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TAX HARMONIZATION AND TAX COMPETITION IN EUROPEAN UNION

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Abstract

The paper deals with the problems of tax harmonization and competition in the Eropean Union (EU). It is discussed from the tax theory point of view as well as from the view of the tax practice. Several attitudes to tax competition and tax harmonization are discussed, including the tax competition theories. The paper presents several successes which have been achieved in the area of direct tax harmonization and indirect tax harmonization. Harmonization failures are mentioned and discussed as well for they are the integral part of the harmonization process in the European Union.

On New Year's Day 1993 a period of accelerated European integration has began. The physical border controls were eliminated and the last political obstacles to free migration of capital and labor were removed. The liberalization was expected to improve the allocation of resources significantly and to boost European economy. The removal of trade barriers was not free from problems. It may exacerbate existing distortions resulting from non-harmonized tax systems and even create new distortions. Capital flight into low tax countries and changes in patterns of international trade caused by different value added tax (VAT) rates are among the consequences that may occur. To avoid such consequences, fiscal harmonization must follow the fall of barriers. It was preferable to allocate Europe's scarce resources according to the principle of tax minimization. Tax harmonization does not necessarily require centrally coordinated actions by the European governments. The competition of tax systems might also be via process of iterative adjustment, bring about requires harmonization.

The European Union (EU) also illustrates the role of tax competition. The barriers to free movement of capital and people were reduced close to nonexistence. Some countries (e.g. Republic of Ireland) utilized their low levels of corporate tax to attract large amounts of foreign investment while paying for the necessary infrastructure (roads, telecommunication) from EU funds. The net contributors (like Germany) strongly oppose the idea of infrastructure transfers to low tax countries. Net contributors have not complained, however, about recipient nations such as Greece and Portugal, which have kept taxes high and not prospered. EU integration brings continuing pressure for consumption tax harmonization as well. EU member nations must have a value-added tax (VAT) of at least 15 percent (the main VAT band) and limits the set of products and services that can be included in the preferential tax band. Still this policy does not stop people utilizing the difference in VAT levels when purchasing certain goods (e.g. cars). The contributing factor are the single currency (Euro), growth of e-commerce and geographical proximity.This article aim is to identify the achievement of tax harmonization process and expose the definitions of tax harmonization and competition.

Keywords:

Tax, tax system, taxation, competition, VAT, indirect tax, direct tax, tax rate, differences, harmonization, EU.

Introduction

Recent changes in the rhythm of European integration and of globalization have dramatically reduced the scope for independent fiscal policies. On the one hand, the efforts to meet the Maastricht criteria and the subsequent stability pact have limited the possibility of reducing tax pressure. On the other hand, the liberalization of capital movements, inside and outside Europe, has increased the elasticity of location choices to tax rates. This is also the case for a limited part of the labour force, e.g. qualified labour. Hence, a larger share of the tax base is being increasingly elastic to tax rates, while there is a need to maintain or increase the tax burden. In such a context, tax policies become more interdependent: increasing or decreasing the tax rate on the mobile part of the tax base is the source of externalities between countries or regions, and the source of an externality on the less mobile tax bases (non qualified labour, sticky activities, and final consumption).

Research problem: Tax differences between countries may cause locative distortions in the capital market because capital will move to the country with the lowest effective tax rate rather than the most efficient use. In addition, differing tax rates may lead to trade diversion, which in turn also may result in welfare losses.

Object of this article – tax harmonization and tax competition process in European Union members.

Aim of this article – to identify the achievement of tax harmonization and tax competition process and expose the necessity to find the best way to have clear business competition in EU member states.

Tasks of this article:

- To expose main principles of taxation in EU Establishing Treaty.
- To present the development of harmonization process in EU.
- To uncover the definition of tax competition.

Research methods: analysis of primary, secondary literature and statistical data.

