

REVISITING THE DEBATE ON HARMFUL TAX COMPETITION IN THE EUROPEAN UNION

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Abstract

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Globalization leads to economic benefits for some countries but may have also many serious negative side effects for others. The increased mobility of economic activities may result in a sharp increase in tax competition between countries. On the one hand, tax competition can have desirable consequences, such as more efficiency, but on the other side it may also have undesirable or harmful consequences, such as race to the bottom. Also, the increasing using of tax havens has resulted in erosion of many countries' tax bases. From of the point of view, there is a need to revisiting the debate on tax competition and to answer whether the tax competition is beneficial or harmful. For this reason, this paper discusses the significance of tax competition in the European Union and deals with the position of tax competition in the European Single Market. This paper discusses an economic purpose of tax competition at currently European Single Market and discusses about harmful effects of tax competition. Based on the findings in this paper the following overall conclusion is drawn. The article makes clear that Member States have a need to protect their tax bases, especially in time of economic crisis, because the foreign direct investment flows might have negative consequences on the choice of tax revenues.

tax competition, harmful tax competition, foreign direct investment, capital flows, race to the bottom

With the creation of the Single Market in 1992, the capital flows was liberalized. While the benefits of established Single Market are often lauded, the worry ever since has been that tax competition among Member States might undermine the welfare state. As well as, in the wake of globalization the tax planning becomes more sophisticated. The opportunities to reduce taxes are constantly increasing and the tax planning is the one way how to reduce tax liability. The international tax planning can minimize the overall tax burden of companies in order to maximize its profits. One of the easier measures of international tax planning is to shift investments to low-tax countries. This leads to tax competition that exists if the tax payers can reduce tax burdens by shifting capital from high-tax jurisdiction to low-tax jurisdiction.

Some Member States try also to attract economic activity by being more tax efficient than other

States. Direct taxation of member countries was not harmonized yet and so special tax regimes are not controlled by European Union policy. Such policy competition between overall national tax systems is in principle good for everyone. However, tax competition may also take the form of special schemes which are designed solely to undercut competition in a certain sector, usually mobile capital. In certain countries tax competition has led to tax reforms, where tax bases are broadened and tax rates are cut. Other countries have introduced preferential tax regimes, which provide low effective tax rates for specific mobile business activities. So, still existing tax differences in direct taxation between countries cause cross-border mobility of capital.

This fiscal competition is often presented as harmful and distortive therefore the European Union and other international organization such

OECD and MMF are promoting policies aimed at preventing the free flow of capital. However, that is inconsistent with principles of the Single Market and free movement of capital. Is so the tax competition really harmful? Are the tax shields and the protection of the tax bases needed? That is very questionable.

Besides, the increasing tax competition leads to discussion if it is desirability or not. Especially in times of crisis, this issue is very important. The opinions on this problem are not stabilized. Opinions on the desirability of tax competition move between two extremes. Proponents of tax competition argue that tax competition is necessary to keep national governments to be tax efficient. By contrast, opponents of tax competition advert to fact that tax competition is economically counterproductive because it leads to fiscal degradation. Opponents of tax competition usually call for tax harmonization.

Nevertheless, tax harmonization is not the counterpart of tax competition and it does not mean that it is less beneficial for an international tax planning. Global tax competition which is caused by the increasing mobility of capital may lead to distortion in the Single Market as a result of fiscal rather than economic motives determining business decision. In this case it is a harmful tax competition which may give rise to the tax base erosion and may lead up to the race to the bottom. On the base of this, it is need to tax harmonization or at least tax coordination within European tax law.

For this reason, this paper discusses the significance of tax competition in the European Union and deals with the position of tax competition in the European Single Market, discusses an economic purpose of tax competition and its harmful effects and examines several strands of the literature that shed light on these questions

MATERIALS AND METHODS

The fundamental principle of tax competition was determined within the paper. The forms and consequences of tax competition were defined and at the same time the tax coordination within the European Union was specified. Subsequently, there was performed an analysis of opinions of tax competition and base on this analysis there were found pros and cons of tax competition and there were discussed its economic consequences. Based on the analysis of capital flight to abroad and effective tax rate each country of the European Union, the current trend of tax competition was identified.

