TAX COMPETITION VERSUS TAX COORDINATION IN THE EUROPEAN UNION

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Abstract: This paper examines the tax competition literature and attempts to draw out its implications for the debate on corporate tax coordination within the EU. Although corporate tax coordination, including tax rate harmonization, has been the subject of intense discussion in the European Union (EU) for many years, EU member states, for the most part, still operate independent and highly varied corporate income tax systems. Interest in tax coordination has increased recently, however, prompted in part by fears that tax competition among the increasingly economically integrated EU nations will over time significantly reduce the level of capital income taxation.

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Key words: tax competition, fiscal competition, tax coordination, tax harmonization.

An issue of competition or tax harmonization within the EU is widely discussed in literature. Studies (Cnossen, 1996; Radaelli, 1999; Bond et al., 2000; Devereux, 2000; Gorter and de Mooij, 2001) reveal the existence of 27 tax systems related to each Member State, with particular national tax policy.

In this context, Member States agree, unanimously, for the following purposes of fiscal policy:

- to enable all categories of businesses, but also the population to benefit from the single market;
- to pursue the objectives set out in EU fiscal policy;
- to be consistent with other EU policies (environmental policy, labor policy, etc.).

Tax competition may arise between countries because of the existence of the 27 tax regimes and may have two sides:

- negative – competition is harmful and it is distorting the nature of the single market. For example, different tax policy could distort the companies' policy regarding investment, if they have subsidiaries and branches in different EU-countries;
- positive – it concerns the potential benefits for the population, such as reduced costs of public services provided by government.

For businesses and people in the Member States to benefit from the single market, the inefficiency of coexistence of the 27 tax regimes must be eliminated. The way EU influences the fiscal policy of the member states, in order to achieve its intended objectives, is the fiscal coordination that works and is compatible with the two principles of European integration:

- The principle of accepting fiscal policies of all countries, under certain conditions;

- Subsidiary - vertical relations between European institutions and national governments.

Tax coordination can be achieved by tax harmonization (convergence of national tax systems, with the purpose of assuring the working of a single economic and monetary market and to approach the welfare level in the EU), and also by removing all barriers to free movement within the single market of goods and services, of labor and capital. Interest in tax coordination has increased recently, partly caused by fears that tax competition between increasingly economically integrated European Union nations will reduce, in time, the revenues from taxes on capital. Indeed, in an extreme scenario, tax competition can generate a “race to the bottom”, in which all countries come to abandon taxation of capital income, relying entirely on labor and consumption taxation. (Zodrow, George R., 2003)

Peggy Musgrave (1967) defines tax harmonization as a process of adjusting national fiscal systems in order to achieve common objectives. Chetcuti (2001) believes that harmonization is the process of removing the tax barriers and discrepancies between national tax systems. Tax harmonization does not appear as an optimal system with a single objective, but also a search of the best possible compromise between economic imperatives dictated by market integration and free movement, on the one hand, and autonomy of Member States regarding fiscal options, on the other hand (Tulai, C., Şerbu Simona, 2005) According to the authors, the harmonization process is not a simple exercise to align the practices of each State to the Community methods of taxation, to achieve uniformity; in fact, harmonization does not mean uniformity.

Tax harmonization is a comprehensive mechanism that can be done at several levels: adjustment of the tax base, of the tax rates and tax procedures; harmonization at all three levels mean a complete harmonization (difficult in practice). Europeans Opinions vary regarding the need for tax harmonization and the form it should take. Sinn (1990, p. 502) underlines the threat that an intense tax competition involves against the existing income redistribution systems. He argues that the most practical way to maintain the current level of redistribution, given the conditions of a high international tax competition – and thus to avoid a misallocation of capital among member countries, due to differential rates of taxation of company profits – is to “harmonize tax rates through collective agreements between European governments”.

In a similar way, Tanzi and Bovenberg (1990, p. 185) highlights the negative effect of differences in corporate profit tax on capital allocation and the impact of fiscal competition in reducing public expenditure. They conclude that, in terms of corporate income taxation, “a certain symmetry between EU countries is needed”. In this respect, the authors suggest the unification of tax bases, establishing a minimum tax rate, taking later into account additional coordination measures, including rates harmonizing.

Cnossen (1990) highlights the benefits of a tax variety, but nevertheless, he argues that “increased mobility of capital and financial innovation […] implies inevitably that all corporate earnings should be taxed at a relatively low, flat rate.” He recommends a harmonized model of the Nordic “dual income tax” (Sørensen, 1994; Nielsen and Sørensen, 1997; Cnossen, 2000). In such a system, the labor income is subject to progressive taxation, while all income from capital is taxed at a diminished, flat rate (while the rates of taxation of capital income vary between Member States).