Taxation principles in EU Rome Treaty

European Union Establishing Treaty (further Treaty) 2nd article expounded economical and social format Union objectives. This Treaty is not only economical there is also talking about human rights, education and etc., but the most important regulating questions is Common market and Economic and Monetary Union (EMU). Union goals are reaching by inoculating free movement of goods, persons, services and capital, composing relevant conditions of competition and coordinate national tax rules. Union members' duty to harmonize direct taxes is not ratified in EU jurisprudence acts.

There are different taxation obstacles, which can incommode construct Common Market. Various countries obtain departure taxes which appear as serious problem in nowadays. Quantified different taxation for local or imported goods and services also large differences of taxes in other members, such as double taxation, different taxation for residents and non-residents companies.

To avoid these problems we have to identify:

- Differences of taxation systems distorting economical neutrality.
- Tax harmonization or at least coordinating between members is required for performance of Common Market.
- Union Treaty forbid total discrimination of other citizens or companies doesn't matter is it open or hidden.(90 a.) e.g. case C-393/98

The general harmonization provisions (articles 94 and 95 of the EC Treaty) form the main legal basis for harmonizing taxes. Article 94 pertains to "directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market."

The Single European Act amending the EC Treaty introduced article 95 stipulating that the Council will adopt the measures for the approximation of the provisions aiming at the establishment and functioning of the internal market. By way of derogation from article 94 it allows for qualified majority decision-making, but according to paragraph 2 this does not apply to fiscal provisions. In addition, some non-binding instruments have been applied. In this case we have these general documents (written bellow) regulating tax coordination.

The main documents regulating tax coordination:

- *Council Directive 2006/112/EC* – main document, regulating VAT taxation order;
- *6th Council Directive 77/388/EEC* – By reason of state members turnover taxes coordination;
- *Council Directive 2006/79/EC* - regulating import VAT privilege aiming cases and order;
- *Council Directive* 83/181/EEC – by reason of Directive 77/388/EEC 14 article 1st part aiming to dismiss the final goods import from VAT tax;
- *8th Council Directive 79/1072/EEC and 13th Council Directive 86/560/EEC* – VAT resumption for persons who are taxable by foreign countries.
- *Council Directive 92/12/EEC* – the basic document establishing the system of excise duty taxation.

Horizontal directive no. 92/12/EEC is related to mineral oils, alcohol and alcoholic beverages and tobacco. Directive further enables individual member states to impose above the scope of excise duties also other indirect taxes (for example from environmental reasons). Application of these taxes does not have to signify any formalities during cross-border trade between member states. Directive, except the object of taxes, also defines taxable fulfillment, production, products moving and tax payments.

The directive is regulating excise duties in general and concrete types of excise duties are regulated by individual directives.

Ethyl alcohol and spirituous beverages excise duty regulating documents:

- *Council Directive 92/83/EEC* by reason of excise duty for alcohol and beverages structure harmonization.
- *Council Directive 92/84/EEC* by reason of excise duty tariffs for alcohol and beverages unification;

Manufactured Tobacco:

- *Council Directive 92/79/EEC due* to taxes for cigarettes harmonization.
- *Council Directive 92/80/EEC* by reason of taxes to other industrial tobacco harmonization.
- Energy Products and Electric Energy
- *Council Directive 92/81/EEC* comprises unification

of basis for tax assessment and adjustment of tax structure in relation to custom tariff. This directive defines individual types of mineral oils subjected to excise duty. If the mineral oil serves to consumption, is sold or serves as fuel, then it is the object of the tax. Directive stipulates that also the product, which is not directly listed as a mineral oil, but is sold or used production of electric energy as a fuel is object of the tax.

- *Council Directive 2003/96/EC* restructures taxation of mineral oils on the energy products and electric energy.

It extends taxation of mineral oils to coal, natural gas and electric energy. This directive sets minimum tax rates on energy products in dependence to purpose of the use. It distinguishes between energy products serving as fuel or as a mean for production of electric energy.

