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Is Corporate Income Tax Harmonization Possible in an Enlarged European Union?

Abstract

The paper presents evolution of changes in the corporate income tax rates in European Union. Enlargement of the EU generated a serious conflict inside the Union. At a base of the conflict lied significant differences in the CIT rates between the "old" and the "new" EU members. Different explanations for "tax competition" are presented as well as some arguments indicating that CIT harmonization is neither possible, nor advisable at the moment.

1. Introduction

Just after May, 1, 2004, enlargement of the European Union, important controversies arose around significant differences in the CIT rates in the „old" and „new" EU countries. Leaders of the countries with the highest share of public spending in GDP, and the same with the highest tax burdens (Germany, France, Sweden) became to accuse the new EU members of unfair competition due to reduction of the CIT rates. They demanded increasing the CIT rates to adjust them to the average level of the rates in the Western Europe.

Indignation of a part of western society represented in the most heated form by German Chancellor Gerhard Schröder and President of France Jacques Chirac grounds on two arguments. The first one reveals misgivings that the low CIT rates in the new EU countries may accelerate outflow of investment from the West to the East, which may result in weakening the rate of economic growth and in increase in the unemployment rate. The next argument sounds like

a kind of blackmail. The leaders of mentioned countries proposed harmonization of the CIT rates on the EU level. Moreover, they suggest that refusal of acceptation of this idea would result in change of the rules of conferring the structural funds for the new EU member countries.

In the first part of the paper theoretical aspects of tax competition are focused upon and various meanings of the very term are explained. Subsequently, the evolution of CIT system in 'old' and 'new' EU countries is displayed. Finally, arguments, which indicate that CIT harmonization is neither possible, nor advisable at the moment, are presented. The main current problem is to harmonize the rules of legal persons' taxation in an enlarged European Union.

2. Tax Competition. Theoretical aspects, the essence and objectives of tax competition

In literature a conviction prevails that in the conditions of proceeding globalization a government is not able to introduce high tax burdens as producers can easily transfer their economic activity to the countries or regions with lower level of taxation. Does it mean a continuous reduction of tax burdens?

H. W. Sinn's concept (1993) is a typical example of neoclassical view on tax competition. It rests on two basic assumptions of the neoclassical model, namely: 1) perfect mobility of production factors, 2) profit maximization as the main objective for the producers and wages maximization as the main objective for the workers. The most mobile production factors, i.e. capital and skilled workers are able to avoid taxation via migration. As a consequence, according to Sinn, a „race to the bottom" would emerge, ruining competition amongst the countries, which – in an extreme case – would lead to zero tax rate with reference to these production factors. Simultaneously, decrease in government revenues would mean necessity of dramatic cuts in public spending and disturbances with realization of the social fairness rules. For this reason Sinn proposes to increase a role of institutional factors, and to implement centralization and harmonisation of taxes levied on mobile production factors.

Acceptation of more realistic assumptions, as well as observation of taxation trends (rates, effective income burdens, share in GDP) does not confirm the existence of race to the bottom-to zero tax rates.

Sinn's model (1993) should be enlarged by at least three additional assumptions:

1. Flow of production factors (migrations to less-taxed regions) is connected with some costs that should be taken into account and compared with potential advantages resulting from lower tax rate on a given production factor.
2. In a short run both capital owners and skilled workers care not only for current profit (income), but for many other factors as well.
3. Alternative costs of tax reduction should be regarded. For example: if a country diminishes the CIT rate to improve competitiveness of its tax system and to attract foreign capital, it will simultaneously have to limit supply of public goods, such as infrastructure or public administration. This means that, like in a case of production decisions, an optimal level of taxation may be designed as a point of equality of marginal profits of tax reduction with alternative costs of this reduction. Assuming that despite reduction of the CIT rates budget revenues will not decrease, the other taxes, like PIT or VAT should be increased. This, in turn, will reduce disposable income and global demand. Again, alternative cost emerges that should be included into the account. As a consequence, tax rates' competition will never lead to maximal (to zero) reduction of taxes (see Sepp and Wróbel 2003).

