FACTA UNIVERSITATIS
Series: **Economics and Organization** Vol. 2, N° 2, 2004, pp. 119 - 125

TAX COMPETITION VERSUS FISCAL INTEGRATION IN EUROPE: A EUROPEAN PERSPECTIVE

UDC 336.22 (4-672 EU)

Klimis Vogiatzoglou

University of Patras, Department of Business Administration
University Campus, 26500 Rio - Patras, Greece

Abstract. *The fiscal aspects of European economic integration have gained relatively little attention and progressed at a very low pace. Although issues of tax harmonization and fiscal integration in Europe have been discussed since the Treaty of Rome, they have recently become a very live and contentious issue. By reviewing briefly the literature, the paper argues that closer co-operation in tax issues – for both indirect and direct taxation – needs to accompany the current state of integration in the EU. Tax competition could undermine economic integration in Europe, while fiscal integration could enhance economic efficiency and economic integration within the common market.*

1. INTRODUCTION

With the completion of the Single European Market (SEM) in 1992 the free movement and mobility of goods, labor, and capital within the whole European economic space have been enhanced sharply. In addition to trade and investment effects, the resulting markets integration of the "1992 program" as well as the increased mobility and exchange of commodities and production factors both have serious implications for the fiscal policies of member states as their tax bases have become increasingly mobile within the European Union (EU).

In fact, this mobility creates fiscal externalities to member countries in the form of migration of national tax bases across countries as a result of tax competition. Furthermore, these externalities affect a broad range of member states' policies and the location of economic activities in the EU. However, while the common market and (thus its fiscal effects) has been institutionally secured, the fiscal aspects of the SEM, have been "temporally" neglected and essentially have been regarded as national competences, where member states confined themselves to the taxation of their national tax base

Received June 10, 2004

without any co-ordination. Thus, despite a particularly high degree of economic integration within the EU, the fiscal aspects of European economic integration have to a large extent gained little attention and progressed at an extremely low pace.

As can be deduced from the preceding paragraphs, the tax competition debate, although in principle global in its magnitude, is especially relevant and salient in the EU context. In fact, the European tax competition-harmonization issue has been on the table since the Treaty of Rome and has arisen recently as a crucial and central economic policy question after the establishment of the Economic and Monetary Union (EMU). However, while competition is considered to be welfare improving and desirable in the private sector, there is less agreement on the tax competition-harmonization debate in Europe. Yet, the question of intra-EU taxation has to be addressed as it affects member countries and the future development of the European economic integration process.

Further on, we review the above-mentioned issues in the EU context and try to link the tax and fiscal competition debate with European integration. Specifically, the paper is organized as follows: Section 2 considers issues of indirect and direct taxation in the European Union and presents the rationale for a move towards greater co-operation, harmonization and integration in fiscal issues between EU member countries. In Section 3 we discuss the implications and the relationship between globalization, tax competition and European economic integration. Finally, Section 4 contents the conclusions.

2. Indirect and Direct (Corporate) Taxation in the Common Market

Since the foundation of the European Economic Community in 1957, there is a perpetual debate going on over the necessity of an overall tax and fiscal co-operation and harmonization in Europe, which recently has been intensified mainly because of EMU. However, concerning this, it may be remarked that the harmonization of commodity taxation was recognized by the "Community" as a long-term goal and laid down in the founding Treaty. Thus, According to Article 99 of the Treaty of Rome (25/03/1957) indirect taxes among member countries have to be brought into accord.

It is widely believed that economic integration requires the removal of barriers and distortions, one of which are the different tax rates and tax systems in a common market. The literature points out and emphasizes the potential welfare gains from indirect tax harmonization [10; 14; 13; 15]. Thus, the free movement of goods and services in the SEM and the proper function of the market itself require the harmonization of indirect taxation.

Although the theory favors commodity tax harmonization, there has been little progress so far towards this direction in Europe. Hence, substantial differences in commodity tax rates still exist so as to cause some distortion. "One of the reasons for its temporary discarding is the worry in some member countries that reduction of indirect taxes would have serious implications for the provision of public goods, and thus welfare in those countries" [13, p. 266]. However, as the recent literature has shown, the above negative welfare effects in terms of public goods provision are avoided when intergovernmental fiscal transfers are allowed [13].

In fact, the progress that has been achieved thus far is the establishment of minimum rates of indirect taxes. Thus, the current system of indirect taxation in the EU is based on the Value Added Tax (VAT) and the destination principle, in which the goods are taxed on the basis of where they are consumed. The minimum standard VAT rate is currently 15%. However, exemptions from this rule apply for a number of commodities (e.g. basic goods and newspapers) in some member states (see Table 1).

