



Effects of Tax Competition on the Economy of EU Member States

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ABSTRACT

This paper aims to analyze the concept of fiscal competition and the goals pursued by the authorities to stimulate the increase of budgetary efficiency. Fiscal competition stimulates economic activity by releasing investments and reducing the profit available for reinvestment by the fact that shareholders' investment income is heavily taxed. Next, the main causes of fiscal competition are identified, the analysis focusing mainly on the impact of globalization, and finally the effects of competition on economic factors, but also those of a political nature are analyzed. Tax competition can be seen as a way to gain global competitiveness. States compete with each other to attract foreign investment. Without fiscal competition, governments could engage in monopoly behavior by charging excessive taxes. As there is pressure to reduce tax rates and budget spending, tax competition can be considered a very important factor in supporting the development of the world economy. With the economic downturn, fiscal policy has been viewed with more interest, as it was expected to be effective in the economic recovery.

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1. Introduction

Through this paper, I set out, starting from the concept of fiscal policy and the role it plays in the States' economy, to analyze the realities and challenges currently facing the EU institutions to find the best solution to ensure a fair tax system for all citizens and all businesses in the Union, to prevent tax fraud and evasion, thus encouraging the free movement of persons and capital, increasing the number of secure cross-border transactions, thus ensuring effective coordination of the functioning of the single market. Given the current situation in the European Union (socially, economically, financially, and medically) still in the midst of the pandemic crisis, with major implications in all areas of society and with complex manifestations in all Member States, taking into account the sovereignty Member States regarding the tax system but also the isolated tax measures taken by the EU through the issued directives, I consider it appropriate and impactful to present (with pros and cons) the current paradigm of competition or cooperation between states on fiscal policies adopted and applied to all participants in the European single market.

Thus, this research aims to answer the question: "tax battle or reasonable support amongst the Member States of the EU"?

Fiscal clash is an ongoing research area in the perspective of quickening the globalization process. This topic directs a significant space in the European Union, illustrated by a high amount of economic assimilation, single currency, and freedom of movement of goods, services, people, and capital. However, there have been few approaches to define this concept.

Tannenwald (1999), in the Encyclopedia of Tax Policy, states that: "Governments engage in explicit tax competition when they establish tax regulations specifically designed to increase the attractiveness of jurisdiction for businesses, residents, the workforce, or consumers. Governments engage in implicit tax competition when they change some fiscal policy objectives to mitigate the effects of competition from other governments".

Keen (2008) outlines tax clash as "a strategic tax context, in the broader context of non-cooperation between tax jurisdictions (countries, states or regions in a federation), in which each sets some parameters of the tax system according to the taxes applied by the others".

This paper first outlines general issues regarding tax competition and its positive and negative effects, followed by a comparison between harmonization and tax competition. I also addressed the impact of fiscal competition on the size of the public sector.

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2. Fiscal policy and the impact of fiscal reforms on the economy

Fiscal policy designates the concept, procedures, and achievements of the state regarding dues and their function in shaping the budget's incomes and the funding of budget disbursements, categories of taxes, their collection and use as an instrument to promote economic augmentation. Fiscal policy can be defined by the way in which budget expenditures and taxes are used to influence the national economy.

2.1 Fiscal policy instruments

The most well-known fiscal policy instruments are taxes. These can be direct or indirect. Taxes and duties provide the sources for payments at the community level. At the same time, they are a common contribution and are paid by individuals, regardless of gender, age, nationality, race, and profession. Everyone pays taxes, even those who do not earn money or who do not own property.