Experience of various countries and statistical data on CIT budget revenues, which were gathered at the end of the nineties in 20th century and in the first years of 21st century, prove that, apart from theoretical considerations, there is no real danger of 'race to bottom' (see Siebert 1990). The World Bank's analyses show that, although a corporate tax rate reaches 28-38% and displays an insignificant decreasing tendency, still CIT revenues increased slightly or remained on the same level of 2-3% GDP, reaching a maximum of 3.5% GDP (see World Development Indicators 2004). Transforming countries of Central and Middle Europe are an exception, since decrease in their budget revenues was caused mainly by privatisation and adopted fiscal policy rather than by other factors (see Mitra, Stern 2003).

3. Definitions and their interpretations

Observation by Sepp and Wróbel of hitherto process of tax competition allows to distinguish two forms of this phenomenon:

1. crawling tax competition,
2. unfair tax competition.

The first form means a long run, relatively slow process consisting in gradual reduction of tax rates in particular countries (reduction may be initiated by some countries and imitated by the others). This in turn conduces to drop in the enterprises' tax burdens, which means higher incomes, more financial sources for investment and for introduction of technical progress.

Unfair competition consists in isolated activities of single countries motivated by the only objective-reduction of the CIT rates in order to attract foreign investors. Rapid reduction of the CIT rates in Ireland and in Hungary was treated as an unfair competition (see Hofheinz 2001, Carney 2001, OECD Economic Surveys 2000). Sometimes such activities are called „tax dumping". It is worth mentioning, however, that economic literature explains this concept in different ways. An opinion may be found that reduction of tax rates for all economic agents (both domestic and foreign) is treated as tax competition. However, tax privileges only for foreign investors should be treated as tax dumping (see Krause-Junk).

As a rule, all transition economies, especially at the beginning of transformation process, created strong tax incentives for inflow of foreign capital. There exists an argument to treat this strategy as fair competition rather than as tax dumping. In a case of less developed countries, lower tax burdens with regard to foreign capital may be treated as a risk premium, e.g. remuneration for investment in a country where financial risk is higher.

The objective of tax competition is to increase attractiveness of a country as a place for capital location and/or to stimulate economic activity of the country.

The first aim is strongly exposed in transition economies due to significant impact of direct foreign investment on economic activity in those countries (as observed by Sedmihradsky and Klazar 2002). Thanks to foreign capital, inflow of new technologies and management methods, improvement of financial discipline as well as increase of exports are possible. For this reason, all the countries of Central and Eastern Europe, especially at early stage of transformation, implemented wide range of tax instruments, including tax exemptions or meaningful reduction of tax burdens for the Western investors (for a long period, up to ten years).

The next goal of reduction of tax rates, e.g. stimulation of economic activity of the country, is especially stressed in the Polish literature. L. Balcerowicz in „The White Book of Taxes" initiated a discussion on fundamental reform of a tax system aiming at reduction of taxes. The objectives of the reform pointed in "The White Book" (Biała Księga…1998) were to be as follows:

1. stimulation of economic growth mainly through investment incentives, creation of new jobs, increase in individual work productivity, improvement of skills, higher profitability of legal incomes etc.,
2. higher social confidence in law, elimination of tax abuses, simplification of tax system,
3. adjustment of tax system to the European Union demands,
4. implementation of tax competitiveness, e.g. elimination of outflow of workers, firms, and capital to the countries with more friendly taxation,
5. regard to changes resulting from transformations in other domains of economic life, for example: wider activities of self-governments or health care system reform.

Fundamental tax reform proposed in the White Book (finally: 22% of PIT, 22% of CIT and 22% of VAT rates) has failed. However, pressure of media has brought some results. Since 2004 the CIT rate has amounted to 19%, and the PIT tax payers may optionally choose the way of taxation: 19% rate with no reliefs or general rules.

4. Corporate income tax in the ‘old’ European Union member countries

Tax systems both in Western Europe and in other developed economies base on an assumption of high payment ability of legal persons running their businesses. Therefore, a nominal CIT rate has been very high for many years, in some countries exceeding or approaching 50%. For example, in 1980 the CIT rate amounted to 62.2% in West Germany, 52% in Great Britain, 50% in France and the USA, and 53% in Japan (Jorgenson and Landau). Only in the nineties a tendency towards lowering the CIT rates became clearly visible. However, decrease in the CIT rates is a very slow process (see table 1). Despite a downward tendency, in 2006 the CIT rates in the old EU countries still reached a level of 25-38% (except for Ireland where the CIT rate amounts to 12.5%).