The relevant data were taken from the EUROSTAT and OECD database. The foreign direct investment flows were monitored within ERUOSTAT. According to the EUROSTAT, the foreign direct investment (FDI) is the category of international investment made by an entity resident in one economy (*direct investor*) to acquire a lasting interest in an enterprise

in another economy (*direct investment enterprise*). The lasting interest is deemed to exist if the direct investor acquires at least 10% of the voting power of the direct investment enterprise.

In this paper, there were used standard scientific methods that allow objective and systematic qualitative and quantitative description of the existent issue. To meet the goal of the paper, the method of analysis, comparison, description and modelling was used. To draw conclusions synthesis method was applied.

RESULTS AND DISCUSSION

Tax competition is one of the most pressing issues for tax authorities in modern economics and it also a highly controversial subject. It refers to a process in which countries attempt to attract capital or taxable profits, by reducing taxes on capital. Countries may also follow more complex strategies and attempt to attract an industry so as to establish a future location advantage, similar as in the new trade theory.

In general terms, tax competition can be defined as improving relative competitive position of one country against other countries by reducing tax burden, as Kiegebeld (2004) stated. Another definition is defined by Mitchell (2009) and according to him tax competition exists when people can reduce tax burdens by shifting capital and/or labour from high-tax jurisdictions to low-tax jurisdictions. The needed requirement for tax competition is a high mobility of capital provided that capital can move across borders at low costs.

It is commonly know that tax competition is a phenomenon but nothing unique. Already Adam Smith in his book *Wealth of Nations* had introduced an interesting idea which is indebted to the present time. Adam Smith (1991) understood tax competition, in contrast to current approaches, so that the state with high taxes was the cause of entrepreneurs from leaving the country. Therefore, he recommended to remove the high taxation for maintain tax bases in the country.

Nowadays, the existence of tax competition is caused by rivalry of countries for tax revenues (tax bases) within fiscal policy of the state. A country may wish to use taxes to attract mobile capital, but also face a strong revenue constraints and high tax collection costs from taxes on factors other than capital. In that case, an incentive that is targeted at new and mobile investment may appear an attractive solution, because it allows both a competitive tax system where needed, and provides revenue from existing capital and immobile activities. So, tax competition, to some extent, serves the healthy purpose of putting pressure on governments to keep spending under control. It can also lead Member States to improve the attractiveness of their tax systems by increasing efficiency.

However, tax competition also has negative effects and can present, in the European Union, a disturbing asymmetry. The liberalisation of

financial markets and the expansion of the Single Market allow companies to pursue strategies of tax minimisation. This is achieved both by choosing the most convenient taxation area for planned activities and by benefitting from mismatches between two tax systems, as Šemeta (2011) noted. Different tax policy so may distort the companies' policy regarding investment, if they have subsidiaries and branches in different EU-countries. That may have a negative impact on the budgets of some countries. As well as, the result of tax competition may well be a tendency toward the race to the bottom which could be endanger tax revenues of Member States that have a higher level taxation than other countries in the European Union.

As above mentioned, the consequences of tax competition may be either desirable or undesirable. This fact can be illustrated on following examples in Tab. I and Tab. II.

I: *Neutrality situation*

	State L (large)	State S (small)
Corporate income tax rate	25%	25%
Taxable capital income	3 000	1 800
Tax revenues	750	450

Source: own calculation

If state number *L* is large and rich on capital revenues and if state number *S* is small and poor on capital revenues, state *S* decides to introduction special regulations for capital income by cutting its corporate income tax rate from 25% to 15% (as in Tab. II). This makes it attractive for investors from state *L* which transports capital from country *L* to country *S* (in Tab. II).