Frey and Eichenberger (1996, p. 339) argue that economists, politicians and various interest groups are generally in favor of tax coordination; they also say that "international fiscal policy remained unresponsive" to the idea that tax competition helps to reduce "political distortions", generated by the government tendency to over-allocate public services. Similarly, Genser and Haufler (1999, p. 345) conclude that the limited recommendations of the Commission Report (1997) should be implemented, but "it can not be inferred an express need to harmonize the tax systems".

Tax competition has manifested itself in recent decades, particularly through tax policies applied to:

- Significant reduction of tax rates (including income tax), to attract capital;
- Incentives and tax incentives (exemptions, deferrals, reductions, deductions for expenses) to attract FDI.

The first angle of which tax competition can be seen is the level at which it is carried out; from this perspective, we have:

- Vertical tax competition between authorities at different levels (federal, central or local);

- Horizontal tax competition between authorities at the same level.

Another criterion for classification of tax competition is the area of intervention, depending on where it can be:

• Tax competition on tax rates (the government decides to change tax rates to attract capital);

• Tax competition on tax base (the trend towards reducing the tax base by granting exemptions, deductions etc.).

With the elimination of barriers to free movement of capital and labor, the European Union illustrates best the role of tax competition. An example is Ireland; from the poorest country in the accession of the Community, in 1972, Ireland became one of the richest in just three decades. Clearly, one of the main factors behind this development was the EU and the significant support received over time. Unlike other states such as Greece, Portugal, Spain, which during the same period and under similar conditions have not experienced the same level of prosperity, reland has opted for a friendly fiscal policy, practicing the lowest rate of corporate income taxes in the European Union. She managed to attract a significant volume of foreign investment, while infrastructure needs were financed from European funds.

Table no. 1 Comparative economic development of Ireland (% of U.E. average – GDP/inhabitant)

Country/Year	1983	1993	1995	1997
Ireland	64%	80%	90%	100%
Portugal	55%	69%	70%	70,7%
Spain	71%	78%	76%	77%
Greece	62%	65%	64%	64%

Source: Eurostat

After the accession of Central and Eastern Europe countries to European Union, the scenario was repeated. Therefore, whilst the abolition of tax benefits for foreign investors, the new Member States were obliged to resort to reducing the levels of taxation, for both foreign and local investors. Major taxpayers in the EU budget (Germany, France, Italy) stood against this situation, saying that new Member States must increase their tax rates, and not generate unfair competition to countries with higher tax levels.

Also, countries with a more friendly tax regime have become targets of attacks by international organizations such as the International Monetary Fund or the Organization for Economic Cooperation and Development. In view of these organizations, tax competition between states will result in serious negative implications for income distribution. Under these conditions, both at EU level and internationally, arises more often the problem of signing multilateral agreements to prevent the emergence of the phenomenon of "tax dumping".

Next, we refer to the basic model of tax competition. One of the early contributors to the tax competition literature was Oates (1972, p. 143), who noted that local governments, in competing for mobile capital, are likely to "keep taxes low to attract business investment" and that the result of such tax competition "may well be a tendency toward less than efficient levels of output of local services." Zodrow and Mieszkowski (1986) and Wilson (1986) formalized this notion in models in which local government reliance on a source-based tax on capital income—e.g., the capital component of the property tax—resulted in under provision of local public services. The intuition behind this result is most clearly seen in the context of the relatively simple structure of the Zodrow- Mieszkowski (ZM) model, which is characterized by the following assumptions:

1. A large number of homogenous jurisdictions;
2. Perfectly competitive markets;
3. A Nash equilibrium in which each jurisdiction takes as fixed the after-tax return to capital and the tax rates set by other jurisdictions;
4. Fixed population and land in each jurisdiction;
5. Identical tastes and incomes for all residents of all jurisdictions;
6. A fixed national capital stock that is perfectly mobile across local jurisdictions;
7. A single good that is produced by capital and the fixed factor (labor/land) in each jurisdiction;
8. Government services that are "publicly provided private goods," benefit only residents, have no spillover effects to other jurisdictions, and can be modeled as purchases of the single private good;
9. Two local tax instruments—a "property tax" that applies to capital income and a head tax;
10. Local governments that act to maximize the welfare of their (identical) residents.

Within this context, Zodrow and Mieszkowski (1983) show that, as the number of jurisdictions increases, interjurisdictional competition leads to abandonment of the property tax by all jurisdictions, coupled with sole reliance on head taxes. In small open economies, the ZM model yields a "race to the bottom", all taxes on capital income being eliminated (Gordon, 1986; Razin and Sadka, 1991).

