FISCAL POLICY IN THE EUROPEAN UNION BETWEEN HARMONIZATION AND COMPETITION

Ph.D Student Eugenia Ramona Nandra
University "Babeş-Bolyai"
Faculty of Economical Science and Business Administration,
Cluj Napoca, Romania

Abstract: This paper presents some aspects regarding competition and harmonization in European Union fiscal policy, especially after the last enlargement on 2007. The problem of tax harmonization is connected with tax competition in the context of increasing capital mobility between different countries. Using a panel data for EU countries, analyzed on 1995-2004, we find significant correlations between the implicit tax rate of business income and corporation profits and the budget deficit, public debt, GDP per capita and the degree of openness of countries, the last variable is used as a proxy for capital mobility.

Key words: fiscal policy, tax competition, tax harmonization

1. Introduction

The European Union is a consequence of the integration efforts of its members. The European Community is based on the rule that competition should be a mechanism to allocate the economic resources (Article 98 of the EC Treaty). This rule is central to the European project since the Treaty of Rome in 1957. So the uniform conditions should be secured for all competitors in the European market. Following this argument, tax rules should not hamper the free movement of goods, services (including freedom of establishments), labour and capital. Or in the other words as far as taxation is concerned, distortion through the tax system, including tax expenditures should be eliminated. This leads to tax systems' integration. However this argument doesn't justify the form of tax integration either through tax harmonization or through tax competition.

The European Court of Justice has ruled that direct taxes fall within the competence of EU member states, however, member states must implement this competence without infringing the law of the European Community.

At present, the VAT and excise duties are harmonized across the EU. Proposals to harmonize the corporate tax system, expressed for the first time in the Neumark Report in 1962, have been widely discussed until today and can be viewed as a centre-piece discussion among EU countries.

The continuous debates show that countries and their representatives differently perceive what tax harmonization is. Some consider it as a complete harmonization of the entire tax (consolidation of a base, rate and rules of payment at a single stage), while others see it also as harmonization of separate fragments of taxation (only the base, the rate, etc.).

The process of tax integration over last 15-20 years was not linear. Some countries introduced some distortional solutions in their tax systems. And process of solving such distortions led to tax integration.

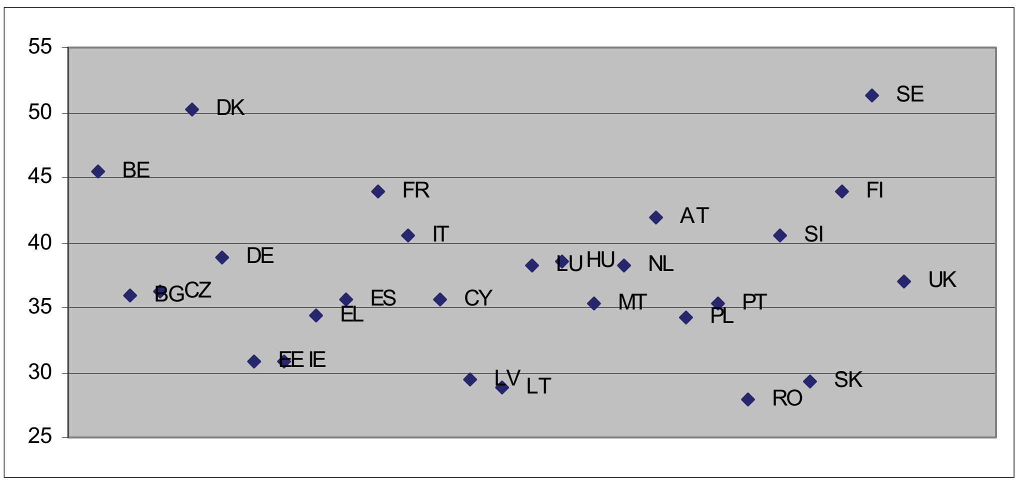
The EU also promote some measures against harmful tax competition for reduce distortions to the single market; prevent significant losses of tax revenue; and reverse the trend of an increasing tax burden on labor as compared to more mobile tax bases.

2. Aspects regarding the EU fiscal policy

The EU it can be considered as a whole, a high tax area. In 2005, the last year for which detailed tax data are available, the total tax ratio in the EU-27 amounted to 39.6 % about 13 percentage points of GDP above those recorded in the United States and Japan.[15]

But not all EU Member States individually display high tax ratios; there are wide differences in tax levels across the Union. Eight Member States display overall tax ratios below the 35 % mark, and the overall tax ratio ranges over more than twenty points of GDP, from 51.3 % in Sweden to merely 28.0 % in Romania. This band reflects the significant differences in the role played by the State within the Member States.