On the other hand, differences in direct tax rates are of greater importance as they cause more severe economic distortions. As a result of the increased international mobility of capital, there has been a convergence of nominal corporate tax rates across many EU countries, which witnesses the trend towards more tax competition in the EU (see Table 2). Although the empirical findings support the view of the downward trend of capital taxation in Europe, there is no evidence of a "race to the bottom" [11; 12; 7].

Table 1. Indirect Tax Rates in the European Union (EU-15)

	Indirect tax system	Standard rate (%)	Reduced rates (%)
Austria	VAT	20	10; 12
Belgium	VAT	21	0; 1; 6; 12
Denmark	VAT	25	0
Finland	VAT	22	0; 8; 17
France	VAT	19,6	2,1; 5,5
Germany	VAT	16	7
Greece	VAT	18	4; 8
Ireland	VAT	21	4,3; 13,5
Italy	VAT	20	0; 4; 11
Luxembourg	VAT	15	3; 6; 12
Netherlands	VAT	19	0; 6
Portugal	VAT	19	5; 12
Spain	VAT	16	4; 7
Sweden	VAT	25	0; 6; 12
United Kingdom	VAT	17,5	0; 5

Note: tax rates on 01/05/2003 *Source:* [4].

In general, taxation distorts the optimal allocation of resources, but the negative effects are stronger when the same economic activities are taxed differently (different tax systems and tax rates) as currently practiced in the EU. A neutral tax system would not distort economic choices and activities and thus would not cause misallocation of resources. By contrast, it would enhance economic efficiency. In fact, even within a country no tax system is perfectly neutral in its effect and it is less likely to be at an international setting.

However, the literature on optimal taxation on capital for a union or group of countries shows that economic (production) efficiency is achieved when capital export neutrality holds, that is when all countries face the same effective taxation regardless of the location of the investment (production) within this group [8; 3].

Table 2. Top Corporate Tax Rates in the European Union-15 (%), 1995-2001

	1995	1996	1997	1998	1999	2000	2001	Difference 2001-1995
Austria	34,0	34,0	34,0	34,0	34,0	34,0	34,0	0,0
Belgium	40,2	40,2	40,2	40,2	40,2	40,2	40,2	0,0
Denmark	34,0	34,0	34,0	34,0	32,0	32,0	30,0	–4,0
Finland	25,0	28,0	28,0	28,0	28,0	29,0	29,0	4,0
France	36,7	36,7	36,7	41,7	40,0	36,7	36,4	–0,2
Germany	56,8	56,7	56,7	56,0	51,6	51,6	38,3	–18,5
Greece	40,0	40,0	40,0	40,0	40,0	40,0	37,5	–2,5
Ireland[1]	40,0 / 10	38,0 / 10	36,0 / 10	32,0 / 10	28,0 / 10	24,0 / 10	20,0 / 10	–20
Italy	52,2	53,2	53,2	41,3	41,3	41,3	40,3	–11,9
Luxembourg	40,9	40,9	39,3	37,5	37,5	37,5	37,5	-3,4
Netherlands	35,0	35,0	35,0	35,0	35,0	35,0	35,0	0,0
Portugal	39,6	39,6	39,6	37,4	37,4	35,2	35,2	–4,4
Spain	35,0	35,0	35,0	35,0	35,0	35,0	35,0	0,0
Sweden	28,0	28,0	28,0	28,0	28,0	28,0	28,0	0,0
United Kingdom	33,0	33,0	31,0	31,0	30,0	30,0	30,0	–3,0
EU-15 Mean[2]	38,02 / 36,02	38,15 / 36,28	37,78 / 36,04	36,74 / 35,27	35,86 / 34,66	35, 30 / 34,36	33,76 / 33,09	–4,26 / –2,93
St. Deviation[2]	8,12 / 10,84	7,91 / 10,74	8,00 / 10,76	6,91 / 9,74	6,40 / 9,10	6,63 / 8,92	5,46 / 7,49	–2,66 / –3,35

[1]The 10% rate is applied to many manufacturing and service-related activities until the year 2010.
[2]The average and standard deviation for the EU-15 is calculated for both tax rates of Ireland.
Source: [5] and own calculations.

