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TAX COMPETITION, HARMONIZATION AND DEVELOPMENT: CHALLENGES AND CONSEQUENCES [1]

This paper aims to emphasize the importance of tax harmonization and tax competition, both for a country's economy and global economy development, which impact on governments' adopted measures to attract investment, skilled labour force, etc. The relationship between the economic development of European countries, expressed as GDP per capita, and tax competition, expressed as implicit tax rate on capital is considered, using data for 1995-2009. The results indicate that tax competition is influenced by macroeconomic variables used (government deficit/surplus, government expenditure and openness), except for the level of GDP per capita (economic development) and government consolidated gross debt, which are not statistically significant.

Keywords: taxation; competition; harmonization; development; panel data; European Union; GMM method

JEL classification: C23, H25, H71, H87

INTRODUCTION

The European Union (EU) is an impressive economic power with countries having different characteristics and levels of development, yet forming one single living 'organism' with its set of 'components' that work together to achieve common goals. However, many aspects that lead to heated debates on the European integration process still exist. Economists, researchers and policymakers continue to seek answers regarding the benefits, consequences and challenges that arise from the process of EU tax harmonization. Thus, these struggles are, and will be for a long period of time, on the agenda of each EU or the accession country.

The current economic crisis has put pressure on the ideologies related to tax harmonization and tax competition, and consequently the idea of tax

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coordination appears more strongly on the horizon. Both tax harmonization and tax competition are supported processes as the first helps to reduce tax evasion, to remove the competition barriers, to increase mobility of labour, capital, goods, and services, while the second facilitates the improvement of tax systems, reduces the tax burden, facilitates a better balance between taxes and public goods and accommodates the inequalities between countries in terms of GDP level. In this general framework, including tax harmonization and tax competition, EU countries should also consider other significant statutory aspect related to the stability pact in which are included limits on the budget deficit which puts pressure on the tax policy of each country.

In the EU, tax harmonization refers to more uniform tax systems, which implies aspects both of indirect and direct taxes. A common external tariff regarding custom duties, a minimum tax rate for VAT, etc. are in force. On the other hand, tax competition may be considered as an instrument of government policy, its concepts, policies and practical approaches in the area of taxation being largely debated in the literature. In addition, the socio-economic concept of a 'race to the bottom' represents one result of the regulatory competition and fiscal policy of countries. The increasing competition between countries in the area of taxation could be, theoretically, a consequence of tax base mobility.

Tax harmonization and tax competition are widely discussed in the literature (Fourçans and Warin, 2001; Hoek, 2003; Baldwin and Krugman, 2004; Mendoza and Tesar, 2005; Killian, 2006; Behrens et al, 2007; Nandra, 2007; Conconi et al, 2008; Kocia, 2009; Slemrod and Wilson, 2009; Junevičius and Šniukštaitė, 2009; Szarowska, 2009), more arguments being formulated related to the advantages and disadvantages related to both concepts. Fourçans and Warin (2001) analysed tax harmonization and competition in Europe, and stressed that in countries with "sound public finance, tax competition would not lead to a 'race to the bottom'". Hoek (2003) analysed tax harmonization and competition in the EU, and noted that "while tax burdens in the European Union have increased substantially in the past 35 years, they did not converge" and "there is no evidence of the 'race to the bottom' in taxing income from capital". Mendoza and Tesar (2005) dealt with the topic of tax competition and the concept of the 'race to the bottom', and the authors noted that the "harmonization of indirect taxation is undesirable because it forces countries to respond to the adverse effects of tax competition on tax revenues by raising highly distorting labour income taxes". Slemrod and Wilson (2009) analysed a framework of tax competition, in which some jurisdictions (tax heavens) are parasitic on the

revenues of other countries, and according to authors, “the full or partial elimination of tax heavens would improve welfare in non-heaven countries”. Junevičius and Šniukštaitė (2009) dealt with the issues related to tax harmonization and competition in the EU, and noted that “tax competition can lead to inefficiency in providing public services”. Wilson and Wildasin (2001) underlined some advantages and disadvantages of capital tax competition. Behrens et al (2007) studied the positive implications of commodity taxation and tax harmonization, taking into consideration the destination and origin principles.