As a general rule tax-to-GDP ratios tend to be significantly higher in the "old" EU- 15 than in the 12 new Member States that joined the Union since 2004, but there are exceptions; for example, Ireland's overall tax ratio is over six points below the EU-27 average, while Slovenia and Hungary's exceed it.



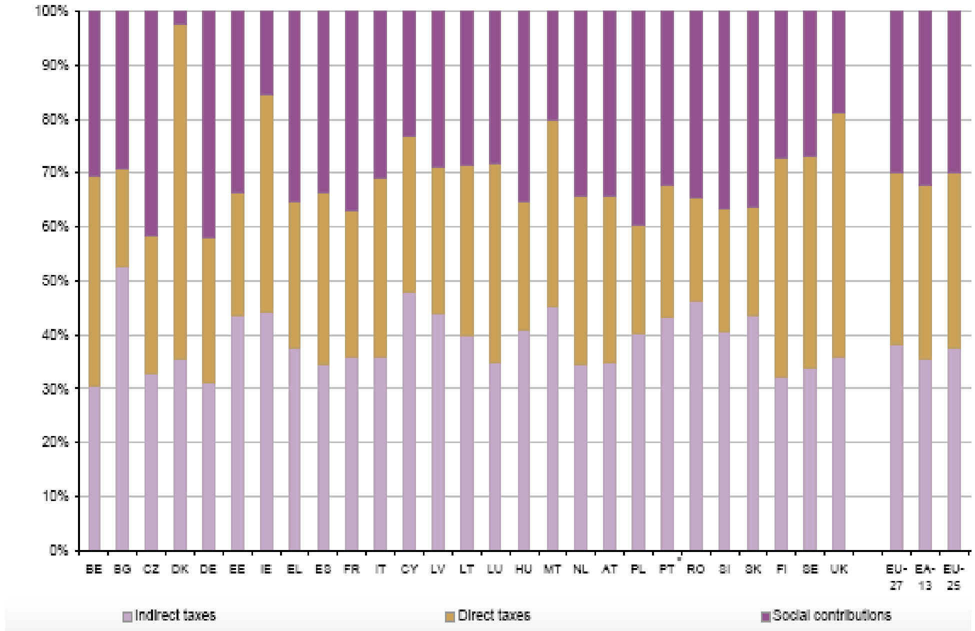
Source: Eurostat, the Statistical Office of the European Communities

Figure no. 1 Total taxes (including social contributions)to GDP for UE member states, 2005

Therefore, the recourse to direct taxes, which are more 'visible' to the electorate, tends to be greater in the countries where tax redistribution objectives are more pronounced (like EU-15); this usually results also in higher top personal income tax rates. Generally, the new Member States have a different structure compared to the

[15] Eurostat, (2007), „Taxation Trends in the European Union", European Commission, ec.europa.eu/eurostat

EU-15 countries; while most old Member States raise roughly equal shares of revenues from direct taxes, indirect taxes, and social contributions, the new Member states often display a substantially lower share of direct taxes on the total.



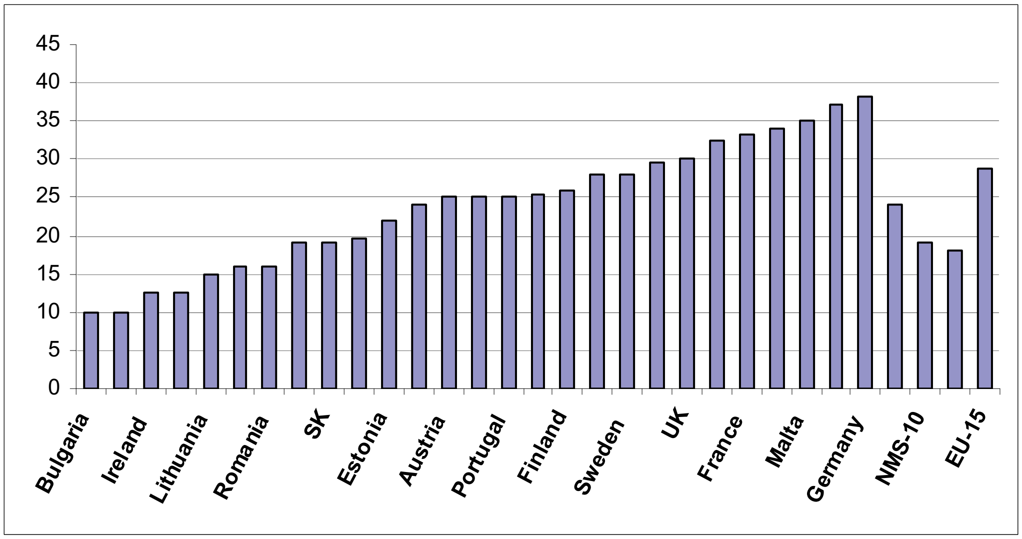
Source: Eurostat, the Statistical Office of the European Communities