Table 1. The CIT rates in the „old" EU countries (%)

Countries	1992	1998	2000	2003	2004	2005	2006
Austria	39.5	34	34	34	34	25	25
Belgium	39	39	39	34	34	34	34
Denmark	34	34	32	30	30	28	28
Finland	41.5	28	29	29	26	26	26
France	34	36.7	36.7	34.33	34.33	34.33	34.33
Germany	58.5	48.37	42.2	39.58	38.29	38.29	38.29
Great	33	31	30	30	30	30	30
Greece	35	35	35	35	35	32	29
Ireland	40	32	24	12.5	12.5	12.5	12.5
Italy	41.8	37	37	38.25	37.25	37.25	37.25
Luxembour	39	30	30	30.48	30.48	30.48	29.6
Netherlands	40	35	35	34.5	34.5	31.5	.
Portugal	36	34	32	33	27.5	25	27.5
Spain	35	35	35	35	35	35	35
Sweden	30	28	28	28	28	28	26

Source: 1992 and 1998 – OECD (2001) Economic Reviews 1999-2000; 2000 – *European Tax Handbook (2000)*, International Bureau of Fiscal Documentation, Amsterdam; 2003 and 2004 – OECD Tax Data Base, 2005 – K. Wach (2005), *Systemy podatkowe krajów Unii Europejskiej*, Oficyna Ekonomiczna, Kraków, p. 50.

Data in table 2 indicate differences between nominal and effective tax rates in 2001. In many countries effective tax rate was lower than the nominal one merely by a few percentage points (Great Britain, Luxembourg and Finnland). Reduction of differences was a result of recent significant limitation of tax reliefs. However, in Ireland and Italy differences reached almost 10 percentage points.

Table 2. Nominal and effective CIT rates in the EU countries in 2001 (%)

Countries	CIT rates	
	nominal[a)]	effective[b)]
Austria	34.0	27.9
Belgium	39.0	34.5
Denmark	32.0	27.3
Finnland	29.0	26.6
France	36.7	34.7
Germany	42.2	34.9
Great Britain	30.0	28.3
Greece	35.0	28.0
Ireland	20.0	10.5
Italy	37.0	27.6
Luxembourg	30.0	32.2
Netherlands	35.0	31.0
Portugal	32.0	30.7
Spain	35.0	31.0
Sweden	28.0	22.9

Source: [a)] *European Tax Handbook (2001)*, International Bureau of Fiscal Documentation, Amsterdam.
[b)] L. Oręziak (2004), Finanse Unii Europejskiej, PWN, Warszawa, p. 236.

Some experiences referring to fiscal policy of Greece, Ireland, Spain or Portugal-the countries that were joining the Union during succeeding enlargements-may be interesting for Poland. Data from table 3 points at similar fiscal policy of the mentioned countries after accession to the EU despite a fact that they joined the EU in different periods of time. Within a few years after accession a share of public spending as relation to GDP was increasing in each country. This was a result of the following factors:

1. Mentioned countries centred upon activities to improve economic infrastructure, to increase R&D and education expenditures to make their economies more competitive;
2. Social pressure towards unification of social standards to fulfil demands of the European Social Card;
3. Collection of public financial sources necessary to co-finance structural funds obtained from the EU.

All of this brought about a growth of fiscal burdens. However, at the same time it proved high mobilization of the new EU members in order to improve future economic position of a country.

Table 3. Share of public spending in Ireland, Greece, Spain and Portugal before and after accession (% of GDP in current market prices)

Countries	A year before accession to the EU	In a year of accession	Within five years after accession				
Ireland	37,0	36,8	42,5	46,3	45,5	43,1	44,0
Greece	30,6	39,9	39,7	41,5	44,3	48,1	47,9
Spain	42,1	41,7	40,6	40,9	41,8	42,7	43,5
Portugal	43,5	44,6	43,0	43,0	42,9	44,0	45,3

Source: Own calculations based on European Economy. Annual Economic Report 1991–1992, ECSC-EEC-EAEC (1991), Brussels, December, no. 50, p. 265.