Wildasin (1989) estimates the magnitude of the inefficiency attributable to tax competition in the basic model when all jurisdictions are small. He 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. The standard tax competition model thus suggests a potential role for tax rate harmonization in a union. Specifically, given the constraint on head tax finance, tax harmonization increases efficiency—that is, if all jurisdictions agreed to raise their capital taxes simultaneously, all would benefit from an increase in the level of public services toward the efficient level. At the same time, given the assumptions of a fixed national capital stock and identical jurisdictions, such a tax increase would have no detrimental effects on either the level or the allocation of capital in the union..

A wide variety of extensions of the basic tax competition model, all of which alter one or more of the assumptions listed above, have appeared in the literature. The basic tax competition model is characterized by (either small or large) homogeneous jurisdictions. Wilson (1991) and Bucovetsky (1991) extend the model to include “asymmetric tax competition” between large and small jurisdictions. 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.

The basic tax competition model has only a single good and thus ignores interjurisdictional trade. Wilson (1987) adds a second good and finds that tax competition induces otherwise identical jurisdictions to specialize in production, with some regions choosing relatively low taxes, low expenditures and production of the capital-intensive good, while others choose relatively high taxes, high expenditures and production of the labor-intensive good. The resulting differences in individual consumption bundles are another source of inefficiency attributable to tax competition..

Baldwin and Krugman (2000) argue that agglomeration economies lead to spatial concentration of manufacturing and high-end services in advanced high income “core countries,” whose residents demand high levels of public services and support relatively high tax rates on capital income. These relatively high rates are sustainable because agglomeration economies create economic rents that can be taxed. Under these circumstances tax harmonization is undesirable, because low income, low tax countries in the periphery would lose their advantage in attracting capital for those activities not subject to important agglomeration economies, while the core countries would have to inefficiently reduce public service levels.

The basic tax competition model assumes that capital is perfectly mobile. However, many forms of capital are immobile in the short run, creating an incentive for governments to increase capital income taxes once an investment location decision has been made. As a result, governments may face an incentive to overprovided public services once capital is installed (Lee, 1997). Tax competition may limit this tendency, if firms have some flexibility in allocating production across facilities in competing jurisdictions (Janeba, 2000). Edwards and Keen (1996) construct a model similar to the basic tax competition model, but assume that state government officials act to maximize a function that includes both (1) the welfare of their residents, and (2) their own welfare, which is assumed to be directly related to revenues diverted to their own purposes – government “waste.”.

Certainly, tax competition is beneficial both for taxpayers and government. The taxpayers are operating in a tax environment that allows them to obtain higher returns and lower tax burden, while the state gains larger budget revenue due to the tax base growth. Also, tax competition requires public authorities to work in conditions of budgetary constraints (low tax rates) and therefore, to promote an effective tax administration. Moreover, businesses consider, in addition to the taxation, the tax administration capacity, which can be seen as being open or opaque to investors; latter claim more and more predictability, transparency, compliance with state law and economic development.

Governments of European countries have responded to increased competition by reducing the actual and legal tax rates. But while the EU 15 countries are promoting a more coordinated tax policy, without having too large discrepancies between their practices, smaller countries of Central and Eastern Europe, with less developed economies are more exposed to tax competition, and are required to sharply adjust their tax rates. This is obvious because, despite the fact that 15 EU countries have higher tax rates, the investment flows are directed into a larger volume to these countries. This means that other factors such as capital market development, cost of finance, economic and financial policy consistency etc. matter as far as taxation in decision making. In fact, despite efforts to close the tax system, competition will increase, taking into account the new emerging business methods. A number of multinational companies are producing services, know-how, departing from traditional production of goods. As a result, their assets are mostly intangible in nature and their activity is increasingly mobile, located in different countries, and therefore sensitive to differential tax rates. (Donath, Liliana, 2007)

In our view, there is no single solution to problems posed by either harmonization or tax competition within the European Union. We consider that an appropriate mix between the two is necessary, given the following::

- On the one hand, tax competition may lead to increased efficiency of public money and the limitation of non-productive activities, and secondly, it can lead to reduced revenue from taxes, and a downward effect of the quantity of public goods provided (thus lowering the general welfare)
- Tax harmonization in the European Union allows the creation of a consolidated tax base, with the following advantages: in multinational companies no longer have to deal with more national tax systems and, also, economic entities are not tempted to arbitration over the border in order to benefit from lower tax rates.

Currently, tax harmonization can't be achieved in political terms, since the fiscal policy is available to the national governments.

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