Figure no. 2 Structure of tax revenues by major type of taxes 2005, in % of the total tax burden

The lowest shares of direct taxes are recorded in Bulgaria (merely 17.9 % of the total), Romania (19.1 %) and Poland (20.5 %); in the latter, the share of direct taxes has diminished by one third since 1995. One of the reasons for this difference can be found in the generally lower tax rates applied in the new Member States on corporate and personal income; as for progressivity, some of the new Member States have abandoned it almost completely by adopting flat tax systems (one example of this is Slovakia, Romania and Baltic's countries). Amongst the old Member States, however, there are other interesting differences. The Nordic countries (i.e. Sweden, Denmark and Finland) rely primarily on direct taxation, whereas some southern countries (in particular, Portugal and Greece) have relatively high shares of indirect taxes. Denmark stands out in another respect; most welfare spending is financed out of general taxation instead of social contributions (only 2%); therefore, the share of direct taxation in total tax revenues in Denmark is in fact the highest in the Union, while social security revenue is very low. Germany shows the opposite pattern: it has the highest share of social contributions and the lowest share of direct tax revenues in the EU-15; a similar pattern is found in France.

Since the second half of the 1990s, corporate income tax rates in Europe have been cut forcefully. The tendency has continued also in 2006, as shown by a 0.8 percentage point drop in the EU-27 average. Although the downward trend has been quite general, corporate tax rates still vary substantially within the Union between a minimum of 10 % (in Bulgaria and Cyprus) to a maximum of 38.7 % in Germany. As in the case of the personal income tax, the lowest rates are typical of countries with low overall tax ratios; consequently, the new Member States typically figure as having low rates (with the noteworthy exception of Malta, whose 35 % rate is the third highest in the Union).

The reverse is, however, not true; unlike the case of the personal income tax, the two Member States with the highest overall tax-to-GDP ratios, i.e. Sweden and Denmark, display corporate tax rates that are not much above the average due to the adoption by these countries of Dual Income Tax systems, which by nature tax capital income at a moderate rate.



Source : KPMG International; http://www.worldwide-tax.com

Figure no. 3 The Corporate Tax Rate, 2007

Hence, the top positions in the ranking are occupied by Germany and Italy, whose overall tax ratios are not amongst the highest but traditionally impose relatively high corporate income tax rates. The German government has, however, recently announced a sizeable cut in the CIT.

Consumption taxes on the rise in most Member States since 2001. The trend is particularly visible in the smaller Member States; several of these are new Member States, which in the last years have been increasing excise duties to conform to the EU minima.

The larger Member States in contrast generally show slightly declining taxation of consumption. The trend towards higher taxation of consumption may, however, be at work also in the larger Member States, as highlighted by the hike in the standard German VAT rate by three points in 2007.

Even the corporate tax rate is decreasing the effective corporate tax rate is not much lower because of broadening tax base cyclical factors. The EU tax policy is designated to assure the four freedom of the internal market for citizens and business and to reducing the economic distortions associated with national tax systems.

3. Review of the literature

Proposals to harmonize the tax system, expressed for the first time in the Neumark Report in 1962, have been widely discussed until today among EU countries. Sinn (1990) points out that though tax harmonization is needed to avoid distortions, it does not necessarily require centrally coordinated actions by European governments.

There are two routes to integration: through harmonization and through competition (Kay, 1993). In the first of these approaches the creation of free trade requires prior alignment of the policies and practices of the states involved. Under the second the favored mechanism is to promote integration as rapidly as possible, and let the consequences for rules follow from that. Generally, the EU's role in taxation has been relatively minor, so far. The EU favors tax harmonization, but it has mainly confined itself to harmonization of indirect taxes.