5. Corporate income tax in the 'new' European Union member countries

At the beginning of the nineties the CIT rates both in the EU countries and in those that joined the EU in 2004 were quite similar (see table 1 and table 4).

However, Central and Eastern Europe countries implemented a different model of public finance and taxation than Western Europe countries did. They revealed a tendency to rapid reduction of public sector size and to lowering taxes. At an early stage of transformation process all transition economies had to implement incentives stimulating economic activity and increasing their competitiveness in order to attract foreign capital. Tax competition became an important instrument of that strategy. The CIT rate was diminishing. All the countries implemented a wide system of tax reliefs and tax holidays, as well as other incentives for inflow of foreign capital. In some countries tax holidays for foreign investors lasted till 2003, or even longer. Hungary was the first country to introduce cuts in the CIT rates: from 40% to 36%, and to 18% in 1995. Since 2004 the CIT rate there has amounted to 16%.

Table 4. The CIT rates in the "new" EU countries (%)

Countries	1992	1998	2000	2003	2004	2005	2006
Cyprus	25	25	25	25	15	10	10
Czech Republic	55	35	31	31	28	26	26
Estonia	35	26	31.56[a)]	31.56[a)]	31.56[a)]	31.56[a)]	31.56[a)]
Hungary	40	18	18	18	16	16	16
Lithuania	29	25	24	24	15	15	15
Latvia	35	25	25	19	15	15	15
Malta	35	35	35	35	35	35	35
Poland	40	36	30	27	19	19	19
Slovakia	45	40	29	25	19	19	19
Slovenia	30	25	25	25	25	25	25

[a)] concerns redistributed profit, for remaining profit the rate amounts to 0.

Source: Tax Bulletins.

Reformers in the Baltic States paid much attention to entrepreneurship stimulation and attracting foreign capital. Purju (2002) points at that frequent changes in the rules of corporate income taxation evidence this. This is expressed by a gradual reduction of tax rates. Additionally (in Lithuania since 1997, in Estonia since 2000), taxation has referred only to distributed profit or to other transactions that might be treated as a hidden form of profit distribution: fringe benefits, gifts and donations, profit transfers. At the beginning of transition, all the Baltic States implemented significant investment reliefs for foreign investors. At the end of nineties, however, they resigned some of the mentioned reliefs and replaced them with reliefs inducing the investors to locate capital in relatively less-developed regions of a country, being in danger of high unemployment.

Very spectacular reduction of the CIT rates took place in 2004. In Poland the CIT rate diminished from 27% to 19%. Slovakia, Lithuania, Latvia and Cyprus lowered the rates to 15% and to 10% in 2005. Such high reduction of the CIT rates in the countries just accessing the EU may be explained as follows:

1. The new EU members were afraid that enlargement of the Union and openness of borders would result in outflow of capital to more stable economies;
2. Reduction of the CIT rates was to attract foreign investors;
3. The new countries accessing the EU probably assumed that expected inflow of structural funds from the Union would enable improvement of economic

and social infrastructure without a need of severe renouncements, of increase in public spending and the same in tax burdens.

Comparison of previously presented behaviours of Ireland, Greece, Spain and Portugal with attitudes of the new EU members indicates that integration with the EU, instead of mobilizing the new countries to increase their efforts to improve their competitiveness, resulted in rather claim attitudes.

6. Arguments of advocates and opponents of tax competition

At the moment it seems that in an enlarged EU finding a consensus in two questions is becoming more and more important:

1. Is tax competition positive or negative phenomenon?
2. Is it necessary to harmonize the CIT rates or rather co-ordination of the CIT system (unification of both the system construction and the rules of taxation) would be a better solution?

So far, neither theory of economics nor the economic practice gives univocal answer to the first question.