But whether or not secondary EU legislation such as Directives and Regulations exists, Member States' tax systems and tax treaties must in any event respect the fundamental Treaty principles on the free movement of workers, services and capital and the freedom of establishment (Articles 39, 43, 49 and 56 of the EC Treaty) and the principle of non-discrimination. Moreover, in more general terms, Article 18 of the Treaty provides that every citizen of the Union has the right to move and reside freely within the territory of the Member States. The Agreement on the European Economic Area extends to individuals and enterprises of EEA States (Iceland, Liechtenstein and Norway) the principles of free movement of goods, persons, services and capital, as well as of equal conditions of competition and non-discrimination. However, secondary EU legislation does not apply in these EEA States.

Tax harmonization

Tax harmonization represents the process of tax system convergence based on common set of rules. As quotes (Kubatova, 1998), there can be identified three main phases during the harmonization process (the harmonization process does not necessarily has to undergone all three stages – it can finished by harmonization of tax bases, for example). Firstly, the tax which is going to be harmonized has to be selected. Secondly, the harmonization of tax base takes place and for the last, the tax rate is harmonized.

Further, there can be defined certain levels of tax harmonization:

- Different taxes in all states.
- Part of the taxes are common, some of the taxes are national – partial harmonization.
- Same taxes in all countries.

The level of tax harmonization, when there are different taxes in all states can be divided further on the situation, when there is no tax harmonization (i.e. there are no double taxation conventions and no cooperation on administrative level) and on the situation, when there is slight harmonization (i.e. there are double taxation conventions and the cooperation on administrative level). (Nerudova, 2008)

When there are applied same taxes in all countries, the following situations can arise:

- Different tax bases – nominal armonization
- Harmonized tax bases – here can be identified another two levels:
  - ⇒ Different tax rates – harmonization of tax bases
  - ⇒ Same tax rates – total tax harmonization.

Total tax harmonization is defined by the tax theory as the result of the structural harmonization (i.e. harmonization of the structure of taxes) and harmonization of the tax rates. Tax harmonization can also be understood as the process (the tools for reaching the selected aim) and the result (harmonization of tax legislation itself) together (Nerudova, 2005).

EC Treaty in Art 93 and 94 considers as the aim of the harmonization process the establishment and smooth functioning of the internal market. If considers the tax harmonization as the tool for reaching of smooth functioning of the internal market, then we can divide tax harmonization further on positive and negative. Positive tax harmonization represents the process of the convergence of the national tax systems of EU member states by the implementation of directives, regulation and other legislative tools.

The result of positive harmonization is the same rules in all member states. On the contrary, negative harmonization is the result of the activity of the European Court of Justice (hereinafter as ECJ). Negative tax harmonization cannot be considered as the harmonization in real sense, for it does not provide the set of common rules, binding for all EU member states. The ECJ case law is binding for the parties involved in the case.

ECJ case law does not comprise the means of remedies. That is the reason why the result of the negative tax harmonization cannot be the situation when there will be the same rules in all EU member states. In respect to the actual development in the area of tax harmonization, the harmonization can be further divided on direct and indirect.

Direct tax harmonization is understood as the classical harmonization process, which tries to harmonize the regulations directly by means of tax directives. On the contrary, indirect tax harmonization is understood as the effort to reach the harmonization of certain tax regulations by means of harmonization of different areas of law – for example commercial law or company law. At present, the situation is clearly visible in the area of corporate taxation.

If we consider the definition of the tax harmonization only as the process in the EU, then the tax harmonization can be understood as the mechanism, which enable to remove tax regulations which create obstacles to smooth functioning of the internal market or which distort the competition on the internal market**.** The aim of the tax harmonization in the European Union is not to reach a unified taxation system, but the convergence and the pproximation of the taxation systems.

