax policy and investments establishes that, by its contents, the tax policy can favour the expansion of investments, and the investments, by their volume, have an influence on the tax incomes collected, thus determining the economic growth. Stimulating investments leads to the creation of new production capacities, expansion of the already existing ones, also to the increase of taxable incomes that largely contribute to the formation of state budgetary incomes. As the countries compete among them for investments, on international level, each government will try to implement a taxation rate at a reduced level.

*Corporate income tax rate in OECD's European countries (2007)*

Country	Central government corporate income tax rate <sup>203</sup>	Adjusted central government corporate income tax <sup>204</sup>	Combined corporate income tax <sup>205</sup>
Austria	25.0	25.0	25.0
Belgium	33.99	33.99	33.99
Czech Republic	24.0	24.0	24.0
Denmark	25.0	25.0	25.0
Finland	26.0	26.0	26.0
France	34.43	34.43	34.43
Germany	26.375(25.0)	21.9	38.9
Greece	25.0	25.0	25.0
Hungary	20.0(16.0)	20.0	20.0
Ireland	12.5	12.5	12.5
Italy	33.0	33.0	33.0
Luxembourg	22.88(22.0)	22.88	30.4
Netherlands	25.5	25.5	25.5
Poland	19.0	19.0	19.0
Portugal	25.0	25.0	26.5
Slovak Republic	19.0	19.0	19.0
Spain	32.5	32.5	32.5
United Kingdom	30.0	30.0	20.0

Source: [www.oecd.org/ctp/taxdatabase](http://www.oecd.org/ctp/taxdatabase)

Thus, regarding the investors' taxation, we can see a discrepancy between the very low taxation quotas used by the new Member States compared to EU, as well as the existence of a narrow taxation basis (the case of Estonia) which was partially widened with the harmonization of the European economic policy.

The recently adhered countries benefit from a very low effective investment taxation level compared to the one used within the union. In some OECD Member States (the Czech Republic, Hungary, Poland and the Slovak Republic) the indicator tax/GDP decreased in 1999-2002, except for the Czech Republic, where it increased from 38.9 to 39.2. As for Hungary, this indicator decreased from 39.1 to 37.7, in Poland from

<sup>203</sup> This column show the basic central government statutory (flat or top marginal) corporate income tax rate, measured gross of a deduction (if any) for net central tax.

<sup>204</sup> This column show the basic central government statutory corporate income tax rate adjusted to find the net rate where the central government provides a deduction in respect of sub-central income tax.

<sup>205</sup> This column show the basic combined central and sub-central (statutory) corporate income tax rate given by the adjusted central government rate plus the sub-central rate.

35.5 to 34.3 and in Slovakia from 34.4 to 33.8.<sup>206</sup> In the last 14 years, the taxation level in EU decreased by 32%, reaching to 25.8%. These diminutions are especially due to the adhesion of the 10 new Member States in 2004.

Generally, the effect of the expansions in 2004 and 2007<sup>4</sup> was a decrease of the taxation average in EU, as in most of “old” Member States the taxation increased in 1995-2000. Except for Ireland, where it decreased from 33.1% in 1995 to 30.8% in 2005 – being one of the factors of the rapid economic expansion of the “Celtic tiger”. Also, in the Netherlands it decreased by 2% from 40.2% in 1995 to 38.2% in 2005. The lowest taxation quotas of the company incomes are in Bulgaria and Cyprus – 10%, Ireland – 12%, Latvia – 15%, Romania – 16%, Lithuania and Hungary – 18%. The highest quotas are in Germany – 38.7%, Italy 37.3%, Malta 35%, and France 34.4%. The 27 EU average is 24.5%, and 28.5% in the Euro area. These taxation differences partially explain the delocalization phenomena of several production units towards to countries with reduced taxation, firstly because the new Member States rely more on indirect taxes rather than the direct ones, and secondly because of the tendency of Central and Eastern European countries especially to increase the competition in order to attract foreign investments. So, these implemented the necessary tax reform in order to modify the taxation of the income of soviet inspired investors<sup>207</sup>, thus orienting the economy towards the modern policy trend.

The preparation of a coherent tax strategy should take into consideration the taxes that can occur regarding the operations of each company from the group in different tax jurisdictions, *ie* direct taxes (income tax, dividend tax, non resident income tax) and indirect taxes (VAT, customs taxes, excise taxes). The preponderance of different taxes and duties within the tax strategy is different according to the objectives of the performed project, the particular activity domain of such company and the areas of interest for the future (eg. expansion on international level, reorganization of distribution activity, sale of a business line, obtainment of significant financing, change of shareholders etc.).