Taxes are imposed and collected by the state to finance the delivery of public commodities and amenities that meet public needs. Luxury goods are usually taxed more (and sometimes include additional taxes and duties, such as excise duties). Goods for basic necessities are taxed less, which makes them more accessible to everyone. We can define the tax as a mandatory payment made to the state, which does not have a direct and immediate benefit for the payer, but which, instead, is used to meet public needs. Fiscal procedure, as a fundamental part of the state's economic strategy, contains the suite of methods, procedures, principles concerning operations, reports, organizations, and detailed guidelines for instituting and gathering taxes, fees, and subsidies, materializing the possibilities of the state, at some stage, in this domain. Fiscal policy can be analyzed, compared, and understood only considering the following factors: the state and level of development of the respective national economy. It was pointed out, for example, that the level of taxes differs from one state to another in relation to their degree of development. This factor also determines the ratio between direct and indirect taxes, the ratio between wealth and income taxes, the ratio between the public and the private sector, the level of citizens' income, the needs of the state budget. The level and structure of taxes differ greatly from country to country depending on the structure and extent of needs covered by the state budget: where spending on education, health, culture is important and state involvement in these areas is important, revenue mobilized to the budget state is higher and therefore taxes will be higher. The overall ratio of taxes to GDP, i.e., the number of dues and net social subsidies as a ratio of gross domestic product, was 41.1% in the European Union (EU) in 2019, downwards from 2018. In the euro region, tax incomes represented 41.6% of GDP in 2019, being unaffected compared to 2018. The tax-to-GDP ratio fluctuates notably between Member States, with the peak share of duties and social taxes in France (47.4%), Denmark (46.9%) and Belgium (45.9%), followed by Sweden (43.6%), Austria (43.1%), Italy (42.6%) and Finland (42.3%). On the other hand, Ireland (22.7%) and Romania (26.8%), ahead of Bulgaria (30.3%), Lithuania (30.4%) and Latvia (31.3%) recorded the lowest rates. Compared to 2018, the tax / GDP percentage augmented in twelve Member States in 2019, and declined in thirteen Member States, mainly in Belgium, Greece, Sweden, and France, where it fell from 48.2% to 47.4%.

2.2 Tax competition in the EU through tax rates

At EU level, the profit tax rates at the time of writing were:

Table 1. The profit tax rates at EU level

	<i>State</i>	<i>Profit tax rate (main)</i>	<i>Remarks</i>
1.	Austria	25%	A decrease of 24% in 2023 and 23% in 2024 is proposed
2.	Belgium	25%	A 20% quota is applied to SMEs for a threshold of 100,000 euros
3.	Bulgaria	10%	
4.	Croatia	18%	For enterprises with incomes of less than 7.5 million kuna (approximately 1 million €) a percentage of 10% is applied
5.	Cyprus	12,5%	
6.	Czech Republic	19%	
7.	Denmark	22%	For oil and gas enterprises the share is 25%
8.	Estonia	14-20% on dividends paid by companies	There is no actual profit toll
9.	Finland	20%	
10.	France	26,5%; 27,5%	From January 1, 2023 - 25%
11.	Germany	30-33%	A combination of taxes, results in a share between 30 and 33% depending on the enterprise's headquarters
12.	Greece	22%	
13.	Hungary	9%	There are several tax rates, applied in various fields

			of activity
14.	Ireland	12,5%	
15.	Italy	24% + local quotas	Financial enterprises are taxed at 27.5%; local rates vary between 3.9-5.9%
16.	Latvia	20%	The actual share is 25%
17.	Lithuania	15%	There are different tax rates (0%, 5% in for certain enterprises in several fields of activity); 20% for financial companies
18.	Luxembourg	17% + other local quotas	There are different levels of taxation, starting from 15%. Municipal taxes and a solidarity surcharge are added
19.	Malta	35%	
20.	Netherlands	25%	There is a quota of 15% for a threshold of 245,000 euros, above this level the quota is 25%
21.	Poland	19%	
22.	Portugal	21%	There is a 17% quota applied to SME type companies for a first level of 25,000 euros; for high profit levels various rates up to 31.5% can be applied
23.	Romania	16%	There are several tax rates for some categories of entrepreneurs: SMEs, PFA, copyrights
24.	Slovakia	21%	A reduced rate of 15% applies to micro taxpayers
25.	Slovenia	19%	
26.	Spain	25%	For banking institutions, the rate is 30%
27.	Sweden	20,6%	