The main characteristics of the value added tax in the European Union are as follows:

− The European system regarding the value added tax has been established and is amended based on the EU directives;

− It had been planed that until 1970 all the states - members at that date to implement the value added tax in their national fiscal systems;

− It has been acted to the standardization of the taxation basis and levels since 1977;

− Some member states have negotiated to obtain VAT exemptions or differential taxation levels for certain regions or territories.

− The standard taxation level is established to a minimum level of 15%, the member states having the possibility to increase such level, but not more than 10 percent points.

− Reduced taxation levels, over-reduced levels (below 5%) and zero level are admitted for certain classes of goods and services. The case of the zero level is a characteristic of the 6th Directive, its goal being to establish a minimal taxation level, namely 5%. However, in some member states and, especially in the Great Britain, there has been accepted the preservation of the zero level by means of waiver, without the possibility to widen the action range of such level to other goods and services. (see table 1)

Table 1. Vat tax rates in EU members states (Source: EK, 2008 July 1st data)

Country	**Standard**	**Drugs**	**Accommodation**	**Food**	**Public transport**	**Books**
Ireland	**21**	**0**	**13,5**	**0/4,8/13,5**	**0**	**0**
Austria	**20**	**20**	**10**	**10**	**10**	**10**
Bulgaria	**20**	**20**	**7/20**	**20**	**20**	**20**
Denmark	**25**	**25**	**25**	**25**	**0**	**25**
Estonia	**18**	**5**	**5**	**18**	**18/0**	**5**
Spain	**16**	**4/16**	**7**	**4/7**	**7**	**4/16**
Great Britain	**17,5**	**0/17,5**	**17,5**	**0/17,5**	**0**	**0**
Latvia	**18**	**5**	**5**	**18/5**	**5**	**5**
Poland	**22**	**7**	**7**	**3/7/22**	**7**	**0/7/22**
Lithuania	**19**	**19**	**19**	**19**	**19**	**19**
Luxembourg	**15**	**3/15**	**3**	**3**	**0/3**	**3**
Netherlands	**19**	**6/19**	**6**	**6**	**0/6/19**	**6**
France	**19,6**	**2,1/5,5/19,6**	**5,5**	**5,5/19,6**	**5,5**	**5,5/19,6**
Slovakia	**19**	**10**	**19**	**19**	**0/19**	**10**
Slovenia	**20**	**8/5**	**8/5**	**8/5**	**8/5**	**8/5**
Finland	**22**	**8**	**8**	**17**	**8**	**8**
Sweden	**25**	**25**	**12**	**12/25**	**6/0**	**6**
Germany	**19**	**19**	**19**	**7/19**	**7/19**	**7**
Portugal	**20**	**20**	**12**	**5**	**20**	**20**
Italy	**20**	**10**	**20**	**4**	**20**	**20**
Greece	**19**	**9**	**19**	**9**	**9**	**4,5**
Romania	**19**	**9**	**9**	**9**	**19**	**9**
Belgium	**19**	**19**	**19**	**7**	**19**	**19**
Malta	**18**	**18**	**18**	**5**	**18**	**5**
Cyprus	**15**	**5**	**8**	**8**	**15**	**15**
Check Republic	**19**	**9**	**19**	**9**	**19**	**19**
Hungary	**20**	**5**	**20**	**5/20**	**20**	**20**

The perusal of the data presented above points out the compliance with the requirements stipulated by EU regarding the minimal and maximum limits as regards the standard level.

It is obvious that only Cyprus and Luxembourg enforce the standard VAT level according to the minimal value stipulated by EU (15%), the explanation for such practice being related to the classification of these states as being part of the area of fiscal paradises with low taxation.

In Germany, Great Britain, Spain, Czech Republic, Estonia, Greece, Lithuania, Latvia, Malta, Holland and Slovakia, the standard VAT level is below the average registered upon EU level while in Austria, Belgium, Denmark, Finland, France, Ireland, Italy, Portugal, Sweden, Poland, Slovenia and Hungary, the standard VAT level exceeds the average registered upon EU level.