According to Killian (2006), “tax competition, even that not considered harmful by the OECD, can damage not only the home country of the emigrating multinational, but also the host country gaining the investment, local communities and the environment”. Tax competition is often seen in relation with investments, the authors underlining the efficiency of the policies, and also the tax policy, in enhancing the flow of capital (Kocia, 2009; Pieretti and Zanaj, 2011; Hristu-Varsakelis et al, 2011; Becker and Fuest, 2011) and mobility (Becker and Fuest, 2010). Kocia (2009) dealt with the relationship regarding institutional tax competition, the economic theory on investment attractiveness and the location of enterprises in the EU, and underlined the impact of tax systems competition on economic growth. Pieretti and Zanaj (2011) analysed the competition to attract foreign capital and according to the authors, “for moderate mobility costs, small economies can attract foreign capital by supplying higher levels of public goods than larger jurisdictions, without practicing tax undercutting”. Hristu-Varsakelis et al (2011) dealt with the topic of corporate tax competition and foreign direct investment. Becker and Fuest (2011) analysed the topic of tax competition in connection with investment (greenfield investment, mergers and acquisitions) and according to the authors, “the coexistence of these two types of investment intensifies tax competition in comparison to the case where there is only greenfield investment”. Becker and Fuest (2010) dealt with the concern that “policies enhancing mobility may boost tax competition”, and according to authors, “a coordination of investment in transport cost reducing infrastructures within union countries enhances welfare and mitigates tax competition”.

Nandra (2007) analysed tax competition in the EU, using panel data techniques, and as starting point the study of Winner (2005) who used a model for OECD countries. Szarowska (2009) analyses the basic theoretic approaches regarding tax competition, creating an analysis of the tax burden in the EU.

Another important issue related to taxation is represented by tax harmonization, and some definitions regarding this are offered in the literature. Still, all have their shortcomings. Mixing the most relevant approaches in defining tax harmonization, it is “the process of removing fiscal barriers and discrepancies between the tax systems of the various countries comprising the European Union” (Glossary of Tax Terms, OECD), “adaptation of each Member State’s legislation to a standard which is common to all Member States and which has been set forth by the EU supranational bodies” (Steichen, 2003), and the “convergence of systems as a result of legislative action at Community level” (European Parliament, 2000). Regarding tax harmonization, there is a “full harmonization, which produces identical tax bases, rates, systems, etc., and partial harmonization or approximation, which involves something less: for example, minimum or maximum tax rates, the elimination of double taxation, etc.” (European Parliament, 2000).

Baldwin and Krugman (2004) studied the topic of agglomeration, integration and tax harmonization, and according to the authors, “greater economic integration may lead to a ‘race to the top’ rather than a race to the bottom”. Conconi et al (2008) analysed three possible tax harmonization scenarios: no tax harmonization (all countries set taxes unilaterally), global tax harmonization (all countries coordinate their capital taxes), and partial tax harmonization (only a subset of all countries coordinate capital taxes). According to the authors, “if capital is sufficiently mobile, partial tax harmonization benefits all countries compared to both global and no harmonization”.

Tax harmonization is a complex process, its objective being that of creating a framework for developing a similar taxation in different countries. One way to accomplish this is by increasing taxes, reducing taxes or a combination of these measures. Tax harmonization may represent the elimination of the differences between EU Member States' tax systems, of the differences between tax bases. Also, this policy may refer to measures targeting a reduction in the gap between various tax rates. The harmonization of taxes has proved to be a slow phenomenon due to the complexity of the problems in this area. The EU advocates tax harmonization, but until the countries will achieve this they are still in a situation of tax competition. The theory supports the need to harmonize the existing tax policy of European countries, but now the competition on the market and the desire to attract investors make governments use different tax rates, depending on taxes, whether direct or indirect. Currently between the

European countries the phenomenon of tax competition also exists, and the countries have progressive tax systems or taxation with flat rates, or different rates of VAT which rise above the minimum.

In conclusion, tax harmonization and tax competition raise strong debates in the literature, various issues requiring analysis and research, especially related to the topic of the main determinants of these phenomena. The rest of the paper is organized as follows. Section 2 presents the challenges and consequences regarding tax competition and harmonization. Section 3 presents the methodological approach and model specification. Section 4 presents the results of the study and the discussion. Section 5 concludes the study.

