Increasing corporate tax competition in Europe

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The new member states of EU tended to maintain their capital absorption capacities and incentives aimed at the inflow of foreign direct investments by reducing their corporate tax rates. The decline in the implicit tax rate on capital was linked to the slowdown of economic growth. Governments fight not only for capital but also for the budgetary receipts. In most countries, changes in the tax legislation aiming at reducing tax rates will have no macroeconomic effects without comprehensive reforms in the redistribution systems and the administration aiming at cheaper government. This article presents the substance of corporate tax competition and summarize the conclusion of arguments for and against tax competition.

Keywords: European taxation, harmful taxcompetition, tax harmonization, corporate tax rates, financial externalities, double taxation

JEL codes: H21, H23

The significance of tax competition

The expression „tax competition" – though commonly used worldwide – is not the proper term for describing the phenomenon lying behind. The typical features of real economic competition (profit oriented effectiveness, economic rationality, self regulatory and price sensitive market, substitutable competitors, etc.) cannot be perceived in national legal systems. From the countries' point of view, tax competition implies that relying on their sovereignty in taxation, certain countries want to attract investors by establishing more beneficial tax regulations compared to other countries in order to acquire a broader tax base. Tax competition is related to regulatory power, „an institutional intervention of a country in the economic behaviour,"[2] the problem of reconciliation national jurisdiction in taxation and supranational regulation. The problem is originating in the fact that whereas the tax systems still be-

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[2] Deák Dániel (2005) p. 19

long to national competence, their effects are becoming more and more international. The sovereign tax policies of the individual countries cause financial externalities.[3]

The evaluation of the significance of tax competition is rather diverse. There are views that emphasise its magnificent role while others say that its importance is overrated in investment decisions, its role is actually peripheral.

According to the common opinion of the literature, when a multinational company decides where to make investments, the most important factor is the general state of the host country's economy. Depending on the type of investment, factors considered with specific weighting are as follows: political and economic stability, state of the infrastructure, the main features of human capital (productivity, qualifications, relative costs, etc.), the size of the market, income level, economic policy and regulatory environment and institutional background. The role of specific investment incentives is gaining in importance when the factors analysed are more or less similar in the potential target countries. In recent years, the relocation of production centres of EU based companies is becoming more and more widespread fuelled partly by the enlargement of the EU. The factors that encourage this process can be mainly derived from the differences between countries concerned.

Procedures that lead to tax competitions

The direct tax systems which are still in force evolved in the years following World War II. The economies were much more closed at that time than now. Companies invested their capital in the country of their headquarters, individuals earned their income in their own country. Applying the principle of headquarter country did not mean a problem in the tax system and it did not cause a conflict with the tax authorities of other countries.

When a national tax system was formed, other countries' tax related actions were not needed to be considered. They did not affect the deci-

[3] Mike Károly (2003) p. 260.

sions of indigenous economic participants, the economy's competitiveness and the formation of the national tax base. With the collapse of Bretton Woods System, obstacles to international capital flows gradually diminished and capital markets became more and more interlinked and global. The new development trends of the world economy strengthened the mutual dependence of national economies stronger.[4] Due to the acceleration of the globalisation processes, not only trade is becoming international but investments and production as well, reducing the significance of geographical boundaries and fuelling global competition. In this process, one of the main integrating factors is the EU – with its single market, economic and monetary union and with its common policy established in other areas.

With the deepening of globalisation, capital markets are becoming geographically more mobile which makes the tax bases more flexible. This gives the opportunity for some countries to create a more favourable tax environment than other countries have in order to attract capital. The differences in certain countries' tax burdens play an increasing role in investment and financial decisions in general and the selection of the geographical location of affiliates in particular. As a result of these factors, a special market is evolving that of countries, or „the market of sovereignty".[5] Thereby, the competition for the investors, workplaces and taxpayers among countries is placed on a new foundation.