Advocates of tax competitiveness advance the following arguments:

1. decrease of tax rates increases earnings of enterprises, which favours development of entrepreneurship and stimulates economic growth;
2. tax competitiveness leads to tax decrease and extorts rationalization of public expenditures and reduction of accreditation given by national budget;
3. tax competitiveness decreases the influence of politicians and decision-makers on economic life – in the situation in which there would be no pressure on decreasing taxes, they would be willing to rise taxes without any limits and without fears of consequences of their actions;
4. lower taxes compensate for low attractiveness of a given country for foreign investment, for example weak infrastructure, inconvenient location (peripheral location of a country), unskilled labour force, etc.;
5. tax competitiveness favours inflow of foreign investment, which increases chances for development of economy and decreases the gap between more and less developed countries (This is revealed in Baldwin and Krugman's research which indicates that predominance of leading countries over peripheral ones, such as Greece, Portugal and Spain, is diminishing (see Baldwin R. E., Krugman P. 2001).

On the contrary, opponents of tax competitiveness highlight the following dangers connected with the decrease in taxes and ‘race to bottom’:

1. lower budget revenues lead to lowering public goods supply and limiting redistribution of state functions;
2. it diminishes competitiveness of economy (because of lower expenditures on infrastructure, Research and Development and education), which can lead to public discontent and as a result have a negative impact on economy;
3. government can try to compensate decreased budget revenues coming from taxes by increasing tax burdens of less mobile factors of production (for example of work, which leads to the rise of labour costs and can increase unemployment) or by increasing indirect rates (which leads to the decrease of consumer demand);
4. it leads to the outflow of capital abroad and the loss of potential budget revenues (Such capital transfer to a country characterised by a lower tax base means that tax payers behave as ‘free-riders’ who take advantage of public goods in their own country and, at the same time, evade to finance them);
5. according to the capital export neutrality theory, maximum public welfare is reached when economic units not benefit from lower taxes in other countries.

7. Perspectives of the CIT rates harmonization in an enlarged European Union

According to the EU Constitution Act, harmonization of tax rates, definition of tax brackets or a minimum tax rate needs an approval of each EU member. In practice, it would be very difficult to obtain such unanimity. It is almost certain that new members would be against; Ireland and Great Britain would for sure veto this idea.

It is worth to point at a fact that an idea of CIT harmonization does not date to the latest enlargement of the EU. Early in the nineties the Commission of independent experts was appointed, headed by Onno Ruding, an ex-Finance Minister of the Netherlands. The Commission was to deal with harmonization of direct taxes. At the early 1992 the Ruding report was presented. The European Parliament recognized conclusions included in the report as worthy to recommend. The Ruding Commission indicated minimum and maximum levels of the CIT rates at 30% and 40% respectively. Minimum 30% rate was

advised both for accumulated profit and for economic agents with a status of physical persons. Need of harmonization of both a tax base and a system of tax collection was mentioned as well by Kupier (1996). Since 1992 attempts to harmonize CIT have nearly failed. Need of unanimity in voting on tax proposals was stressed as a main cause of mentioned failure. Experts were of opinion that even at majority of voices the Ruding's proposals were not real, as a process of tax harmonization was very arduous and time-consuming. Moreover, it needed lots of legislative changes in tax and accounting regulations in the EU countries. Changes of tax rates within the last decade have pointed at existence of a crawling tax competition.

The next attempts of tax harmonization have failed as well. Code of Conduct for Business Taxation accepted by the EU Council on December 1, 1997, is not a formal document. It is just a set of rules that should be abided to limit a phenomenon of tax competition that is treated as harmful competition. In March 1998 the EU Council appointed another team of experts, headed by Dawn Primarolo, a Treasury Minister of Great Britain. Again, the effects of their efforts were not implemented. It occurred that from amongst 271 investigated tax solutions 66 were essential for localization of economic activity within the EU and were acknowledged as harmful. Member countries were obliged to repeal them; however, due to lack of sanctions, merely nothing has changed within the last years in order to remove harmful regulations (see Patterson 2002: 17-18).