1. CHALLENGES AND CONSEQUENCES REGARDING TAX COMPETITION AND HARMONIZATION

Some challenges for tax harmonization may be the situation of tax competition and the differences between countries in terms of GDP per capita. Moreover, tax harmonization is a challenge to tax competition, due to the fact that it may reduce the 'rivalry' in diminishing the tax rates. Tax competition is the phenomenon characterized by the existence of a lower tax burden to encourage the inflow of resources, investments, labour force, etc., and a strategy in this area generally aims to minimize the taxation level. The globalisation process influences all the aspects of the economy and society, and tax competition is strongly linked to globalisation. The governments may keep tax rates to an acceptable level in order to attract investment, boost entrepreneurship, etc., and consequently to improve the country's competitiveness through tax policy reforms.

According to Nandra (2007), the harmonization of indirect taxes and the competition of direct taxes are considered the best solutions for the EU. Tax competition is blamed for reducing the tax base in countries with high taxation, while lower taxation may especially pursue objectives such as providing more incentives, exemptions, deductions, etc. Consequently, the main questions arising are: What are the rules of competition?; What are the differences between countries in terms of macroeconomic indicators, GDP per capita, investments, capacity to attract resources, etc.?. Competition between tax systems may generate a trend of reducing the tax burden on the tax bases, especially for those with higher mobility. Tax competition is a "noncooperative tax set by independent governments, under which each government's policy choices influence the allocation of a mobile tax base among 'regions' represented by these governments" (Wilson and Wildasin,

2001), “a process by which the convergence of tax systems is secured through the operation of market forces, without deliberate harmonization or coordination” (European Parliament, 2000). Depending on the taxes used in the adopted measures, there may be competition regarding tax rates (setting lower tax rates compared to rates from other countries), or competition that refers to the tax base (providing incentives, deductions, etc.).

Regarding harmful tax competition in the EU, a Code of Conduct for business taxation exists. Adopting this Code, the countries have undertaken to roll back existing tax measures that constitute harmful tax competition and to refrain from introducing any such measures in the future. The Code refers to tax measures which may have an impact on the location of business in the EU. The potentially harmful measures may be identified if an effective level of taxation is significantly lower than the general level of taxation in a country, if tax benefits are reserved for non-residents and if there are tax incentives for activities which are isolated from the domestic economy and if there are tax advantages granted in the absence of real economic activity and so on. Competition is a natural, omnipresent, normal event that appears due to the existence of various tax systems. The ‘dark side’ of competition when referring to taxation is its ‘harmful’ effect caused by the distortions within the market (especially regarding investment issues). Still, tax competition has also positive influences, or benefits, especially on households (lower cost of education, health care, sanitation, etc.).

For countries with lower levels of per capita GDP in the EU, lower rates of taxation are among the stimulus to attract investment and encourage entrepreneurship, and consequently tax harmonization may actually represent an obstacle for the development of EU countries, with the strongest negative effects for countries with lower levels of per capita GDP. The economic, social and cultural differences between EU countries may transform tax harmonization into an untouchable goal for a long period of time. Still, an important issue is related to the higher degree of tax harmonization and if this degree would really satisfy the taxpayers and help countries in the catching up process, thus improving the level of economic development.

Tax harmonization is an important topic which starts heated debates, especially related to a common tax system in the EU, in order to improve labour mobility and discourage tax competition between countries. There are differences between countries in terms of tax policy, but these differences may also have various effects in the single market.

A dilemma arousing the interest of the researchers is related to how harmonization can be an effective solution to eliminate differences, to

achieve an alignment of tax rates, and at which level, namely at lower tax rate levels or at higher tax rate levels. To ensure an optimal policy, a tax harmonization measure that aims at the alignment at higher tax rates levels may be considered, depending on the various types of taxes. But, in the case of a certain tax, choosing the alignment at a higher tax rates level, regardless of the level of development registered by countries, could undermine the growth process, and tax harmonization could be an obstacle to achieving economic and social development. Tax harmonization may generate similar tax rates in various regions, countries, etc.