The *political base* for the countries' market is formed by the priority of the principle of human rights according to which the rights and the freedom of citizens are more important than the self-determination and sovereignty of individual countries'. The *economic base* of the „market of sovereignty" is created by the fact that the expenses of leaving a country and its tax system is becoming lower and lower if more beneficial economic conditions are offered somewhere else. The mobility of the tax bases will probably grow further, which can be strengthened by the commercial and financial innovations of the Internet. Apart from

[4] Tanzi (2010)
[5] Mázsa Péter (2001)

the traditional political aspects of measuring performance (like for instance fairness), the requirement of economic effectiveness is gaining in importance in the countries' market.

The problem of harmful tax competition

Both positive and negative elements appear in the overall effects of globalisation on tax systems. The tax-collector countries do not like the fact that the capital flow which is freer than before provides new possibilities for minimising payable tax and avoiding tax payment. At the same time, tax competition encourages countries to reduce the taxes of mobile production factors themselves in order to attract capital. This effort can increase the tax base of the country attracting investments and it can lead to the erosion of the national tax bases in the capital exporting country endangering its tax revenues.[6]

Governments are interested in protecting their revenue sources. In order to stop the decrease in tax revenues and to reduce the budget deficit caused by overspending (within the conditions of tax competition) governments tend to enhance the taxes and duties levied on less mobile productive factors, like labour and consumers. These trends can lead to the fall of employment and it can distort the tax system as well. In a system, which does not prefer the internal capital accumulation, external source can only be obtained at the expense of the domestic taxpayer.[7]

The OECD plays a leading role in the international fight against damaging tax competition. It deals with this issue in a comprehensive project. According to the OECD[8] the tax competition can be potentially damaging if it distorts the financial and investment procedures, and thus undermines the fairness of tax structures, damages taxpaying morale, changes the desired levels and structures of taxes and public expenditure, shifts part of the tax liabilities towards labour, immobile assets and consumption which increases the administrative costs of tax authorities and taxpayers and the burdens of tax collection.

[6] Galántainé M. Zs. (2003)
[7] Balogh (2004a) p. 18
[8] OECD (1998)

The question is the border between damaging and non-damaging tax competition. According to the *„Code of Conduct for Business Taxation"*[9] member countries of the EU made commitments (the provisions of the Code are not obligatory) that in the future, their taxation systems will exempt from practices of harmful tax competition and, on the other hand, they will withdraw those previous provisions on tax allowances influencing the selection of the geographical location of business and compete with each other in the EU. According to the Code of Conduct, a tax provision can possibly be harmful if it results in a significantly lower tax burden than that, prevailing in the economy. According to Community law, taxation practices can be regarded harmful which constantly and systematically damage the fiscal neutrality, if it is not in line with the „tax system's nature or internal structure."[10]

Based on this, it must be examined whether the provisions of the actual tax law are integrated in the overall tax system.[11] In corporate taxation, exceptional preferences and selectivity are prohibited means not only in taxation, but in the Community's competition law as well.

The harmonisation of national tax systems can be one way to stop tax competition, but this may face political opposition in many cases – especially in the field of indirect taxes.

Tax harmonisation and tax competition

Legal harmonisation in the EU aims to ensure the free movement of goods, services, people (labour force) and capital by establishing the same competitive conditions in the single market. In the field of taxation, the requirement is that differences in national tax laws should not inhibit and distort trade and the flow of production factors among member countries.[12] The differences in national tax laws that inhibit integration may spontaneously fade away partly as a result of market trends, partly that of by tax competition among the countries. On the other

[9] OJ (1998)
[10] ECR (1974) p. 709.
[11] Deák Dániel (2005)
[12] Losoncz Miklós (2004)

hand, differences can be reduced by approximating consciously the different tax systems of the member states as well as by positive Community tax harmonisation. The Treaty of Rome aimed at abolishing taxes in trade among member countries which have the same effect as customs tariffs.

Corporate income taxation is so far in the competence of the member countries, but for establishing an internal market which is free of tax obstacles co-operation is needed among the member states if they want to avoid double taxation or extreme tax competition. In corporation taxation, the Council agreed on two directives and made an agreement in 1990 in order to ensure an uninterrupted international capital inflow.