Thus, "in a union aspiring to free trade, such as the European Union, the goods produced in any country should be burdened with the same tax rates in order to allow suppliers to produce the goods where the real resource costs are lowest. Harmonization thus favors economic competition by easing the mobility of firms and workers across jurisdictions" [6, p. 336]. It has to be noted that, the free movement of goods and factors of production in the SEM, which increases the mobility of these items to a significant extent, gives the opportunity and makes it easier to member countries - as opposed to non-members - to take advantage of this fact by undercutting tax rates in order to attract capital and high-skilled labor (human capital) at the expense of other member countries. As a consequence, there is a distortion of competition in the production and the market place.

Tax competition changes the cost structure of production (location), which is not achieved by advances in technology and increased productivity, but on the contrary by administrative regulations (lower tax rates). Economic efficiency would require that companies must face the same effective tax rate wherever it locates in the EU [2]. Furthermore, the theoretical literature on capital tax competition[1] – which however makes restrictive assumptions, has a relatively simplistic lay-out and abstracts from the specific situation and realities of the EU – predicts the "race to the bottom" process of tax rates and the inefficiently low level (supply) of public goods as a result of tax competition, and thus prescribes more or less some form of tax harmonization or co-operation.

However, among economists there is no consensus over the necessity of fiscal-tax harmonization. One line of argument stresses the advantages of tax competition in terms of economic welfare gains that arise from the efficient use of public resources and the Pareto-efficient allocation of public goods [1; 9]. The other view is that tax competition could lead to a "race to the bottom", which in turn could lead to a sharp reduction of government revenues and public goods [16; 17; 18].

This lack of consensus is also reflected by the reluctance of EU governments to come into an agreement on capital tax rates and by the slow development of corporate tax harmonization in Europe so far. In particular, early attempts to harmonize tax systems of member states have not been successful. Recent initiatives, which mark a new approach of harmonization attempts, seem to be more promising. Specifically, in December 1997, the Ecofin Council agreed on a tax policy package, which had been proposed by the European Commission and included a "Code of Conduct" for corporate taxation in the EU so as to tackle "harmful tax competition". However, the resulting measures of this approach are less binding to members.

3. Globalization, Tax Competition and European Integration

It is a fact that the high and increasing international mobility of capital is not only a European but also a global phenomenon, associated with the ongoing globalization process. Thus, the current tax competition issue in Europe is part of a wider question of economic policy in a constantly changing and integrating world economy.

Yet in view of EMU and EU enlargement, there is a question of how the present applied regulations in the field of EU taxation could be further developed so as to, on the one hand, face the increasing pressure of globalization and tax competition, and, on the other hand, remove another obstacle to free cross-border activity in the SEM (completing thus the integration of the market) and foster economic integration in Europe. A satisfactory reply presupposes the examination of at least two issues, namely: 1) whether globalization and European economic integration are in some sense complementary or rival to each other, and 2) whether tax competition in Europe subserves the integration or disintegration among EU states.

Although it may seem that globalization – as a process of global economic integration – includes European integration, the latter is a process of regional economic integration with objectives such as the avoidance of the "adverse effects" of globalization and international competition for members via the enlarged and more favorable economic space (which is institutionally assured), and the continuous deepening of economic integration,

[1] For an excellent presentation of the theoretical tax competition literature, see [19].

co-operation and socio-economic cohesion among member countries.[2] It is obvious that, on the one hand, economic integration in Europe exhibits a much higher degree of integration and moves towards a deeper and more complete form of economic integration than the globalization process induces, and on the other hand, that the objectives of those two integration processes are quite different for a number of issues.

Particularly, this means that tax competition is not a problem for the globalization process itself, where the integration among the world's economies is much weaker. By contrast, within the European Union fiscal externalities arising from intra-EU tax competition are more significant. Furthermore, tax competition among EU states is in contrast with the objectives of European economic integration as indicated by official EU documents and treaties. The tax competition phenomenon and the recent trend of undercutting corporate tax rates in the EU have not been induced by the requirements of the European economic integration process. It is rather the result of the general trend of falling corporate taxation in the world economy.

Finally, it has to be stressed that the current situation – with 25 different tax systems in the SEM and without any co-ordination among member economies – could undermine the process of economic integration in the EU or even cause a trend towards disintegration in Europe.

4. Concluding Remarks

From the preceding discussion it should become clear that the current EU tax system – for both indirect and direct taxation – constitutes a temporary solution and it is at transitional stage. In fact, the different tax systems in the SEM create a diverse and chaotic picture in the field of EU taxation, which cannot be in accordance with the current state of integration. On the other hand, the response to increasing economic integration and tax competition in Europe cannot be simply tax harmonization. As emphasized by the literature, in certain cases such a development would have negative welfare effects for some members and does not fully address the fiscal aspects of the integration process. However, it lays the foundation for closer co-operation in the tax field and paves the way for fiscal integration in the EU.