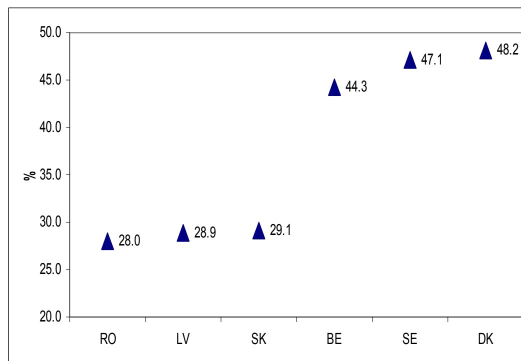

Figure 1. Highest and lowest tax burdens in the EU (Total Taxes (including SSC) as % of GDP), 2008

Source of the data: Taxation trends in the European Union – Data for the EU Member States, Iceland and Norway (Eurostat, DG for Taxation and Customs Union, 2010)

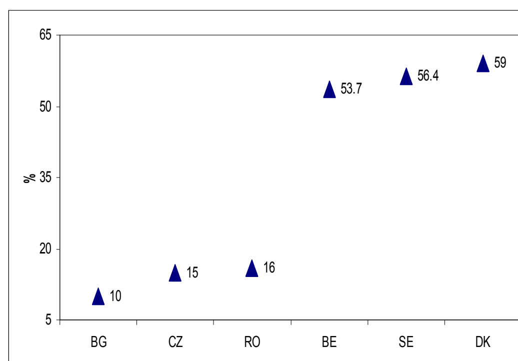

Figure 2. Top statutory personal income tax rates in EU countries, 2008

Source of the data: Eurostat News Release, 2009

Note: the rate is for the highest tax bracket. For Denmark and Sweden another tax is included – municipal income tax.

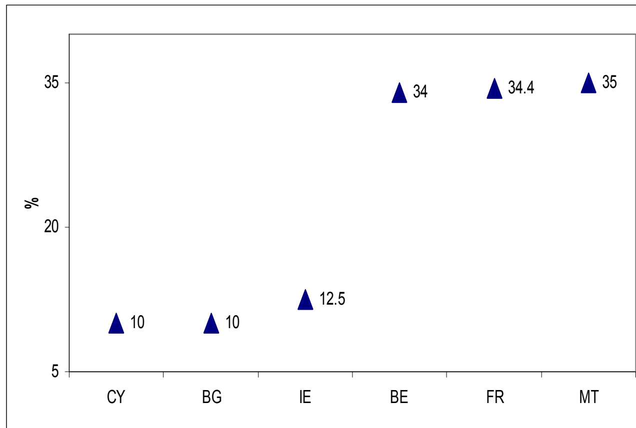

Figure 3. Top statutory tax rate on corporate income, 2008
Source of the data: Eurostat News Release, 2009

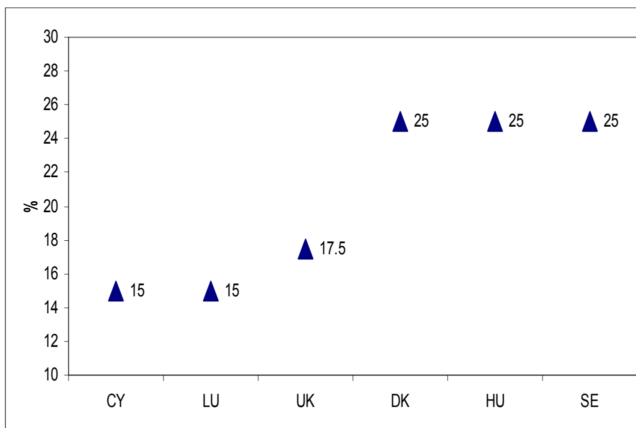

Figure 4. Highest and lowest standard rate of VAT (%) in EU countries, 2010
Source of the data: Taxation trends in the European Union – Data for the EU Member States, Iceland and Norway (Eurostat, DG for Taxation and Customs Union, 2010)

Tax harmonization can be both a harmonization of tax rates or tax base. In terms of tax burden or tax rates, tax harmonization looks as follows (see Figure 1, 2, 3, 4):

- there are groups of countries where a lower limit of tax shares in GDP (or tax rates) is observed;
- there are groups of countries where the highest values of tax shares in GDP (or tax rates, depending on various taxes) are displayed.