The aim of the *Merger Directive*[13] is the abolition of tax obstacles to acquisitions, the transfer and the exchange of shares. According to the requirements of competition neutrality, the taxation of capital gain deriving from M&A may be delayed. The intention of the directive is that if there are changes, asset transfer or exchange of shares between companies having affiliates in two (or more) member countries of the EU, should be the same taxation system should be applied for these transactions as if these transactions were accomplished within a member country.

The *Parent and Subsidiary Directive*[14] ensures uniform taxation rules for mother and subsidiary companies working in different member countries. Its objective is to avoid eventual double taxation, which inhibits the free flow of capital in the single market. According to the directive, the profit of the subsidiary company should be taxed where it is operating, the mother company's country can not levy more tax on the profit, or the tax paid may be included in the tax liability. The other relevant legal source of harmonisation is the *Convention 90/436/EC*, which is a multilateral agreement applicable within the Community, and its aim is to avoid the associated companies' double taxation in accordance with the legalised supervision of the accounted price.

[13] 90/434/EC (OJ L 225/1. 20. 08. 1990)
[14] 90/435/EC (OJ 225/6., 20.08.1990)

The „*Code of Conduct*" and the „*Interest-Royalty Directive*"[15] play also an important part in the harmonisation of the direct taxes. The Interest-Royalty Directive is intended to abolish the taxation of royalty and interest payment of two associated companies and affiliates in various member states. The objective of the directive is to ensure that royalty and interest payments among member states are subject to tax only in the member state of residence, through the abolition of any tax thereon in the state of source. This directive aims to eliminate double taxation, and reduce time-consuming procedures and formalities to recover any deductions at source after these have been made. It also intends to avoid cash-flow disadvantages that arise as a result of the lapse of time between the date when tax is levied and the date when such tax is set off or refunded.

In connection with tax competition, tax harmonisation is important from two aspects. *First*, the harmonisation of direct taxes is narrow-ranged and does not contain provisions on the tax bases and the tax rate so far. The freedom of national tax systems is rather big, in the course of their regulations only some principles have to be considered. The national legal rules on taxation must not contain negative discrimination or provisions which might restrict the freedom of competition. They should be in line with the legal rules of the Community – which are much stricter – particularly in establishing provisions which may concern state aid. Member countries should respect the principle of Community loyalty while exercising tax sovereignty. The possibilities for tax competition are rather wide-ranging. *Second*, tax harmonisation could be used to restrain tax competition if proper community rules were established.

The *Common Consolidated Corporate Tax Base* (CCCTB)[16] proposal by the European Commission provides new set of rules for computing corporate tax base of companies operating across-borders in EU Member States. The CCCTB should be a new step of the tax coordination in the EU, but it does not specify tax rates. Member States continue to de-

[15] 2003/49/EC (OJ L 157/49, 26.06.2003.)
[16] COM(2011) 121/4, Brussels, 2011/0058 (CNS)

cide their own corporate tax rates. CCCTB probably will create increased but fairer tax competition within the EU.

Those countries that apply higher tax rates are sensitive to harmful tax competition and are in favour of determining a minimal tax rate. Since the collision of interests is very strong, no directive has been proposed on this issue yet. Furthermore, to harmonise structurally the national tax legislation it would be necessary to elaborate a coherent tax policy at the level of the Community which would be in accordance with the fiscal policy of the EU. However, the tax policy is not part of the EU's common policies yet. The fact that Community decisions on taxation may still be made only by common consent makes harmonisation difficult, and in certain areas even impossible in the enlarged (and still expanding) European Union.

Arguments for tax competition

Differences in taxation in member countries may create the possibility of arbitrage of tax obligations in the case of the mobile factors of production that may affect the international flow of capital influence its size and direction. The different tax systems can have an impact on the investment decisions of multinational companies. Differences incorporate income tax rates may have other consequences as well. Companies registered in different member countries are taxed differently which means they compete under different conditions on the same internal market of the European Union. As regards the promotion of foreign direct investments, the significance of tax allowances cannot be overrated because the general conditions in the host countries are becoming more and more similar within the regions and the wider world as well.[17] This is the outcome of globalisation and the diffusion of information and communications technologies, etc. With the integration of markets the market size loses in significance as a determining factor of foreign direct investments, but it strengthens the importance of those investments that produce for exports.