II: *Situation in case of low-tax jurisdiction*

	State L (large)	State S (small)
Corporate income tax rate	25%	15%
Taxable capital income	1 800	3 100
Tax revenues	450	465

Source: own calculation

According to the Tab. II, the change in tax rate in state *S* increases state *S*'s tax revenues, whilst state *L*'s tax revenues are lowered by 40%. The budgetary gain for country *S* is much smaller than the budgetary loss for country *L*. The fall in tax revenues for state *L* is by 300 items and the increase in tax revenues is by only 15 items. There is evident, that situation leads to the tax base erosion and shifting of tax burden. Probably, the fall in tax revenues will have to be compensated by an increase tax on non-mobile factors or an increase in government borrowing or by a reduction in public spending in state *L*. But that is not good way for compensation of tax revenues

and this situation leads to harmful tax competition. So, tax competition can have consequences that regarded as undesirable or harmful by certain countries, but as desirable by other countries.

Additional, it can be suppose too, that both countries want to raise as much tax revenues as possible, and they are not sure what the other country will do. If country *L* thinks country *S* will choose a low tax rate, so the state *L* will choose as the best strategy a low tax rate. As well, if state *L* thinks country *S* will choose a high tax rate, so the country *L* will choose low tax rate. Country *S* reasons the same way. Both states choose a low tax rate. This may lead to the tax race to the bottom which may endanger tax revenues of both countries.

Above mentioned this is a cause of harmful tax competition. Tax competition is harmful if measures are specific and targeted at foreign tax bases without affecting the national tax base. As Kovács (2005) noted, competition on the overall tax burden is generally seen as fair, but tax competition is harmful and unacceptable when it is aimed at attracting foreign tax base. Author so points to the fact that tax competition in this form leads to a global and undesired loss of revenues for governments and may imply a distortion of tax structures towards immobile factors and have negative consequences on employment in some countries.

Avi-Yonah (2000) supply evidence that tax competition forces government to increasingly switch from taxation of capital to taxation of labour income and to consumption taxes. As well, according to Terra and Wattel (2008) harmful tax competition is commonly understood to exist where Member States damage each other's budgets rather than to help create economic activity. Schön (2000) adds, that tax competition leads to a progressive erosion of the tax base, that tax competition causes the financial powerful taxpayer turns into the "free rider" of the domestic welfare state and that tax competition leads to a massive inequality of treatment between mobile and less mobile source of income, above all between labour on the one hand and monetary or real capital on the other.

Additional, Razin and Sadka (1991) argue that inefficiency occurs through cross-border investment of capital which could reduce the corresponding tax bases of the high-tax country and create a negative externality. As well as Sinn (1997) noted, tax competition between countries for mobile tax bases distorts the incentive of governments to supply an efficient level of public goods. As well, Mintz (1999) notes, tax competition can introduce inefficiencies in a nation's tax system because countries afraid of tax-base flight will lower tax rates to an artificially low point and all countries will be worse off as a result.

In broad sense, there are two categories of negative opinions on tax competition. First, tax competition changes international allocation of capital in an inefficient manner and second, tax competition

leads to a deterioration of tax bases, ultimately causing an under-provision of public goods.

On the other hand, the tax competition is in some situations positive. As Teather (2005) noted, tax competition brings great benefits, to all society and not just to those who directly take advantage of it. Author further adds that tax competition acts as a check on governments' ability to raise taxes; it ensures that governments have more limited funds and thus provides incentives for governments to spend more wisely. As well, Janeba with Schjelderup (2004) meant by tax competition a possibility of allocation efficiencies in public spending. Additional according to Griffith, Hines and Sorenson (2008), tax competition can lead to improved public sector efficiency and in contrast, tax coordination can have negative effects in light of the failure to accommodate particular national needs.