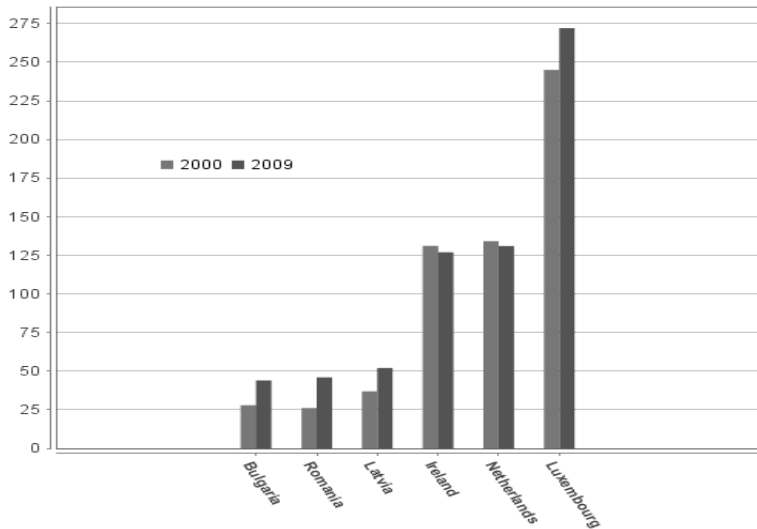

Figure 5. GDP per capita in EU countries (top and bottom), PPS (EU27=100)
Source of the data: Eurostat

In a period when the global economic crisis threatens to return stronger than in 2008, tax competition puts a higher pressure on activities, sectors, economy, and on tax policy, thus the taxation – development nexus becoming even more important to be analysed, considering the potential assessment of the existing relationships further used in order to tackle the unwanted effects.

2. METHODOLOGICAL APPROACH AND MODEL SPECIFICATION

Tax harmonization and tax competition may be considered two sides of the same coin called 'integration process'. Tax policy is influenced both by harmonization and competition, and a policy that aims to harmonize tax rates may influence the tax competition. If total tax harmonization will ever occur, this would bring strong influences on tax competition, and a lack of competition in any area may lead to the 'domination of poverty'. This paper aims to investigate the influence of various macroeconomic variables, and also economic development, on tax competition, expressed as the implicit tax rate on capital in EU countries for 1995-2009 employing the Generalized Method of Moments (GMM) estimator.

The model is developed taking into consideration the ‘horizontal tax competition’, meaning that governments at the same level are competing. In this paper variables from Nandra (2007) are used, and the correlations between the implicit tax rate on capital, of which on capital and business income, and various macroeconomic variables are examined, using panel data for 21 EU countries (Belgium, the Czech Republic, Denmark, Estonia, Ireland, Greece, Spain, France, Italy, Latvia, Lithuania, Hungary, Netherlands, Austria, Poland, Portugal, Slovenia, Slovakia, Finland, Sweden, the United Kingdom). The countries from EU27 which are not included in the analysis due to the lack of data on dependent variable (ITR) are: Bulgaria, Germany, Cyprus, Luxembourg, Malta, and Romania. The data is sourced from Eurostat.

The GMM estimator is a robust, consistent and efficient estimator, based on instrumental variables which are the variables correlated with the explanatory ones, and uncorrelated with the disturbances. The model developed in the next section is described as follows:

$$Y_t = \alpha + \gamma Y_{t-1} + \beta X_t + u_t \tag{1}$$

where Y_t is the dependent variable, Y_{t-1} is the lagged dependent variable and X is a set of explanatory variables.

For such models, it is important to note the value of J-statistic test, which tests if the model is well specified and the instruments are valid. The value of J-statistic is used to calculate the Sargan test p-value. Also, the Sargan test is a test of the validity of the instrumental variables.