Theoretical background of tax competition

On November 5th, 1997, in its Report: "Measures to fight against tax competition in the European Union" (European Commission, Bull. 6-1997) the European Commission recommended a coordinated action against tax competition in Europe, the objective being to reduce distortions still existing within the Single market, to avoid losses on tax receipts and to establish tax structures more in favor of employment. The Ecofin Council of December 1st, 1997 gave its assent on the resolution relating to a code of conduct in the field of companies taxation, and approved the idea of tax harmonization on savings. In June 2000 the European Council finally agreed on a compromise on taxes on savings. European countries will have to inform other countries about savings made by residents from other member states. We should expose theoretical background of this process.

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. Often, this means a governmental strategy of attracting foreign direct investment, foreign indirect investment (financial investment), and high value human resources by minimizing the overall taxation level and/or special tax preferences. Although often presented as a benefit for capital, tax competition is generally a central part of a government policy for improving the lot of labour by creating well-paid jobs (often in countries or regions with very limited job prospects).

As quotes (Nerudova, 2008), competition is generally considered as the factor, which increases market effectiveness, for it enables the effective allocation of the sources. The same is not true for tax competition. In case of the market failure, the competition is not able to ensure effective source allocation. Taxes represent the market failure, for the taxpayer does not receive any equivalent for the paid tax and therefore it is not interesting for him to pay taxes in jurisdiction, in which he uses the public services. Tax competition could lead to the restriction of the public sector. In extreme situation it could result in removing of the tax.

According Cecchini, tax competition is harmful, for it decreases the tax bases of neighboring countries and deforms the effective allocation of capital and services. The decrease of the statutory tax rates increases the competitiveness of the state. The result is the increased inflow of the good, services, capital and qualified labour force into the state with low statutory tax rates. The negative effect is represented by the decrease of the state budget revenues and implicitly also by the decrease in the economic growth of neighboring countries.

Certain degree of tax harmonization, mainly in the area of corporate taxation, is needed, for the present situation does not allow EU companies to fully use the advantages connected and provided by the internal market, as mentions (Nerudova, 2008).

Tax competition can lead to the inefficiency in providing public services. As further mentions Edward Cartwright, the inefficiency can be found mainly in the area of the size of the redistributive programs. Therefore the tax competition is perceived as harmful, mainly by the groups, which highlight the task of the redistributive programs. The author mentions that also the positive side of the tax competition can be found, for it prevents the excessive expansion of the public sector.

Tax competition cannot be considered as the competition in real sense. Therefore it is not possible to search for the parallels between the market competition and tax competition. While in market competition, the law of supply and demand dominates, the tax competition is the play of political and economic interests. The looser in that game are immobile factors (labour force) and the winners are the owners of the capital (mobile factors). When the tax competition results in the decrease of the yield from the capital tax, the decrease is compensated very often by the higher taxation of labour force. At present there is no unified regulation of the corporate or personal income taxation in the European Union. Based on the above mentioned, tax competition can be considered as beneficial, for it creates the pressure on the decrease in the budget expenditures. Therefore it could help to increase the competitiveness of the EU as a whole. On the other hand, unlimited and uncontrolled tax competition in the area of the mobile factors can endanger the budget revenues of EU member states and to endanger the redistributive role of public finances.

As quote Daniel J. Mitchel let us expect the analogy between the tax competition and market competition. If the market competition results in the higher effectiveness and meets the demand, the tax competition has to result in higher budget effectiveness and in satisfaction of the voters. The result of the tax competition in the area of corporate taxation in the EU is the situation, when the tax rates in different jurisdictions reflect mainly the international aspects of taxation and partly also the preferences of the member states. The tax competition itself leads to the spontaneous harmonization effect – i.e. to the spontaneous convergence of the tax rates and therefore there is no need for artificial harmonization. As quotes (Nerudova, 2008), the declaration that the tax harmonization is needed due to the internal market or monetary union, is incorrect. The above mentioned supports by the example of the U.S.A., where there are remarkable differences in taxation, even though it is the area with higher economic and political integration than European Union. The fears from spillover effects to the low tax jurisdictions are according to the author not just. Higher tax jurisdiction in the EU offer qualified labour force and stable business environment. On the contrary, low tax jurisdictions try to establish on the internal market. The author adds, that in case that the process would be stopped by the tax harmonization, the European Union would be less converged than ever before.

