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Tax Competition – Areas of Display and Effects

By

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Abstract:

In the past, governments had more freedom in setting their taxes as the barriers to free movement of capital and people were high. The gradual process of globalization is lowering these barriers and results in rising capital flows and greater manpower mobility. Tax competition exists when governments are encouraged to lower fiscal burdens to either encourage the inflow of productive resources or discourage the exodus of those resources. With tax competition in the era of globalization politicians have to keep tax rates "reasonable" to dissuade workers and investors from moving to a lower tax environment. Most countries started to reform their tax policies to improve their competitiveness. However, the tax burden is just one part of a complex formula describing national competitiveness. The other criteria like total manpower cost, labor market flexibility, education levels, political stability, legal system stability and efficiency are also important.

Introduction

The concept of "tax competition" was introduced by Charles Tiebout (1956) and started from the idea of the existence, for public assets, of the equivalent for the markets of public assets. As a consequence, the taxpayers should opt for those residences which offer them the combination of public assets and tax rates (meaning the prices of public assets), which would satisfy most of all their preferences. In their turn, the tax authorities shall try to attract the taxpayers within their own jurisdictions, giving them the combination tax rates – public assets, as they wish, until reaching an optimum dimension of the base assessment, meaning that which allows the minimization of the cost for the provided public assets.

The analogy with the competition between the private economic agents can be looked at in the shape of two hypotheses. On one hand, it can be

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translated as a “race” towards the cost reduction, which is equivalent to the rise of the efficiency with which the public funds are spent, and on the other hand, it can be noticed an effect of “limiting the waste”, by offering an attractive combination of prompt and reliable delivery of the public assets, for a price which would not exceed the level necessary for covering the costs and obtaining a reasonable profit.

Tax competition displays especially regarding the attraction of:

- direct foreign investments, considered as being more and more important for generating workplaces in the countries of the European Union;
- mobile financial capital (portfolio investments), useful for financing the investments, for strengthening the financial markets and obtaining comparative advantages in delivering financial services;
- financial flows inside-company, which can be channeled towards the own tax jurisdiction by attracting those corporate functions used for the international transfer of the profits;
- workforce with high professional skills.

Tax competition presents both advantages and disadvantages. Low tax rates may stimulate economy and, under the proper conditions, may increase the finances at the budget. But if they are too low, these may be harmful for the finances at the budget and may endanger the public assets, such as infrastructure, education and health.

Positive effects of tax competition

One says that tax competition is capable of generating important ***positive effects.***

I. It is about, first of all, the *reduction of the vulnerability of the taxpayers in regard to the exploitation carried out upon them by the state.*

However, it must be taken into account the existence of some inherent limitations in displaying this protection effect. Therefore, the taxpayers can not avoid the necessity of living or having the residence in a state, so they remain “exploitable” (unlike the users of a private market, who can decline to purchase the too onerous asset or service).

Then, the activity of tax authorities allows the coercion, while the owners of resources less mobile can not carry out this kind of censorship upon authorities.

Finally, the authorities can form (by coordination or tax harmonization) real “cartels”. Tax cartels are more harmful than the commercial ones, as commercial decisions are made every day, while reorientations of tax policy are made a lot rarely.

The problem with this argumentation line is that it presumes that the authorities' decisions are intrinsically unfavorable to citizens, which can only take place if politicians attend narrow groups of interest and/or bureaucrats aim for own objectives, of maximizing the profit or the prerogatives. Or, is the things are really like that, then the preferable manner to correct these

distortions is the direct action upon them, not by indirect mechanisms, such as tax competition, which may generate own distortions.

II. Tax competitions may stimulate *the rise of budgetary efficiency,* as it determines the presentation of the best services at the lowest cost for the taxpayer.

As tax competition reduces the resources of the budget, the expenses must be well «managed», thus limiting the waste. But this thesis is valid only if the government acts as a benevolent maximizing item of the citizens' welfare, hypothesis which is though in contradiction with that which funds the first argument.