Table 1

The variables used in the model

Variables	**Explanation**	**Expected sign**	**Obtained sign**
$ITRCBI_{it}$	dependent variable: implicit tax rate on capital, of which on capital and business income		
$ITRCBI_{it-1}$	lagged dependent variable: lagged implicit tax rate on capital, of which on capital and business income	(+)	(+)
$GDEF_{it}$	government deficit/surplus, % of GDP	(-)	(+)
$GDEB_{it}$	government consolidated gross debt, % of GDP	(-)	
GDP_{it}	gross domestic product, euro per inhabitant	(+)	
$GEXP_{it}$	total general government expenditure, % of GDP	(+)	(+)
$OPEN_{it}$	openness, ratio of the sum of imports and exports to GDP	(-)	(-)

Source: authors’ contribution

In the literature, various studies used different proxies for the degree of tax competition (Luna et al, 2007; Nandra, 2007; Maşca et al, 2011a,b). Luna et al (2007) analysed the situation of local governments in reaching a legal sales tax rate maximum, using two variables to proxy the influence of tax competition, namely a variable for sales tax rates and a dummy variable. Nandra (2007) considered that the implicit tax rate of capital and business income indicates the measure of tax competition. Maşca et al (2011a,b) analysed the determinants of State intervention, and its implications in terms of public policy, and developed an analysis using the overall tax burden as proxy for tax competition.

Regarding the openness of an economy, Guscina (2006) analysed factors related to movements in the labour's share, and the author used four proxies for trade openness, namely ratio of trade to GDP, trade share with developing countries, foreign direct investment to GDP ratio (FDI being a proxy for capital mobility) and ratio of capital flows to GDP (used as a measure of capital mobility). Nandra (2007) considered the degree of openness of countries (ratio between the sum of imports and exports to GDP) as a proxy for capital mobility. Siklos (2008) examined the determinants of bond yield spreads, and used the standard measure of the openness of an economy, proxied by the sum of exports and imports to GDP.

Regarding the explanatory variables used in this study, the descriptive statistics is presented in Table 2. Also, this study tests the hypotheses presented in Table 3.

Table 2

Descriptive statistics for panel data, 21 countries (common sample)

	ITRCBI	**GDEB**	**GDEF**	**GDP**	**GEXP**	**OPEN**
Mean	22.324	50.939	-2.279	19077.410	46.309	0.995
Median	22.150	49.550	-2.300	20850.000	46.500	0.944
Maximum	63.100	130.400	6.800	43400.000	64.900	1.745
Minimum	2.500	3.700	-14.300	1500.000	33.200	0.444
Std. Dev.	9.732	28.503	3.338	11000.490	6.801	0.371
Skewness	0.906	0.637	-0.376	0.084	-0.074	0.242
Kurtosis	5.534	3.113	3.885	1.818	2.392	1.766

Source: authors' calculation

Table 3

The hypotheses used in the study

1. The degree of tax competition is positively influenced by past developments
2. There is a negative relationship between budget deficit and tax competition
3. Public debt is negatively correlated with the degree of tax competition
4. The level of economic development (per capita GDP) promotes the tax competition
5. The level of public expenditure is beneficial for the tax competition
6. The level of openness stimulates tax competition

Source: authors' contribution

3. RESULTS AND DISCUSSIONS

In Table 4 the results which form the dynamic GMM model are presented. The model is validated with the Sargan test (Sargan test p-value) of the overidentifying restrictions. A model that is overidentified is a model which has more instruments than endogenous regressors and the rejection of the Hypothesis H_0 means that one or more of the overidentifying restrictions are not valid. A high p-value of the Sargan statistic shows that the model is well specified. In our case, the p-value of the Sargan test does not reject Hypothesis H_0 of correct specification, thus supporting our estimation results.

Table 4

Dynamic panel data model with fixed effects (cross-section)

Dependent Variable: ITRCBI; Method: Panel GMM; Transf.: 1st Diff.; Sample (adjusted): 1997-2009; Periods incl.: 13; Cross-sections included: 21; Total panel (unbalanced) obs.: 232; White period instrument weighting matrix; White period std. err. & cov. (d.f. corr.); Instr. specif.: @DYN(ITRCBI,-2); Constant added to instr. list

Variable	Coefficient	Std. Error	t-Statistic
$ITRCBI_{it-1}$	0.36	0.06	5.754***
GDEF	2.06	0.25	8.104***
GDEB	-0.20	0.15	-1.297
GDP	-0.00019	0.00031	-0.609
GEXP	1.62	0.06	26.440***
OPEN	-11.94	3.55	-3.360***
Sargan p-value	0.255		