Frey and Eichenberger (1996) state that tax harmonization is normally advocated because it reduces *economic* distortions and tax competition because it reduces *political* distortions.

Klaver and Timmermans (1999), however, question that tax competition will hurt the European welfare states. They argue that the rising tax burden on labor in a number of countries has more to do with their failure to make structural adjustments in the public sector and their traditionally low tax burden on capital than with excessive tax competition. While Krogstrup (2002) suggests that, while full-fledged harmonization is unnecessary, a tax floor would be advisable.

On the other side the idea of tax competition is not new; it can be finding in the famous Wealth of Nations of Adam Smith. The debate on tax competition has started with the model developed by Tiebout (1956), which examines competition among governments over mobile households and it is assumed that households select the region according to their preferences for the mix of taxes and public expenditures through voting with their feet. Tiebout argues that competition for mobile households is welfare enhancing. Integration of Europe follows the conclusions from Tiebout model applied at the government level, which are competing for capital and for firms.

In the literature are many points of views that try to reveal the fiscal externality generated by tax competition through the race of the bottom in tax rate and under provision of public goods in equilibrium like in basics models of tax competition developed by Zodrow & Mieszkowski (1986), Wilson (1986), and surveyed by Wilson (1999). This view is contrasting to the thinking of conservative policymakers and the Public Choice literature.

Brennan and Buchanan (1980), or McLure (1986) have argued that competition in general, and competition among governments in particular, is beneficial because it reduces government waste and disciplines politicians. If tax rates are cut in the process of competition, government expenditures have to be reduced; this helps to avoid waste and inefficiencies in the public sector. (Boss, 1999)

The views on tax competition are divided in two parts. There are the models where tax competition leads to inefficiently low taxes due to positive externalities, and reduces welfare, may support the notion that international cooperation between countries (i.e. like in the EU) can alleviate the downward pressure in tax rates and leave all countries better off. But there is also a whole group of models which reveal the positive effects of tax competition through reducing the inefficiency in government spending and stimulate the optimal ratio *taxes-public goods* for contributors which have the possibility to choose the jurisdiction which offer the best ratio.

4. Tax Harmonization –a solution for EU fiscal policy?

The 1987 proposal of the European Commission with regard to indirect taxes was based on a rather ambitious goal of tax harmonization. Though tax harmonization ensures an efficient international resource allocation within the private sector by equalizing relative prices across borders, it does not ensure an efficient resource allocation between the private and the public sectors since it does not respect cross-country differences in the preference for income redistribution (Hagen et al., 1998).

Tax harmonization exists when taxpayers face similar or identical tax rates no matter where they work, save, shop, or invest. Tax harmonization can be achieved two different ways (Mitchel, 2004):

- *Explicit tax harmonization* occurs when nations agree to set minimum tax rates or decide to tax at the same rate. The European Union, for instance, requires that member nations impose a value-added tax (VAT) of at least 15 percent. The EU also has harmonized tax rates for fuel, alcohol, and tobacco, and there are ongoing efforts to harmonize the taxation of personal and corporate income tax rates.

- *Implicit harmonization* occurs when governments tax the income their citizens earn in other jurisdictions. This policy of "worldwide taxation" requires governments to collect financial information on nonresident investors and to share that information with tax collectors from foreign governments. This "information exchange" system tends to be a one-way street since jobs and capital generally flow from high-tax nations to low-tax nations. Under this indirect form of tax harmonization, just as under the direct form outlined above, taxpayers are unable to benefit from better tax policy in other nations, and governments are insulated from market discipline.

Both forms of tax harmonization have similarly counterproductive economic consequences. In each case, tax competition is emasculated, encouraging higher tax rates. This hinders the efficient allocation of capital and labor, slowing overall economic performance.

Table no. 1 Tax revenue by main tax categories, % of GDP

	Indirect taxation		**Direct taxation**		**Social contributions**	
	Tax rate % GDP	Countries	Tax rate % GDP	Countries	Tax rate % GDP	Countries
1. Min rate	11,5	**LT**	6,1	**BG, SK**	1,1	**DK**
2. Av. rate	13,8	**EU27**	12,8	**EU27**	13	**EU27**
3. Max rate	19	**BG**	31,2	**DK**	16,4	**FR**
Diff. (3)-(1)	7,5		25,1		15,3	
Standard dev.	1,9		5,39		3,55	
Interpretation	Harmonization		Tax competition		Average of harmonization and tax competition	

Source: Eurostat, http://epp.eurostat.ec.europa.eu

Tax harmonization can be carried out in the following components of taxation:[16]

1. Harmonization of an object of taxation - occur as an imperative prescription that member states all must tax a specified object, in the case under discussion, corporate profits.