III. In the third place, tax competition can *stimulate economic activity,* by releasing the investments of one part from the burden of the taxing, which damps them in many ways: by discouraging the saving and, therefore, reducing the "*pool*" of available investment capital (Teather, 2005); by reducing the available profit for reinvestment; and, by the fact that, if the revenue from investments of the shareholders is strongly taxable, then the companies would have to pay higher equities in order to attract capital.

A study presented under the aegis of OCDE has estimated that economies grow one-half of 1 percent (0.5 percent) faster for every 10-percentage point reduction in marginal tax rates (Mitchell, 2004). But this effect is not equally produced. If the reduction of very high tax rates stimulates the rise, one can not say the same thing about the tendency to zero of some very low tax rates.

IV. Finally, tax competition *allows the obtaining of some information which would "discover" the desirable features of a tax system.*

Negative effects of tax competition

Tax competition is not always a game with a positive value, the circumstances in which its ***consequences are negative*** are neither a few, nor rarely encountered. Concisely presented, they refer to:

A. *Producing a suboptimal level of public assets*: as the tax competition intensifies, it is more and more difficult for the taxpayers to be taxed at levels which would cover the marginal cost of delivering the public assets.

It is true that this hypothesis seems to be infirmed by a study of Tanzi and Schuknecht (2000), according to which there aren't any indications that the countries which mobilize lower budgetary revenues in proportion to the GDP, "produce less desirable social economic indicators" than the countries with higher budgets in proportion to the GDP: much of what governments want to achieve through public spending could be achieved by levels of spending ranging from, say, 25 per cent and 35 per cent of GDP (Micossi, Parascandolo & Triberti, 2003).

More than that, the statistic data do not support the thesis of a reduction, at the level of the European Union, of budgetary cashing, capable of limiting the delivery capacity of public assets, not even regarding the taxes which are the most influenced by tax competition, those upon the revenues of corporations (profit or corporate tax). Finally, it is not obvious that a possible reduction of budgetary revenues should be automatically translated as a

under deliver of public assets. Firstly, it is expected that, in such a situation, the governments would react compressing the budgetary transfers.

B. *General erosion of budgetary revenues*, with the consequence, among other things, of frustrating the reduction efforts of budgetary deficiencies, a problem which is particularly delicate in the European Union, in the context of the limits imposed by the Pact of Stability and Rise.

This effect is presumed to rise from many causes:

- reducing the cashing from the taxes upon the tax mobile bases, as a consequence of reducing the tax rates;
- the flow of mobile factors of production from the countries with high rates towards those having lower taxes, with the consequence of reducing the tax bases in the countries which practice higher tax rates;
- the reallocation of mobile factors of production can also lower factor payments to immobile factors, thus further eroding the tax base (Rabitsch, 2007).

As it is shown below, this phenomenon hasn't been encountered in practice so far, but for some small countries which engaged themselves in an aggressive tax competition, with the purpose of attracting investments of important dimensions in proportion to their economic dimension.

More than that, although it could be checked in practice, the reduction of budgetary revenues would be a negative effect of tax competition only if the dimension of public budgets would be the optimal one, previous to their reduction.

According to a study, if governments were otherwise perfectly efficient, tax competition would reduce levels of capital taxation by 3 per cent. To put this in perspective, levels of capital taxation in the EU are roughly 20 per cent of GDP (EU (European Commission), 2004b), so a reduction of 3 per cent of expected capital taxation receipts amounts to a reduction in government revenue of roughly 0.5 per cent of GDP. In other words, even if governments are perfectly efficient, the damage caused by tax competition will amount to government spending being 0.5 per cent of GDP below the optimum. Of course, this is on the assumption that governments are perfectly efficient, and so perfectly benevolent and knowledgeable; if government inefficiencies lead to taxes being more than 0.5 per cent of GDP above their optimum then tax competition is likely to be beneficial (Teather, 2005).