Source: authors' calculation

***/**/* - Statistically significant, respectively at the 1%, 5%, and 10% levels.

According to the results, Hypothesis 1 is confirmed, meaning that the degree of tax competition is positively influenced by past developments. The dependent variable used with lag as regressor is statistically significant, and its positive influences underline that governments do not change tax rates from one year to another. The budget deficit is directly correlated with the implicit tax rate. Thus, Hypothesis 2 is not confirmed. Tax systems should put a lower pressure on low income households and on SMEs, the 'engine' of development which should have a permissive tax system and should benefit from fiscal support. Public debt and per capita GDP (economic development) are not statistically significant variables and this may suggest that tax competition does not depend on the per capita GDP level, thus being more dependent on the facilities offered by each country, this also offering a higher capital mobility.

Government expenditure shows a direct relationship with the dependent variable, meaning that, as governments decrease the level of expenditure, a decrease in taxation also appears which impacts on tax competition. Hypothesis 5 is confirmed, that the level of public expenditure is beneficial for tax competition.

According to the estimation, the openness variable is indirectly correlated with tax competition. The indirect relationship may suggest that an increase in the openness of economies may result in reducing the tax rates. Thus, Hypothesis 6 is confirmed.

In conclusion, tax competition is an important phenomenon for EU countries especially for countries with lower levels of per capita GDP, being influenced by many facets of the economy and society. Tax competition is a 'strategy' that aims through various approaches to sustain economy growth especially through reductions in tax rates.

CONCLUSIONS

Tax competition and tax harmonization are complex, long-debated concepts, still both offer advantages and disadvantages for EU countries in terms of jobs, investments and other resources. The advantages of tax harmonization are underlined by the reduction of compliance costs, transparency for the taxpayer, tax neutrality regarding the optimal allocation of resources and to support individual and inter-nation equity of taxation, and the redistributive effects of taxation; while the advantages of tax competition are related to the downward pressure on tax burden, fiscal discipline, a proper balance of tax level and public goods (Schön, 2003).

Tax competition is a ‘healthy’ side of contemporaneous economies, and in a ‘world of profit’ the proper solution for countries is not to increase labour taxation or to maintain an equality between tax rates for profits and labour income (wages). According to Steichen (2003) ,“harmonization of taxes would for various reasons take place upwards, close to the level of high-tax countries” and “harmonization thus looks like a ‘race to the top’”. Consequently, tax harmonization may be an obstacle for economic growth and development, especially for countries with lower levels of per capita GDP.

This paper developed a dynamic GMM model for 21 European countries, in the 1995-2009 period. The findings suggest that the negative correlation between trade openness and capital taxation may support the hypothesis that taxation shifted from capital to other production factors (i.e. labour). Without a similar economic growth among the EU countries it is difficult to accomplish tax harmonization. The results of the model require careful explanation and the model should be improved in the future including other relevant variables in order to express the development – tax competition nexus. Tax harmonization may also be considered a ‘strategy’ that aims to stop the change of direction regarding the flow of labour force, capital, investments, entrepreneurship, resources, etc., the flow of resources leaving the country with high taxes (countries where taxation has a higher level) for countries with a lower taxation level.

The differences between countries, not only in taxation issues, transform the EU into a living ‘organism’, with its institutions, with its countries and people. A certain degree of competition among the EU countries, even in the taxation area, may support the competitiveness of enterprises, and not only that. In the EU, a general solution for situations which are generated by tax harmonization or tax competition does not exist, and for a long period of time both phenomena will be ‘active’ and will present consequences in society and the economy. Each EU country has its right to control and create its own tax policy, this aspect being related to the sovereignty of a country.

Tax competition is an important phenomenon for the EU countries, being influenced by many facets of the economy and society. This phenomenon is important especially for countries with lower levels of per capita GDP. Further research should consider the relation between tax harmonization/tax competition and other important macroeconomic variables. These relationships should be evaluated empirically first considering a longer time period, dummy variables for country characteristics and for various events that happened during the analysed period, such as the accession of the countries to the EU, the economic crisis (which exerted pressures on tax harmonization and tax competition), and so on.

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