The discussion on the harmfulness of the tax competition has led to the development of certain models, which has been verified on the empirical data. In the tax competition theory there can be found two basic strands. First of them highlights the role of "tax game" and tries to identify tax reaction functions, which shows the dependence of the state on the tax policies of its neighbours. Most of the authors in that strand of literature have found out that the governments are adjusting the tax rates in reaction to the changes in the tax rates of its neighbours, which support to the standard tax competition theory. Corporate income taxes influence the corporations in their decisions about investments placements. From that reason the tax policy of the government tries to attract the tax bases in the frame of tax competition and not the voters, for the corporate income tax influences them only marginally. Edward Cartwright and Myrna Wooders have dealt in their research with the empirical estimation of tax reaction functions in case of corporate income taxes among OECD countries. They have proved the existence of positive correlation coefficient in all the cases – i.e. the decrease in tax rate of neighbouring country was followed by the studied country. (Devereux, Lockwood and Redoano, 2002) quote that each country behaves strategically in the process of setting up the corporate income tax rates in respect to the corporate income tax rates set in neighbouring countries. The authors point out another very important factor in the tax competition – voters and politics. The government policy makers are following the tax rates of other states, for in case that they would set higher tax rates than neighbouring countries have the government need not to be voted again in elections.

The second strand in literature which can be found in tax competition theory is the influence of capital mobility on the level and structure of the tax rates. In that area the authors highlight the negative impact of capital mobility on the capital tax rates and the level of public expenditures. Some authors as (Garrett and Mitchell, 2002) fined positive relation between capital mobility and the level of capital tax rates and public expenditures, which is in contradiction with the "race to the bottom" theory which was mentioned above. The compensation theory serves as the basis for the theoretical arguments of the authors finding the positive relation between the capital mobility and the level of public expenditures. The compensation theory is based on the idea that economic integration (and connected increase in the capital mobility) causes also secondary effects as for example recession in some sectors of economy or higher volatility in consumers incomes, which leads to the higher demand for the public expenditures, mainly in the form of social programs. The defenders of compensations theory suppose, that higher tax burden on labour as a result of increase in the capital mobility should be compensated to the tax payers in the form of special social programs, which would be financed from the increased tax revenues from that type of tax.

Conclusions

Tax competition theory suggests that small countries set lower tax rates than large countries. It appears that the five largest EU members have indeed an effective tax rate that is on average higher than in the smaller member states. The mean effective tax rate of small EU countries was 24.6%, whereas the mean effective tax rate of large EU member states was no less than 35.8%. The difference between small and large countries declined.

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. However, tax burdens in the EU increased on average by almost 50% in the past 35 years, while they did not converge. Since capital is much more mobile than labor it can be expected that the tax burden has partly shifted from capital to labor. Yet, there is no evidence for a "race to the bottom".

There are two routes to integration: through harmonization and through competition. 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. Insofar the EU has been involved in direct taxation, it mainly pertains to corporate taxes

EU decision-making on taxation still requires unanimity making progress in tax harmonization a difficult and cumbersome process. So far, the achievements with regard to tax harmonization in the EU have been most pronounced in the field of indirect taxes, in particular the VAT. Minimum rates have been set, but no maximum rates. As a result, VAT rates differ across EU member states. Moreover, VAT tax bases differ between member states because of derogations and exemptions. Less progress has been achieved with regard to harmonization of excise taxes. Harmonization in this field has been very slow and often spontaneous.

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