C. *The movement of tax burden upon the less mobile tax bases*, with negative effects on social plan.

The loses of budgetary revenues associated to the reduction of tax burden upon the mobile factors of production could be, theoretically, compensated by increments of indirect taxes, but these – also a consequence of the harmonization measures taken for a few decades at the level of the European Council / European Union – are already at high levels. This situation leads to the re-setting of the structure of direct taxes, meaning that the less mobile tax bases come to be taxed more than the mobile ones. According to a Report of the Commission from 1996 (“Monti Report”), within the European Union the tax rates of the capital and

independent activities (*self-employed*) decreased with a tenth between 1980-93, while the tax rates of the employees increased with a fifth (Bratton & McCahery, 2001). On the other hand, though, the budgetary cashing from the taxes on personal incomes in relation to GDP remained practically constant as a proportion of GDP of over 20 years: they represented 11 percent of GDP in 1980 and 10,8 percent in 2002 (Boss, 2005).

Unrighteous effects appear also due to their driving effect, in order to tax the personal incomes, the reductions of the tax rates upon the corporations' revenue. This takes place as, if the corporate tax is more reduced than the personal one, there is a tendency of the natural persons to organize the activity in the shape of a trading company, thus taking advantage of the lower tax rates. In order to avoid this pervert effect, many countries aim to align the marginal tax rate on personal income at the profit tax rate, with the consequence of reducing the progressiveness of personal income taxation and, implicitly, of the re-distributive capacity of the entire tax system (Rixen & Uhl, 2007).

Also, the structure of the delivered public assets changes in the favor of those appreciated more by the most mobile taxpayers, social fractures may occur, as a consequence of the citizens' segregation or pervert situations such as "the exploitation" of the generous social services from a country, without contributing with taxes to their support ("the fiscal-social nomadism" of the taxpayers who change their residence according to the costs and benefits offered by each national system *in different stages of life).*

Since the fear towards the outgoing capital attracted by more attractive destinations, fiscally speaking, seems to have been at the basis of the restraints of several European countries to reorient the taxes from the labor taxes towards those of capital income taxes, limiting the tax competition might have as a result a collateral result making this readjustment, with the consequence of stimulating the employment. This effect doesn't seem to be important, but: stimulating a rise with 10 percentage points of the effective tax rate of the capital incomes in the European Union-15 and a reduction of the labor tax so that the public revenues could be maintained constant show that the reduction obtained like this of the unemployment rate is only of 0,6 percentage points (Sorensen, 2001).

In this respect, there might be brought as counterargument the fact that the authorities should respond to the tax competition by reducing the taxes, not by transferring them to other tax bases (Teather, 2002).

D. *Influencing the decisions of placing the investments* (distorting the allocation of resources: these are taken from the most efficient usages);

A strong and suggestive analogy of this situation is offered by the theft of valuable jeweleries, with the purpose of their melting and using just the valuable metal which are made of.

This effect of the tax competition was sometimes argued, considering that choosing the place for an investment depends mostly on other factors than the tax regimen (e.g., approaching the consumers, cheap labor force and with an adequate qualification, infrastructure, favorable regulations, and so on).
Nevertheless, if there aren't important differences between the host-countries from the point of view of other elements, the tax regimen can have an important

role, a phenomenon stressed by several studies which identify a connection statistically significant between the tax level and foreign direct investments. Recent assessments (2000 and 2003) at the EU level reached to results remarkably close regarding the effect of the tax rates in the host-country determine a rise of the foreign direct investments in that country: a 1 percentage point decrease of the host-country tax rate determine a rise of the foreign direct investments in that country by 4.3 per cent (Cnossen, 2002) and, respectively, 3.3 per cent. (Eggert, 2006).

But the tax system influences the investment decisions and indirectly, through the effects which other of its parameters have upon the business climate: the ambiguities of tax regulations, multiplicity of tax rates, frequent and unpredictable amendments of the rules, and so on.

Recent studies emphasized another important feature of the relationship between the tax regimen and foreign direct investments.

This way, it was shown that the host-country taxation play a limited role in investment decisions when investment is horizontal (i.e. targeting market access), as, in this case, the opportunity cost is given by the export one and there aren't locational alternatives. But when investment is “vertical”, representing a chain of an international productive network (global), there are several localization options, and the resulted end-product compete with the similar ones made by other producers. In this case, minimizing the production cost is more important so that the level of taxes from other possible different placings play a more important role (Lahreche-Revil, 2006).