Source: https://ec.europa.eu/taxation_customs/taxation-1/eu-tax-policy-strategy_en

Figure 1 highlights the tax rates. These quotas differ significantly across the 28 EU Member States. When the income tax in Hungary was reduced to 19%, this led Austria to lower it from 34% to 25%. Poland has also reduced this tax from 27% to 19%. The lowest nominal tax rate is 10% and is recorded in Bulgaria and Cyprus. These are followed by Ireland with a share of 12.5%, Latvia, Lithuania with 15% and Romania with 16%. All of them have nominal shares below the EU28 average, which is 22%. At the opposite pole with the highest nominal corporate tax rate is Malta with 35%, followed by France with 33.33%, Belgium with 33% and Spain with 30%.

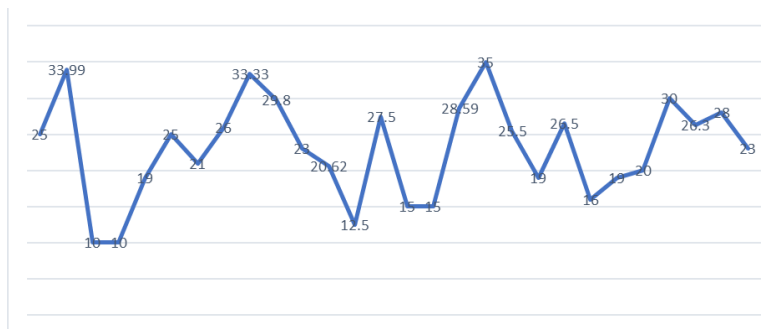


Figure 1. Combined share of corporate income tax (%)

Source: Personal processing based on the data from Table 1

Figure 2 compares nominal and combined corporate duty rates in the EU28. The merged shares include, in addition to the nominal quota, the one benefiting from the central authority and the percentage quotas of profit due to local authorities, as well as certain surcharges. The largest difference is in Germany, from 15% for the central authority to 29.8% for the combined quota, which includes 14% for the local authorities. Belgium also has a crisis surcharge of 3%, which benefits only the central authorities, with a combined share of 33.99%. In Hungary, the combined share is 22.62% and includes, in addition to the nominal share of 19% and 2% for local authorities. Portugal has a local profit share of 1.5%, reaching a combined share above the EU28 (23%) average of 26.5%.

Savings with a low tax rate are not necessarily a model for other economies. Companies understand the need to pay taxes and the fact that collecting taxes is not an easy task for the Government. The government has a responsibility to use taxes, to achieve economic and social goals, and to improve the infrastructure and quality of life of its citizens, who in turn will benefit from the activities of companies.

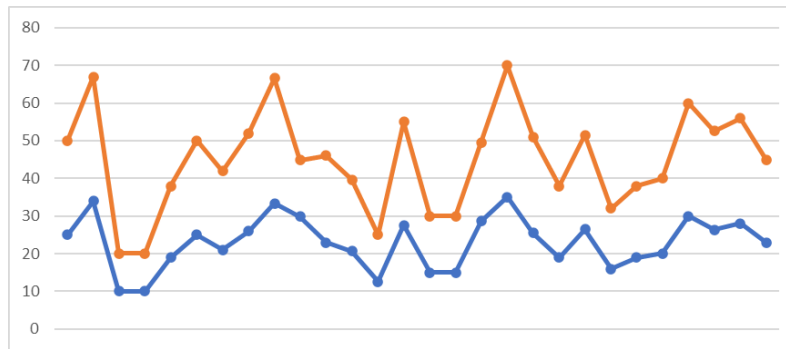


Figure 2. Nominal (blue) and combined (orange) corporate tax rates in EU 28

Source: Personal processing based on the data from Table 1

The new VAT regulations from July 1st, 2021, have a key effect on customs authorities as well. In 2018, Hungary and Ireland conveyed tough opposition to any attempt to standardize corporate and other tax rules in the European Union, declaring that such actions would affect competition in the single market. Hungary, which depends heavily on foreign financing to sustain its economy, has the tiniest corporate tax rate in the EU at 9%, while Ireland's share of 12.5% is the same through the lowest of the 28-member community.