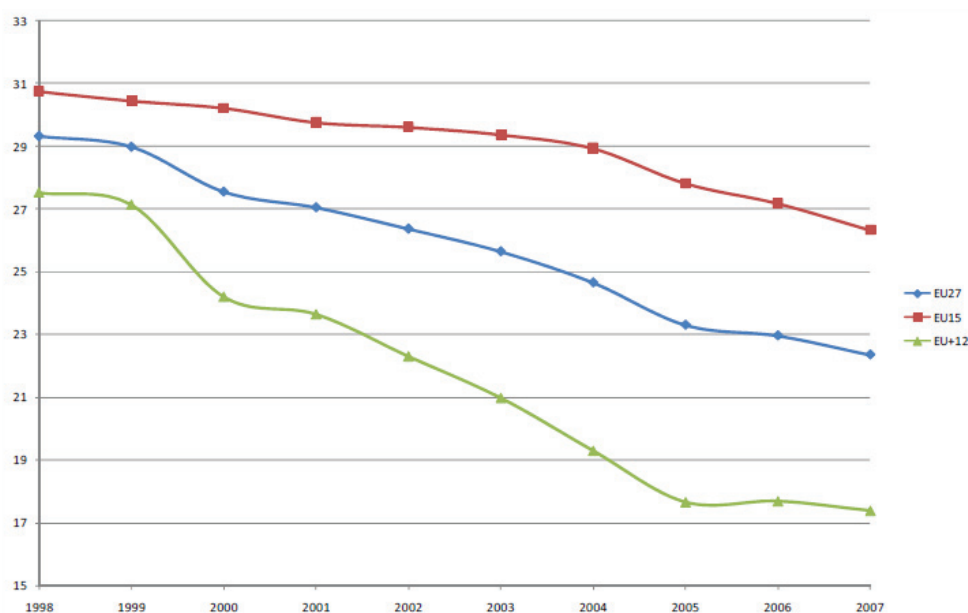
According to the Killian (2006), the flow of capital to less developed tax-bidding countries can be a good thing, creating employment and spreading the benefits of prosperity. Edwards and Mitchell (2009) add that more tax competition means more productive economies and higher living standard and that tax competition drives down tax rates on the most inefficient types of taxes, and thus helps to expand the global economic pie.

Due to these above mentioned arguments for and against tax competition it is difficult to say, if tax competition is fair or harmful. From the legal point of view it is even more problematic to find a starting point for this distinction. Nevertheless, it is obviously, that tax competition is for some countries good thing but for some countries tax competition means danger of low budgetary revenues. Already mentioned, the race to the bottom is problem.

What is a real position of tax competition in the European Union? Is there a threat of race to the bottom? One can however assume that the threat race of the bottom is not justified. Even though, most European countries decreased their statutory corporate tax rate over the last ten years (most countries decreased the corporate tax rates three or four times), the tax rates don't fall to zero. The EU-15 average went from close to 50% in 1985 to slightly less than 30%. The average for the twelve countries that joined the European Union in 2004 and 2007 is about 10 percentage points lower. It may negatively affect their long term ability to collect revenue to fund social programmes. Nevertheless, the investors are not influenced only by statutory corporate tax rate but certainly other aspects in economics as political environment, legal system, infrastructure and other tax incentives. From point of this view the effective corporate tax rate is determinative for decision of investors than statutory corporate tax rate. Effective tax rate so provides information on tax burden on companies and on incentives in the use of new capital.

Is also evident that significant cuts in statutory tax rates applied by most of the Member States during the last decade, it has not had any effect on the tax burden to which listed companies in the European Union are subjected, as pointed García, Rodríguez and Arias (2011).

Within the European Union, the difference in tax levels between the old EU-15 and the new Member States is considerable. Most of the new Member States present even lower corporate effective tax levels than the candidate countries. Between the old Member States, there is less dispersion in the effective tax levels than between the new Member States.