Finally, another important feature of the relationship between the foreign direct investments and the variation of the tax rates is its nonlinearity. Concretely, the investments do not seem to respond significantly only to important reductions of the tax rates, which can have two explanations: even if the European Union is a well-integrated economic space, there are still significant transaction costs associated to the cross-border capital flows (especially in the shape of direct investments), so that it is created a kind of an “arbitrage tunnel”, in the way that the companies redirect their activities only if the changes of tax rates are high enough to “come out” of this tunnel. Secondly, the small reductions of tax rates can be enough in order to compensate the “avoiding” of taxes carried out by methods already tested of tax planning in tax jurisdictions of which rules became well-known to the corporate taxpayers (Lahreche-Revil, 2006).

There are opinions according to which there is no valid reason in order to treat the tax regimen other than the other defining elements for the attraction of a certain placing potential for investments. Since the taxes represent the financing source of the public assets delivered to the citizens, assets which can be regarded as an indirect way of remuneration, an investment decision made according to them is equivalent to a decision made according to the labor force cost from one country to another (Teather, 2005).

E. Inducing strategic interactions among the tax authorities of “prisoners' dilemma” type, with the consequence of establishing to lower and lower levels of tax rates (*race to the bottom*).

The existence of this effect is empirically researched. A study refering to the situation from EU concludes with a 10%-point higher tax rate in neighboring countries implies an 8% higher rate in a particular European country (Mooij, 2004).

Its development is much facilitated by the occurrence, in the contemporary world, of the possibility of dissociating the advantages (infrastructure, education) and, respectively, the inconveniences (contribution to public cashing) which are presented by a tax jurisdiction or another, phenomenon known under the name of *free riding*.

It is practically impossible to can be determined which of the presumed effects of tax competition are more susceptible to display, since this thing depends on a variety of factors, which specialty literature emphasized step by step:

- availability of the alternative mechanisms which can substitute the taxes as an instrument of attracting the capital;
- asymmetries among the countries from the point of view of dimensions and endowment with resources;
- condensing the production in certain geographic spaces ("agglomeration" within the "center-outskirts" models);
- existence of scale economies in delivering public assets and services;
- offering by the public sector of some inputs which reduce the private production cost;
- mobility level of production factors;
- existence or not of the home bias;
- possibility of cross-border compensation of tax losses, and so on.

Tax competition – How does Romania React?

Tax competition is a two blades gun, a boomerang which turns against the state, which tries to attract capital through reduced tax quotas of the profits. The investors who today applaud the obtained tax facilities, tomorrow they will run, since they won't have labor force trained at the standards imposed by the level of technological development. A symbolic taxation of business means less money to the public budget, so it means amounts which are not enough for qualitative education, for primary medical care, for rehabilitating and maintaining of a fund of human resources to European standards.

Romania is not the most attractive country, fiscally speaking. While in our country double taxation makes unattractive the stock market, the Czech Republic and Bulgaria introduce more friendly flat taxes (15% in Czech Republic and 10% in Bulgaria). But, Romania can become the economic center of Balkans.

The reality is rougher. We take the 12th place from 19 places[2] in the area regarding the taxes' share in the net revenue of a company (with 46,9 per cent - table 1) and this taking into consideration the main taxes and tax rates (on

[2] *Paying Taxes 2008 – The global pictures*, The World Bank and PricewaterhouseCoopers Survey, 2008.

revenue, on profit, on property, Health Insurance House) and not all the 278 para-fiscal taxes which disturb the free initiative in Romania.

Meanwhile, the wind of change breezes near us. In 2007 and 2008, five countries from the area (Albania, Macedonia, Montenegro, Bulgaria and Czech Republic) have introduced flat taxes smaller than quota of 16% from Romania.

In Romania, the flat tax is seen as a panacea, either as an universal evil. For the followers of the flat tax, who want to tax with 16% everything related to economy, it solves all the problems, despite double taxation which brings in its Romanian shape. For its competitors, it is the cause of inflation and of introduction of new taxes, even though the budgetary revenues are rising.