[16] Lithuanian Free Market Institute, (2006), "Harmonization of the Corporate Tax Base in the European Union", Analytical Study, http://www.freema.org

2. Harmonization of a tax base - regulation is laid down for principles and rules which are applied to calculating the tax base.

3. Harmonization of the rules of tax payment - regulation is set for payment of the corporate tax. Harmonization of tax payment rules is usually combined with harmonization of a tax base and rates.

4. Harmonization of a tax rate. In this case a minimal (uniform or maximal) tax rate is fixed. If harmonization of a tax rate is implemented separate from harmonization of a tax base, this is also called nominal harmonization.

Concerning the strategies of harmonization there are two solutions (Tulai & Serbu, 2005):

1. harmonization through market;
2. negotiated harmonization.

If fiscal system harmonization at EU level was regarded with hostility for a long time because of state sovereignty now it is necessary for avoiding all fiscal barriers for the Common Market. The different options for harmonization are due to national different fiscal policies that are adopted for the member states.

It can be expected that the welfare effects of tax harmonization will be unequally distributed, both over countries and over interest groups within countries. Large countries tend to benefit more from tax harmonization than small countries. Since large countries have certain advantages over small countries, they can impose higher taxes and yet remain competitive. Enterprises in small countries more often need to cross borders if they want to expand their activities than companies in large countries. Moreover, companies in a small country have fewer opportunities for loss compensation and depreciation relief than enterprises in a large country (Hoek, 2004).

5. TAX COMPETITION – A PANEL ANALYSIS FOR EU COUNTRIES

Using the panel methodology through a multiple regression with estimation by random effects we try to demonstrate some hypotheses that reveals the main arguments favorable for tax competition. Based on the hypotheses demonstrated in our model we can affirm that the best solution for European Union is harmonization for indirect taxes and competition for direct taxes.

Tax competition is necessary in the future tax policy of EU as while as tax competition is under some macroeconomic constraints as budget deficit and public debt. We can appreciate that this constrains are more efficient than other solution for eliminating and combating so called *harmful tax competition*.

Our analysis is for a period of ten years, based on annual data. The dependent variable is implicit tax rate of capital and business income. We introduce control variable - public expenditures as percentage of GDP. We estimate the impact of budget deficit and public debt on the tax burden of capital in a standard random effects model. This article analyzes 27 countries, EU members in the present, for 1995-2004 periods.

We have taking into consideration all 27 countries even in that period weren't all EU members, but for our study is important especially for predicted what it would be in the future and taking into account the major differences between the old and the new member states.

Our start point was the study of Winner (2005), which made a similar model for OECD countries We try to develop a specific model for EU taking into account the present day of EU countries, who are engaged in a race of tax competition under unequal starting conditions. Unequal conditions means that although all EMU and prospective EMU Member States have to satisfy the two conditions of the stability pact (i.e. public debt lower than 60% of GDP and budget deficit lower than 3% of GDP) they do not start from equal starting positions concerning public debt and budget deficit (Halkos & Kyriazis, 2006)

This study try to reveal the impact of the two major constraints that have to accomplish EU members (3% for budget deficit and 60% for public debt as a ratio to GDP) on the degree of tax competition in which can be involved every EU member state. Two hypotheses are demonstrated by this study:

H_1: Budget deficit limit the degree of tax competition manifestation.

H_2: Public debt and public expenses are correlated with the degree of tax competition manifestation.