The EU countries with the uppermost standard VAT duties are Hungary (27%) and Croatia, Denmark, and Sweden (all at 25%). Luxembourg has the lowest standard VAT duty at 17%, followed by Malta (18%) and Cyprus, Germany, and Romania (all at 19%). The EU's average VAT duty is 21%, six percentage points greater than the standard minimum VAT rate imposed by EU regulations.

Several countries have implemented temporary changes to the VAT rate due to COVID-19. Reducing VAT taxes on commodities and services sold by impacted industries, especially the economic consequences of the pandemic, such as the hospitality sector, were the most frequent. Two EU countries have taken a wider approach: Germany has diminished its standard VAT rate from 19% to 16% and the reduced VAT rate from 7% to 5% from July 1st to December 31st, 2020. Ireland has decreased the standard VAT rate from 23% to 21% from September 1st, 2020, to February 28th, 2021.

2.3 The positive effects of tax competition

Competition between governments can also have positive effects, and we will continue to highlight the factors that increase efficiency in the public sector. The main positive effects are:

- Impact of taxes;
- Concentration of production;
- Impact on the size of the public sector;
- Increasing budget efficiency;
- Stimulating economic activity.

The impact of taxes (reducing the vulnerability of taxpayers to their exploitation of the state) is manifested outside the community, occurring in the situation where taxes imposed in one community have as final supporters residents of other communities (tax exporting). Also, a transmission of the tax burden is the taxation of capital income of non-resident investors. "Thus, local public authorities that impose taxes that lend themselves to the phenomenon of repercussions will tend to oversize the volume of local public services provided, as consumers will perceive that they have a lower cost."

As the share of assets held by residents increases because of the globalization process, their fiscal pressure will automatically increase. This leads to an unjustified increase in public spending. In this case, competition between governments to attract mobile factors can have a positive impact by limiting these trends. In conclusion, tax competition has a fairly high potential to produce beneficial effects.

Concentration of production is a phenomenon that takes place in developed countries. Thus, the public goods made available to the citizens are in a larger volume, which is why the taxes paid by them are higher, compared to the less developed countries.

The impact on the size of the public sector is the most important positive effect of tax competition and many theories have developed its implications.

The theory of public options explains the natural tendency of unjustified growth of the public sector. Theorists point out that government officials do not make decisions that maximize the well-being of citizens, but rather maximize their own well-being. Thus, the public sector is constantly seeking to maximize revenues from the private sector. Buchanan and Brennan demonstrate that "competition between governments, as well as competition from the private sector, limits the state's ability to strengthen its control over the economy."

However, even if in theory the tax competition leads to the well-being of citizens, in practice everything is not as well defined and perhaps because politicians continue to make negative decisions for the economy, through spending that only leads to budget deficit. Thus, tax competition remains an indirect way to bring efficiency to the public sector.

Increasing budget efficiency is stimulated by fiscal competition, as the taxpayer has the best services at the lowest cost. However, the state must not waste its resources, it must manage them carefully, because the increase in expenditures automatically leads to a reduction in the budget.

The stimulation of economic activity takes place by releasing investments from part of the tax burden. Thus, there is no longer a constant fear of saving and increasing available capital or heavily taxed dividends.

2.4 The negative effects of tax competition

Adverse effects refer to:

- Producing a suboptimal level of public goods;
- Erosion of budget revenues;
- Shifting the tax burden of less mobile tax bases;
- Distortion of resource allocation;
- Inducing strategic interactions between tax authorities.

The production of a suboptimal level of public goods is due to the intensification of fiscal competition, which reduces the tax burden on taxpayers, but in this way public spending cannot be fully covered in the long run.