1: Corporate effective average tax rates (EATR) from 1998 to 2007 [%]

Source: Elschner, Ch., Vanborren, W., 2009

Overall, one can observe a higher consolidation in effective tax levels for the old Member States. The new Member States show more changes in their tax policies. Also, there exists the fact, that in the EU-15 there are several large countries that do not react on tax competition in the same way as small, usually more open, countries.

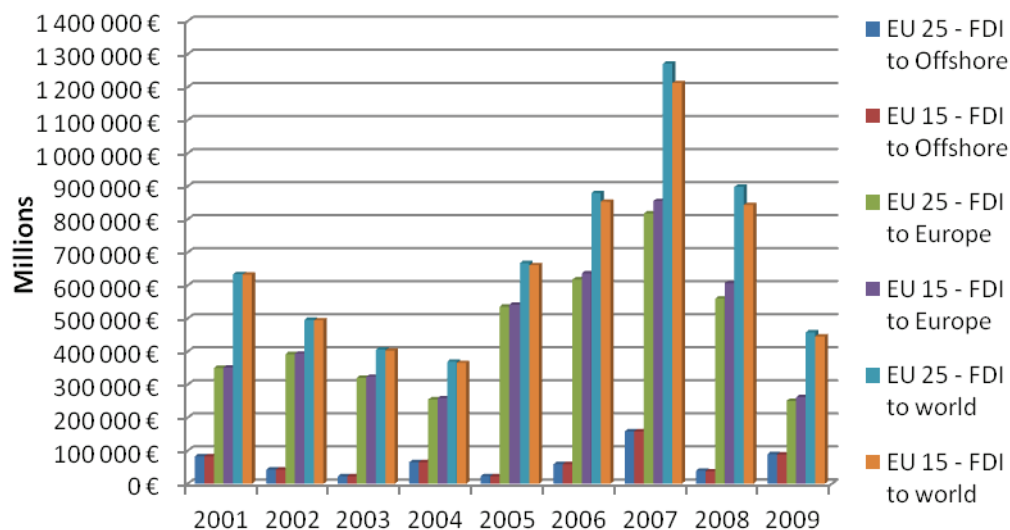
From the Fig. I, there is evident the changes in the effective tax rates when the effective tax rate have fell.

These changes in tax rates have resulted in an increase the movement of capital not only across the European Union. The cause of the increasing mobility of capital, however, was not only fiscal policy, but also an extension of the European Union by other countries in 2004. From Fig. II is quite evident that outflow of mobile capital is mainly from state of EU-15. The most of investment is also concentrated within the European Union. One could generally say, that more than half of the investment remains within the European Union.

As follows from Fig. II, increase of investment was most pronounced in 2007. Since 2008, foreign direct investments fell to below the level of investment of year 2001 except the investments into the offshore financial centres.

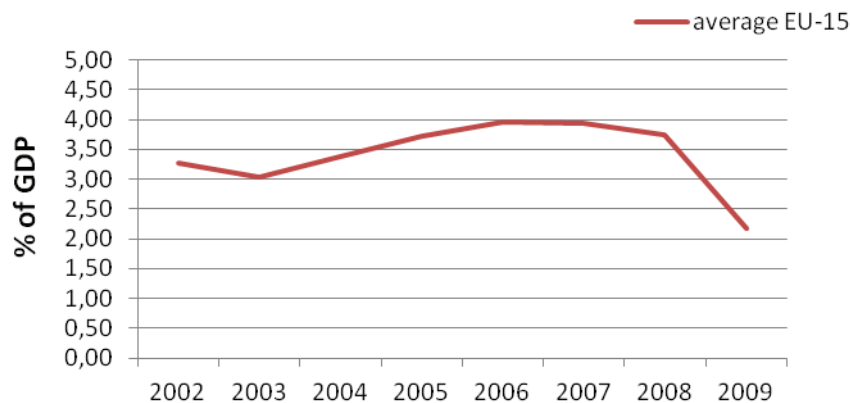
The fall in outflow of capital investment was resulted by economic crisis, but certainly too some extent by fixation of rates and tax reforms of the Member States. Probably, some states were not already enough motive to tax policy which will be attract foreign capital. Many countries have also reformed their tax systems in 2008 to 2009 and expanded tax bases, which the company might not be appealing. As well since 2008, tax rates were not changed in these countries.