These hypotheses are verified using the next equation for the model:

(1) $ITR_{it}=c_0+c_1BD+c_2PD+c_3GDPC+c_4OP+c_5UES+c_6CONSGDP+c_7EGR$

In the next table we are presenting the results:

Table no 2. Estimation results from panel regression

Independent variable	***DEPENDENT VARIABLE:IMPLICIT TAX RATE on capital and business income(ITR)***
Constant	28.89 (0.00)
BD (Budget deficit)	0.27** (0.01)
PD (Public debt)	-0.06** (0.01)
GDPC (GDP per capita)	0.23** (0.01)
OP (Openness)	-0.06*** (0.000)
UES (Country area as percentage of EU area)	-0.22 (0.53)
CONSGDP(Consumption as percentage of GDP)	-0.05 (0.64)
EGR (Economic Growth Rate)	-0.10 (0.37)
Number of observations	203
R^2	0,81

Notes: p-values in parenthesis. ∗∗∗Significant at 1%; ∗∗Significant at 5%; ∗Significant at 10%;

We consider as indicator for evaluating the tax burden, the effective tax rate, calculated as a ratio between the effective tax and the tax base. At the European Union level data about the effective tax rate are very scarcely and in this case we choose an Eurostat indicator: **implicit tax rate an capital and business income** calculated as a ratio between the effective tax on capital and business income and the effective tax base, taking into account all deductions or exemptions.

The independent variables used by the model are presented below:

DB (Budget deficit) - As a percentage of GDP, is the main constraint in front of tax competition (Eurostat).

DP (Public debt) - For covering the budget deficit every country has two main solutions: raising the taxation or rising debt ratio. If the debt ratio is increase we are expected to have a lower taxation on the short time but in the long time the public debt it will be covered from rising taxation, and we can say that public debt is a delayed tax for contributors (Eurostat).

***GDPC* (GDP per Capita) -** It is an important difference between the old member states which have a high GDP per capita comparative with the new member and we expect to obtain some correlation between this variable and evolution of tax burden, implicitly the manifestation of tax competition (Penn World Table).

***UES* (Country area) -** Area of every member states as percentage of total EU area (Wikipedia).

***CONSGDP* Consumption as percentage of GDP** (Penn World Table).

***OP* - Openness** is used as a proxy for capital mobility, the main factor which is favorable for tax competition. Is calculated as a ratio between the sum of imports and exports to GDP(Penn World Table).

***EGR* - Economic Growth Rate** (Penn World Table).

Table no. 3. Interpretation of model results

VARIABLES	
Budget deficit	Is the most significant variable and is direct correlated with the implicit tax rate and also with the tax competition. If one country have a high budget deficit, which is bigger than 3% from GDP it is very difficult for that country to engage in the tax competition race. One unit change in budget deficit is follow by 0.31 unit change in the same direction of implicit tax rate on capital and business income (from the first equation).
Public debt	It is a significant variable but the correlation is not so powerful like with budget deficit and the correlation is indirect because in most of the cases the budget deficit is covered by public debt and only after that by rising taxes. When taxes raising the public debt are lower and vice versa. From our study we can see that for countries like Italy, Greece, Belgium is difficult to engage in the tax competition because the level of their public debt is double for the level required by the EU.
GDP per Capita	It is significant variable only in the first three equations, the correlation is direct, and this confirm that we can see from descriptive analysis that the new members state which have a lower GDP per capita are more engaged in the tax competition comparative with the old members states (EU 15).
Country area	The same situation like for the Population variable.
Openness	This variable is significant correlated with tax competition because is a proxy for capital mobility which is an important factor in tax competition developing. If the capital mobility is very high there is the possibility to choose the jurisdiction with a lower taxation and this lead to reduce tax burden through tax competition.

Note: The others variables (Consumption as percentage of GDP, Economic Growth Rate) have an insignificant correlation

From this empirical study we may conclude that the future of EU tax policy is based not only tax harmonization, but also on tax competition. The fight for combating the harmful tax competition is welcome but has to be done with the proper instruments and we consider that the satisfying the two conditions of the stability pact (i.e. public debt lower than 60% of GDP and budget deficit lower than 3% of GDP)are the best instruments for limiting the harmful tax competition.

Conclusions

To summarize the EU initiatives on tax harmonization, only the VAT rates and the excise duties have achieved a high degree of harmonization with the establishment of the Single Market and the abolition of intra-Community tax controls. Apart from the VAT and the excise duties, the indirect taxes may be harmonized following the article 93 EC Treaty and therefore help preventing double taxation, tax avoidance and disturbing of tax competition.

Some level of coordination is needed in the area of company taxation; however, the Commission proposed a common tax base for European companies without fixed rates, aimed in the long term at a harmonized European corporate tax base. The Commission proposal of the Home State Taxation scheme would be based on mutual recognition of the Member States' tax rules and tax coordination. European coordination may help to avoid tax revenue losses as the capital is mobile across EU countries

The personal income tax and the tax on dividends of individuals should stay under each Member State's national rules. According to the Court of Justice, in the absence of the EU harmonization, the *personal income taxation* shall be safeguarded as each Member State's national policy. In addition, general and final provisions of the EC Treaty abolish under article 293, double taxation within the Community and encourage the respect of the rights of individuals in cross-border situations. .