[17] Taylor (2000)

The increasing tax competition is also expressed in the reduction of corporate tax rates *Table 1.*

Table 1.

Corporate tax rates in 2004 and in 2011[18]		
	2004	2011
Austria	34.00 %	25.00 %
Czech Republic	28.00 %	19.00 %
Finland	29.00 %	26.00 %
France	35.40 %	33.33 %
Germany	39.58 %	15.00 %
Japan	42.00 %	30.00 %
Luxembourg	30.38 %	21.00 %
Netherlands	34.50 %	25.00 %
Poland	27.00 %	19.00 %
Portugal	33.00 %	25.00 %
Romania	25.00 %	16.00 %
Switzerland	24.10 %	8.50 %
United Kingdom	30.00 %	26.00 %
United States	40.00 %	35.00 %

The tax policy which encourages investments has spread in less developed countries, therefore its importance is even bigger now that the EU absorbed eight less developed Eastern –European countries. The new member states tended to maintain their capital absorption capacities and incentives aimed at the inflow of foreign direct investments by reducing their corporate tax rates further. The inflow of foreign direct investments is a particularly significant contribution factor to long-term sustainable economic growth and structural and technological modernisation. The tax treatment of FDI is a very important part of this policy.

[18] Source: KPMG (2004), Deloitte (2011)

The emergence of global companies will have a significant impact on government tax revenues. These companies are likely to be more sensitive to tax allowances, because they will be better able to exploit them by transferring their activities from one country to another. In the delocalization of international companies, the effect of the taxation aspects is more and more pronounced. Considering the entire European Union, those relocations that are not made into member countries (which go out of the EU) can cause direct or indirect, long-and medium-term or immediate difficulties and problems. One of the most directly perceived effects of relocations is that people will lose their jobs and the possibility of finding a new job is decreasing in the affected regions and branches. Those employees are especially endangered who work for an off-shore multinational company's branch or subsidiary. But nowadays it is not rare to see the relocations of small and medium sized companies that produce significantly more technological extra value added or that follow their customers abroad. Problems do not stop at the level of an individual because growing unemployment can have national consequences if, for instance, the budget needs to spend more on social purposes. Losing jobs can also lead to social exclusions and the growth of social extrusion of which affects are rather wide-ranging. The deterioration of the labour market and efforts aimed at saving on labour costs can reduce internal demand with the consequence of a slowdown in economical growth.

If European companies are forced to reduce R+D expenses on experiments, that is, to reduce their innovation capacity which forms the basis of their future while competing with other companies operating on lower costs. The companies which remain in the EU usually have to face higher costs than the competitors. This may ultimately cause a market share reduction and the loss of competitiveness for them.

All in all, it can be stated that the processes and the effects generated by company relocations may affect adversely the fulfilment of the objectives of the Lisbon Strategy, the establishment of more workplaces with better quality, social cohesion and the protection of the environment.

Arguments against tax competition

• The sovereign tax policies of the countries cause financial externalities.

• The reduction of the tax base may endanger the fulfilment of the national objectives and the insurance of public obligations.

• The tax burden of the factors of production will be distorted, the tax structure will be deformed, the tax burden of labour force and consumption will increase, labour force will be more expensive, its competitiveness will decline, and there will be problems with employment.

• Tax competition serves the interests of global capital.

• With the existence of various, often changing, sometimes inconsistent tax rules; the requirement for predictability and planning is not achieved in the national tax systems.

Arguments for tax competition

• Less competition barriers, better resource allocation, bigger welfare.

• Favourable tax policy for the less developed countries, which is an asset for catching-up.

• The general tax burden reduction can increase the competitiveness of the EU as a global partner.

• Tax competition forces the modernisation of the general government.

• At present, there is no political consensus on how to elaborate and run a coherent tax policy in the EU. Majority voting is an obstacle to this kind of changes

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