References

1. Boss, A., "Do We Need Tax Harmonization in the EU?", *Kiel Institute of World Economics Working Paper*, No. 916, 1999.
2. Devereux, M. and Pearson, M., "Corporate Tax Harmonisation and Economic Efficiency", *Institute of Fiscal Studies Report Series*, No. 35, 1989.
3. Dutton, J., "The optimal taxation of international investment income: A comment", *Quarterly Journal of Economics*, vol. 46, pp. 373-380, 1982.

[2] According to Article 2 of the Treaty of Rome "it shall be the aim of the Community, by establishing a Common Market and progressively approximating the economic policies of member states, to promote throughout the Community the harmonious development of economic activities, a continuous and balanced expansion, an increased stability, an accelerated raising of the standard of living and closer relations between its member states."

4. European Commission, *VAT rates applied in the member states of the community,* Directorate-General for Taxation and Customs Union, Luxembourg, 2003.
5. European Commission, *Structures of the Taxation Systems in the European Union,* Directorate-General for Taxation and Customs Union, Luxembourg, 2003.
6. Frey, B. and Eichenberger, R., "To Harmonize or to Compete? That's not the Question", *Journal of Public Economics*, vol. 60, pp. 335-349, 1996.
7. Griffith, R. and Klemm, A., "What has been the Tax Competition Experience of the last 20 Years?", *IFS Working Paper*, No. 04/06, 2004.
8. Horst, T., "A note on the optimal taxation of international investment income", *Quarterly Journal of Economics*, vol. 44, pp. 793-798, 1980.
9. Janeba, E. and Schjelderup, G., "Why Europe Should Love Tax Competition – and the US Even More So", *NBER Working Paper*, No. 9334, 2002.
10. Keen, M., "Pareto-improving indirect tax harmonization", *European Economic Review*, vol. 33, pp. 1-12, 1989.
11. Kenneth, S. and Webb, M., "Capital Taxation, Globalization and International Tax Competition", *Econometrics Working Papers*, No. 0301, University of Victoria, 2003.
12. Krogstrup, S., "Are Corporate Tax Burdens Racing to the Bottom in the European Union?" *EPRU Working Paper*, No. 04-04, 2004.
13. Lahiri, S. and Raimondos, P., "Public good provision and the welfare effects of indirect tax harmonization", *Journal of Public Economics*, vol. 67, pp. 253-267, 1998.
14. Lockwood, B., "Can commodity tax harmonization be Pareto-improving when governments supply pubic goods?", *Journal of International Economics,* vol. 43, pp. 387-408, 1997.
15. Lopez-Garcia, M., "On the welfare and revenue effects of indirect tax harmonization", *Economics Letters*, vol. 60, pp. 185-193, 1998.
16. Musgrave, P. and Musgrave, R., "Fiscal Coordination and Competition in an International Setting", in: McLure, C.; Sinn, H.-W. and Musgrave, P. (ed.), *Influences of Tax Differentials on International Competitiveness*, Deventer, 1990.
17. Sinn, H-W., "Tax Harmonization and Tax Competition in Europe", *European Economic Review*, vol. 34, pp. 489-504, 1990.
18. Sinn, H-W., "The Selection Principle and the Market Failure in Systems Competition", *Journal of Public Economics*, vol. 66, pp. 247-274, 1997.
19. Wilson, J.D., "Theories of Tax Competition", *National Tax Journal*, vol. 52, pp. 269-304, 1999.

PORESKA KONKURENCIJA VS. FISKALNA INTEGRACIJA U EVROPI: EVROPSKA PERSPEKTIVA

Klimis Vogiatzoglou

Fiskalni aspekti evropske ekonomske integracije privlačili su relativno slabu pažnju ekonomskih analitičara. Mada su se pitanja harmonizacije poreza i fiskalne integracije u Evropi javila još od sporazuma u Rimu, još uvek su vrlo aktuelna i sporna. Uz kratak osvrt na literaturu iz ove oblasti, autor iznosi tvrdnju o neophodnosti veće saradnje na području poreske politike - u pogledu direktnog i indirektnog oporezivanja - u okviru postojećeg stepena integracije u EU. Poreska konkurencija bi trebalo da narušava tokove ekonomske integracije u Evropi, dok fiksalna integracija treba da uveća ekonomsku efikasnost i ekonomsku integraciju unutar jedinstvenog tržišta.