Due to a "race to the bottom" taxes on capital income might no longer contribute sufficiently to the financing of public expenditure and it might become difficult or even impossible for governments to perform their usual tasks. An under supply of public goods and/or an erosion of the welfare state are feared to be the outcome of tax competition.

At the very least, the tax burden might be shifted away from highly mobile capital towards immobile factors such as labour; this would raise labour costs and impede the reduction of unemployment especially in Western Europe. The harmonization of tax rates is thought to be the remedy at least for indirect taxes.

EU member states participating in EMU have given up the possibility of an independent monetary policy. Therefore, they have fewer policy options, so they might have incentives to use taxes to achieve competitive advantages, which may intensify tax competition. The conclusion is that every EU member states have a different degree of tax competition and this degree is limited by the EU requires concerning the budget deficit which have not exceed 3% of GDP and 60% for public debt.

REFERENCES

1. Boss, A. "Do We Need Tax Harmonization in the EU?" Kiel Institute Working Paper No. 916, 1999
2. Brennan, G., Buchanan, J. "The Power to Tax: Analytical Foundations of a Fiscal Constitution", Cambridge University Press, 1980
3. Frey, B. S., Eichenberger, R "To Harmonize or Compete? That's Not the Question", *Journal of Public Economics*, 60(3): 335-349, 1996
4. Hagen, K.P., Norrman, E., Sørensen, P.B "Financing the Nordic Welfare States in an Integrating Europe", in P.B. Sørensen (ed.), *Tax policy in the Nordic Countries*, MacMillan Press, Basingstoke/London, pp. 28-71, 1998
5. Halkos, G.E., Kyriazis, N.C. "Is "Is tax competition harmful and is the EU an optimal tax area?", Journal Law and Economics, 21:p. 163-177, Springer Science & Business Media, 2006

6.	Kay, J.	"Taxation Policy and Economic Integration", in: A. Knoester (ed.), *Taxation in the United States and Europe: Theory and Practice*, St. Martin's Press, New York, pp. 156-164, 1993
7.	Klaver, J.A.M. Timmermans, A.J.M.	"EU Taxation: Policy Competition or Policy Coordination?", EC Tax Review, 8(3): 185-190, 1999
8.	Krogstrup, Signe,	"What do Theories of Tax Competition Predict for Capital Taxes in EU Countries? A Review of the Tax Competition Literature," HEI Working Paper No. 05/2002, May 2002
9.	McLure, C.E.,	"Tax competition: Is what's good for the private goose also good for the public gander?" National Tax Journal XXXIX, pp. 341-346.
10.	Mitchel, D, J.,	„The Economics of Tax Competition: Harmonization vs. Liberalization", 2004,
11.	Hoek, P.,	„Tax Harmonization and Competition in the European Union", 2004
12	Sinn, H.W.	"Tax Harmonization and Tax Competition in Europe", *European Economic Review,* 34(2-3): 489-504, 1990
13.	Tiebout, C.,	"A Pure Theory of Local Government Expenditures", Journal of Political Economy 64, 416-24, 1956
14.	Tulai, C., Şerbu, S.,	„Fiscalitate comparată şi armonizări fiscale", Editura Casa Cărţii de Ştiinţă, p.136, 2005
15.	Wilson, J. D.,	"A Theory of Interregional Tax Competition", Journal of Urban Economics, 19: 296-315, 1986
16.	Wilson, J.D.,	"Theories of tax competition," National Tax Journal, 52, pp. 269-304, 1999
17.	Winner, H.,	"Has Tax Competition Emerged in OECD Countries? Evidence from Panel Data", International Tax and Public Finance, 12:p. 667-687, 2005
18	Zodrow, G., Mieszkowski, P.	"Pigeou, Tiebout, Property Taxation and the Underprovision of Local Public Goods", Journal of Urban Economics 19, pp. 356-370.
20.	* * *	Harmonisation of the Corporate Tax Base in the European Union, Analytical Study, http://www.freema.org, 2006
19.	* * *	Taxation Trends in the European Union, European Commission, ec.europa.eu/eurostat, 2007