In a debate organized by the "Wall Street Journal", the president of the Czech Republic, Vaclav Klaus (the architect of the tax reform from 2008) drew the attention that proportional taxation can not be a solution to all the problems which an economy confronts with. Also, the laureate of the Nobel Prize for economy, Gary Becker, warned that "a flat tax is not so flat", referring to the double taxation and to the taxation of special groups of interest. "Which is desirable is a low rate of taxation, doesn't have to be flat" was the conclusion of the American economist.

Which shakes the tax competitiveness of Romania in the area is above the high share of social contributions, the radical form of applying the flat tax. There aren't taxed only the regular incomes with 16 per cent, but also the savings and investments.

The extension of the flat tax principle to all the income forms puts us on the second place in the area regarding the tax on equities. Ahead of us there is only Poland, with 19 per cent. Neither to the tax on capital revenues we are not much better, since we are somewhere in the average of the area. But in Estonia, after introducing the flat tax, it was eliminated the double taxation of profit and equities. Taxing the equities is also absent in Croatia and Hungary. Noticing that it loses ground regarding the tax competitiveness (115th place in the world, with a share of taxes of 48,6 per cent from the commercial revenue of companies), in exchange, the Czech Republic introduced starting from the 1st of January 2008 a proportional taxation system. Regarding the tax on income of natural persons, the ex-system with four rates (12, 19, 25 and 32 per cent) was replaced with a flat tax of 15 per cent, which would be followed by a new discount of 12,5 per cent in 2009. In exchange, the social and health contributions were included in the tax basis of the tax on income.

According to the calculations of the American expert Alvin Rabushka, the author of the most important treaties about the flat tax, including the contributions in the tax basis makes that in reality the flat tax applied to the income in 2009 to be of 19,4 per cent and not of only 12,5 per cent. Another component of the tax reform from Prague aims the tax on profit of the companies: this was reduced from 24 to 21 per cent in 2008, going to be dropped at 19 per cent in 2009. Which, in practice, means only that in 2009, the Czech Republic (through 19,4 per cent tax on income and 19 per cent tax on profit) will be equal to Slovakia, where is a flat tax of the personal incomes and that of companies of 19 per cent.

Meanwhile, in Romania there are several forms of double taxation: on profit and equities, on income and on the trading of capital assets, and so on.

But in the current European context, Romania needs a simple and competitive tax vision, which would attract the investors and bring forth a transparent and easy to manage business environment, in parallel with bringing to light the underground economy and severe fighting of tax evasion. Still, the highest risk is that tax legislation to be held by certain groups of interest, opposing to the main principle of defending the competition and not the competitors.

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Total Tax Rate – in Eastern Europe

Table 1

Country	**Total Taxe Rate - TTR (% of comercial profits)**	**Corporate income tax TTR**	**Labour tax TTR**	**Other taxes TTR**	**TTR Rank**
Albania	46,8	17,7	24,5	4,6	105
Bosnia and Herzegovina	44,1	21,5	17,2	5,4	90
Bulgaria	36,7	6,6	26,6	3,5	59
Croatia	32,5	11,4	19,4	1,7	34
Czech Republic	48,6	5,9	39,5	3,2	115
Estonia	49,2	9,3	38,3	1,6	118
Georgia	38,6	14,1	22,6	2	70
Latvia	32,6	2,2	27,2	3,3	37
Lithuania	48,3	8,3	35,2	4,9	112
Macedonia FYR	49,8	13,1	33,2	3,5	119
Moldova	44	10,5	31,6	1,9	89
Montenegro	31,6	9,3	20	2,3	30
Poland	38,8	12,7	23,6	2,1	67
Romania	46,9	10,4	34,4	2,1	107
Russia	51,4	14	31,8	5,7	131
Serbia	35,8	11,7	20,2	3,9	53
Slovakia	50,5	9	39,7	1,8	121
Slovenia	39,2	14,3	22	2,9	74
Ukraine	57,3	12,2	43,4	1,8	145

Source: Paying Taxes 2008 – The global pictures, The World Bank and PricewaterhouseCoopers Survey, 2008