The tax race is the reason that makes the EU to show concern towards the countries that establish very low taxation quotas. The taxation effective quotas take into consideration the statutory quotas, and also include aspects related to taxation basis, such as the provisions for accelerated tax depreciation, taxation credits etc. Thus, Baldwin and Krugman<sup>208</sup> published a theoretical pattern of industrial agglomeration s where the tax policy, even under the capital mobility conditions, does not lead to competitive taxation quotas due to rentals. Therefore, there will be no competition of excessive taxation quotas between “center” (old EU Member States) and “outskirts” (new Member States), but a “keen race” among the latter is not to be excluded.

The responsibility of adopting the tax policy within EU comes to the Member States’ governments, this being the main reason why the tax harmonization is characterized by inconsistency (in most cases, unanimity is necessary to adopt decisions).

The tax measures providing a significantly low level of effective taxation, including the zero tax, compared to the quotas applied in general within the member States, are considered potentially harmful. The following aspects are considered when assessing the harmful potential of tax measures:

- Analyze if the advantages are granted only to non residents or only concerning the transactions performed by non residents, and if these advantages are protected on the domestic market so that they do not affect the national basis of taxation;
- Pursue if the advantages are granted without performing a significant activity on the Member States’ market, thus establishing if these offer such tax advantages;
- Determine if the rules for profit determination regarding the activity of a group of multinational companies “are different from the internationally accepted principles, especially from the rules agreed within OCDE”;
- Examine the tax measures from the perspective of the advantages offered, including the cases where the legal provisions are relaxed at the administrative level, in a non transparent way.

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<sup>206</sup> Bernardi, L., Chandler W.S., M., Gandullia, L., Tax Systems and Tax Reforms in New EU Members, Routledge Studies in the Modern World Economy, London, 2005, page 28.

<sup>207</sup> Martinez-Vazquez, J., McNab, R., The Tax Reform Experiment in Transitional Countries, National Tax Journal, vol 53, no 2, 2000, pages 273-298.

<sup>208</sup> Baldwin, R., Krugman, P., Agglomeration, Integration and Tax Harmonization, National Bureau of Economic Research, working paper no. W9290, 2002, p. 11.

## Approaches on tax competition

A great part of the specialty literature, including Wilson<sup>209</sup> deals with the basic pattern of tax competition. This supposes that the production of goods is determined by two factors: work that is immobile between areas and the capital which is mobile. Also, they are considered the zero commercialization costs and the fact that the companies face a perfect competition. Within this pattern, the authorities choose the imposition of the capital in a Nash game.

The standard approach supposes the comparison of balance rates when the capital is involved in migration operations or not. The intermediary result, called balance taxes, was modified and expanded by the researches made in the domain. In one of these approaches, in which the authorities assumed the deviation from the maximization of social satisfaction, the tax competition can improve the prosperity by moving the balance rates closer to the social optimum in a second-best approach.

Ludema și Wooton<sup>210</sup> studied the impact of globalization on the enhancement of tax competition, starting from the fact that both factors, having an influence on the mobility cost and on the commercialization cost, change. Their conclusion is that the decrease of commercialization costs can attenuate the tax competition, and the reduced mobility causes multiple effects. These authors, together with Andersson and Forslid<sup>211</sup>, Kind, Midelfart-Knarvik and Schjelderup<sup>212</sup> pointed out that the concentration will give birth to the need of space for deploying the activity. Therefore, the state benefits from the tax applied on rents for the mobile factor, thus compensating the decrease of the commercialization costs.

The growth of European admission is not a new development, the commercial and natural barriers being eliminated several times starting with the 40s. To achieve the comparison, they start from the fact that Europe is divided in two parts: a central part benefiting from developed economies and a peripheral part characterized by developing economies. Also, they established that the aggregate taxation, represented by the incomes from taxes and duties in GDP, suffered modifications as follows: in the 70s, the precipice between outskirts and center increased compared to the 60s, while between 80-90s the difference reduced significantly, the high taxation countries trying to keep up with the other countries where there was a tendency to decrease it.

Both the European Union and OECD<sup>213</sup> (Organization for Economic Co-operation and Development) introduced towards the end of the 90s initiatives meant to stop the tax competition considered as *harmful*. Fuest, Huber and Mintz<sup>214</sup> emphasize in their research that there is a powerful pressure exerted by the increase of competition on the governments concerning the reduction of taxation.