The new EU members found themselves under a pressure of increasing the CIT rates to bring them closer to the rates existing in the old EU countries. A question arises whether the new countries should yield that pressure. We personally think they should not. The following arguments speak in advocacy of our opinion:

1. The CIT rates are just one of the factors influencing competitive advantage of a country. Development of infrastructure, stability of economy, respect to law, efficiency of collecting receivables - are of much importance, too.
2. Level of tax burdens should be correlated with an access to credit and with development of capital market and possibilities of issuing stocks.
3. Poland and other transition economies have different structure of budget revenues in comparison with the old EU countries. High share of indirect taxes, e.g. a structure typical for the countries with “south tax mentality”, is a result of historical and social conditions, high share of underground economy, and low effectiveness of tax administration. Referring to Laffer curve, a hypothesis may be formulated that increase in the CIT rates does not necessarily have to end up with a growth of budget revenues.

4. Countries that joined the EU in 2004 are small as a rule (except for Poland), of secondary importance, out of a center of integration area. As a consequence of this, even preferential tax rates will not significantly grow an inflow of investment from Western Europe.
5. Even if we assumed that thanks to lower CIT rates the new EU members would attract a lot of capital from the EU, we should evaluate it positively, also from a viewpoint of Western countries. It would mean an acceleration of the process of unification of economic development, which would result in lower transfers from rich to poor EU countries (see Kudła 2005).
6. Level of nominal CIT rates is an essential, but not the most important factor determining real tax burdens. Real (effective) tax rate is affected seriously by construction of tax system, especially by tax base, rules of depreciation' calculation, kinds and range of tax reliefs, taxation of dividends on profits transferred amongst different partnerships with capital ties, possibilities of joint accounting of losses in a case of partnerships with capital ties. In reality, combination of decreasing tax rates with wider tax base and reduction of tax reliefs often brings about maintenance of effective tax burdens at the same level. Moreover, they often even grow. Let's take an example of Sweden. Till the eighties tax system in Sweden (like in most of other countries) was grounded on a narrow tax base and high tax rates. A nominal CIT rate amounted to 56%. However, due to a very narrow tax base with lots of exceptions and reliefs, an effective CIT rate reached a level of 20% merely. In the nineties the nominal CIT rate amounted to 28%. Simultaneously, tax base was significantly widened. As a result, the effective CIT rate rose to about 25% (Lodin 2001).
7. Actually observed reduction of the CIT rates and pressure on lowering public spending seem to be a temporary phenomenon (Kudła 2005). It is commonly known that reduction of taxes leads to diminishing supply of public goods. Lowering R&D and education spending would not be a good solution in a long run, because the future of national economy is based on science. It could cause a civilization and economic stagnation. However, a different scenario may be taken into account as well. Some Western Europe countries may, pressed by the new EU members, lower the CIT rates and diminish public spending. Germany is an example of such a country. It is going to lower the CIT rates to increase investment attractiveness of its economy in order to fight high unemployment. Such direction of changes may be unfavorable for the whole EU. It would mean a distinct change of priorities in economic and social policy of the Union.

8. Concluding remarks

Attractiveness of a country and competitiveness of an economy may be improved not only through reduction of taxes. Development of technical infrastructure, growth of R&D spending, higher level of education of society, efficiency of law and public administration are important factors, too. Experiences from Greece, Ireland, Spain and Portugal indicate that a process of accession was usually connected with increase in public spending. Although the mentioned countries joined the EU in different time, in each country public spending grew after accession. The countries made efforts to increase competitiveness of their economies and to collect budget financial sources necessary for supporting structural programs financed from the EU structural funds.

The new EU countries have chosen different direction of evolution of their tax systems. However, the old members of the Union did not approve it. Despite a pressure to harmonize the tax rates, there are some arguments for not accelerating this process.

There is no doubt that rules of corporate taxation should be harmonized. However, reformers should start with unification of basic issues that affect a tax base, namely revenues and costs of obtaining revenues, as the rules of calculation differ across the member countries. This in turn affects the enterprises' effective tax burdens. Unification of the rules of taxation for legal persons is then more urgent than harmonization of tax rates.

Implementation of a uniform tax base will influence the productivity of enterprises, which will cause finance transparency of an enterprise. This will also reduce international accounting costs in corporations which have their branch offices in numerous countries. Therefore, it is logical to uniform tax base. However, opponents of this idea claim that such changes would be the first step taken towards unification of tax systems in all EU countries. Taking into account the fact that tax policy is treated as a key element of national competence of EU members, unification of the tax base will be probably a long-lasting process.

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