The erosion of budget revenues leading to large efforts to reduce the budget deficit is a delicate issue in the European Union.

The main causes of this effect are: the reduction of the revenues from the taxes on the mobile tax bases, because of the reductions of the tax rates; the flow of factors of production coming from countries with high tax rates to countries with lower taxes; the reallocation of the movable factors of production can negatively affect the remuneration of the immovable factors, with the consequence on the additional erosion of the tax bases.

However, this phenomenon has manifested itself in very few countries, especially with economic problems, which have developed an aggressive fiscal competition, in the idea of attracting large investments. Shifting the tax burden on less mobile tax bases with social repercussions. To compensate for the budget losses due to the decrease in the tax burden of taxpayers, caused by the existence of fiscal competition, governments are trying to find solutions. A first idea is to increase indirect taxes, but at the level of the European Union countries their level is already high, especially in the case of excise duties and customs duties.

Distorting the allocation of resources by influencing investment location decisions. This effect has often been challenged, as tax competition is not the main factor in attracting investment space, but it is also the proximity of consumers, cheap labor, their professional qualifications, infrastructure costs, etc. However, many studies have shown that lower tax rates have increased investment.

The induction of strategic interactions between tax authorities, an effect known as *race to the bottom*, refers to the establishment of the lowest possible levels of tax rates. Discussions about the inefficiency of governments in competing for capital have led to the emergence of models that express this phenomenon, but it is not empirically documented. A study conducted in 2004 by Ruud de Mooji highlighted the situation in the European Union. Thus, a 10% increase in tax rates in neighboring countries leads to an 8% increase in tax rates in European countries.

2.5 Materialization of the fiscal competition' effects

The manifestation of these effects of fiscal competition depends on a multitude of factors, which the literature has gradually highlighted:

- Availability of alternative mechanisms that can replace taxes as a tool to attract capital;
- Asymmetries between countries in terms of size and endowment with resources;
- Concentration of production in certain geographical areas;
- The existence of economies of scale in the supplying of public commodities and amenities;
- Possibility of cross-border compensation for tax losses;
- Providing the public sector with inputs that reduce the private cost of production.

2.6 Measures taken to prevent tax competition

The creation of the Single Market and the emergence of the Monetary Union have led to differences in national tax systems, which have a growing influence on economic decisions taken by individuals and legal entities. Member States and the European Commission have tried to prevent the negative effects of tax competition, especially the migration of national tax bases, as a result of companies moving to another state in search of the most favorable tax regime. Even if such competition can have beneficial effects by limiting governments from taxing and spending, it still distorts the structure of the tax.

The main measures taken by the European Union in the fight against harmful tax competition are known as the "Monti Package", adopted in 1997. These were:

- The measures included in the Code may operate based on the nominal tax rate, the tax base or any

- other relevant factor;
- Elimination of distortions in the taxation of capital income, a minimum level of interest taxation is established;
- Measures to eliminate withholding taxes on cross-border interest and royalties paid between companies;
- State tax aid.

3. Conclusions

As a wrap-up, I consider that the research issue has been sufficiently debated with solid arguments on both levels but that, now, there is no single model for applying taxation in the EU, the ideal model being far from being identified and applied.

Fiscal competition is undoubtedly a topical research topic, especially in the perspective of hastening the procedure of globalization and digitalization. This subject is becoming progressively important in the European Union, which is depicted by a prominent degree of economic integration, a single currency and the free movement of merchandises, services, people and capital.

Therefore, tax clash and the principle of cooperation between Member States lead to a reduction in taxes on movable factors, a reduction in the volume of public services and, finally, an augment in the proficiency of using public funds.

The negative effects associated with this phenomenon, discussed in countless studies, seem to be insignificant for the well-being of citizens, but to gain economic efficiency, states must protect themselves against the risk of eroding tax bases. The growing financial instability in the world must be considered. For this reason, harmonizing direct taxes, and especially those on capital income, could be a beneficial solution.

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