The economic theories support the fact that the authorities have at their disposal two instruments of determination: tax rate and tax basis. In the standard pattern developed by Zodrow and Mieszkowski<sup>215</sup>, then resumed by Wilson<sup>216</sup>, one instrument is used – the tax on income produced by investing the capital. The introduction of corporative tax in the Zodrow, Mieszkovsky and Wilson pattern supposes its equivalence with a tax on the income brought by investing the capital plus a rent fee of the production factors. In other words, the fixed factor is taxed with a statutory rate plus a rate on the earning brought by the capital (call the effective tax margin rate).

According to Baldwin and Krugman, the European Union countries should establish common rates for taxes in order to avoid a *keen race*<sup>217</sup> with possible effects of welfare for the states adopting low levels. The starting assumption is the following: the other factors of influence being equal, the producers will orient towards the countries with more reduced rates, and the absence of a firm coordination to try to

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<sup>209</sup> Wilson, J D., Theories of Tax Competition, National Tax Journal, no. 2, 1999, p. 269-304.

<sup>210</sup> Ludema, R., Wooton, I., Economic geography and the fiscal effects of regional integration, CEPR Discussion, Paper 1822.

<sup>211</sup> Andersson, F., Forslid, R., Tax Competition and Economic Geography, CEPR DP 2220, august 1999.

<sup>212</sup> Kind, H., Midelfart-Knarvik, K., Schjelderup, G., Industrial agglomeration and capital taxation, Norwegian School of Economics, Department of Economics, Discussion Paper 7/1998.

<sup>213</sup> OECD, Taxing Profits in a Global Economy, Paris, 2001.

<sup>214</sup> Fuest, C., Huber, B., Mintz, J., Capital mobility and tax competition: a survey, CESifo working paper, no956.

<sup>215</sup> Zodrow, G., Mieszkovsky, P., Pigou, Tiebout, Property taxation and the underprovision of local public goods, Journal of Urban Economics, no. 19, 1986, p. 356-370.

<sup>216</sup> Wilson, J D., A Theory of Interregional Tax Competition, Journal of Urban Economics, no. 19, 1986, p. 296-315.

<sup>217</sup> Baldwin, R., Krugman, P., Agglomeration, Integration and Tax Harmonization, National Bureau of Economic Research, working paper no. W9290, 2002, p. 2.

reduce the taxes in order to attract investors will determine a competition that will reduce the taxation even more. In reality, there are factors that allow the differentiation. The welfare countries offer the capital the advantage of the existing solid infrastructure and of accumulation of experience so that they allow a higher taxation. But the balance should be carefully maintained because, if the taxation is too high, the phenomenon of capital migration will occur.

The mobility of labour within the European Union is undoubtedly lower than the mobility of capital: the globalisation and the closer integration of the capital markets and the accelerated penetration of the new communication technologies have done much to encourage the international mobility of activities, in particular in the financial sector. While liberalisation of the financial markets has considerably improved the efficiency of resource allocation and reduced the cost of financing, it has also widened the scope for tax planning and increased the opportunities for tax avoidance and evasion and thus helped to erode the tax base in many countries in the world. This concern was recognised by the Council when it agreed that the liberalisation of capital movements should be accompanied by appropriate tax measures.

### **The need for a more co-ordinated approach in taxation policy**

There is a clear contrast between the need for progress in tax co-ordination and the decisions adopted so far in this area, which has been substantially lagging relative to many other areas of European integration. Tax co-ordination at the EU level has suffered from two main obstacles: the decision making rules and the lack of an overall perspective showing the economic and social downside of failing to reach decisions.

Under EU law Member States are largely free to design their direct tax systems so as to meet their domestic policy objectives and requirements. However, national tax rules designed solely or primarily with the domestic situation in mind may give rise to incoherent tax treatment when applied in a cross-border context. An individual or corporate taxpayer who is in a cross-border situation may suffer discrimination or double taxation or face additional compliance costs.

*Coordination and corporate tax base harmonisation* : this initiative is complementary to the Commission's ongoing legislative initiatives in the direct tax area. The Commission believes that the only systematic way to address the underlying tax obstacles which exist for corporate taxpayers operating in more than one Member State is to provide multinational groups with a common consolidated corporate tax base for their EU-wide activities. The Commission has announced its intention to present a comprehensive legislative proposal for such a Common Consolidated Corporate Tax Base (CCCTB) in 2008.

However, the CCCTB will only apply to companies which are eligible and opt for it. There is still a more general need to ensure better co-ordination for the benefit of individual and corporate taxpayers and to prevent erosion of Member States' tax bases through mismatches and abuse.

This initiative does not aim to replace existing national tax systems by a uniform Community system. It seeks to improve the functioning of the 27 national taxation systems in the Internal Market by improving cooperation between Member States and better coordination of their rules.

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