What effect has this fact on the threat of race to the bottom? I think no effect because the tax rates have stabilized and are not reduced further. Currently, the Member States recognize that way of tax cutting is not real reasons of debt crisis; however, the states at least try to keep tax rates at the same level or try to expand tax bases. Nowadays, race to the bottom is



2: EU direct investments flows

Source: EUROSTAT database and own editing



3: Tax revenues on corporate income in EU-15

Source: OCED database and own editing and calculation

not evident. This pronouncement can also support the argument that corporate tax revenues in EU-15 were increased in case if the tax rates were cut in the Member States. The turning point is year 2008 to 2009 again, when the corporate tax rates were stabilized and the economic crisis including crisis in the Euro zone impacted on the internal market of the European Union. Since this time, tax revenues markedly fall. However, tax revenues do not fall due to capital outflows from the country, but due to the economic and financial crisis. Development of tax revenues can be seen in Fig. III.

Even though, there is no evidence for the race to the bottom, it is not possible to say clearly, if tax competition is good thing although tax competition may encourage economic activities and investments which may increase economic growth. There is no single solution to problems posed by either harmonization or tax competition within the European Union. On the one hand, tax competition may lead to increased efficiency of public money

and on the other hand the tax coordination may prevent tax evasion and avoidance which are easily applicable within tax competition because the tax systems are not transparency.

From this reason, tax competition requires little action at European level, given the principle of tax sovereignty for Member States in the area of direct taxation. There is certainly scope for exploring measures of tax coordination at European level to reduce distortions or incentives for tax avoidance. Base is the principle of transparency. Exchange of information reduces the scope for tax evasion and increases the scope for effectively countering double non-taxation that arises as a result of mismatches. Other initiative in the framework of coordination in this area is application of general anti avoidance rules (GAAR) and specific anti avoidance rules (SAAR) not only in tax treaties but also in national law. The Member States have a need to partial protect their tax base in their national level against tax evasion and tax avoidance.

SUMMARY

Globalization leads to economic benefits for some countries but may have also many serious negative side effects for others. The increased mobility of economic activities may result in a sharp increase in tax competition between countries. On the one hand, tax competition can have desirable consequences, such as more efficiency, but on the other side it may also have undesirable or harmful consequences, such as race to the bottom. Also, the increasing using of tax havens has resulted in erosion of many countries' tax bases. From the point of view, there is a need to revisiting the debate on tax competition and to answer whether the tax competition is beneficial or harmful.

For this reason, this paper discusses the significance of tax competition in the European Union and deals with the position of tax competition in the European Single Market. This paper discusses an economic purpose of tax competition and discusses about harmful effects of tax competition.

Generally, it is difficult to say if tax competition is fair or unfair. Nevertheless, it is obviously, that tax competition is for some countries good thing but for some countries tax competition means danger of low budgetary revenues. On the one hand, tax competition may lead to increased efficiency of public money and on the other hand the tax coordination may prevent tax evasion and avoidance which are easily applicable within tax competition because the tax systems are not transparency.

Already mentioned, race to the bottom is feared, but nowadays, race of the bottom is not evident, because since 2008, tax rates were not changed in these countries and foreign direct investments decreased. Currently, the Member States recognize that way of tax cutting is not real reasons of debt crisis; however, the states at least try to keep tax rates at the same level or try to expand tax bases.

Also, the article makes clear that Member States have a need to protect their tax bases, especially in time of economic crisis, because the foreign direct investment flows might have negative consequences on the choice of tax revenues. There is certainly scope for exploring measures of tax coordination at European level to reduce distortions or incentives for tax avoidance.

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