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TAX SYSTEM COMPETITION – INSTRUMENTS AND BENEFICIARIES

SUMMARY

Tax competition among states and jurisdictions has already been examined many times in the economic literature. However, the main scope of the research was focused on a tax rates competition in income taxes and its consequences in bringing direct investments. This scripture/commentary tries to analyze various instruments and beneficiaries of the tax system competition and provide a general overview on this subject.

Keywords: tax competition, tax system, fiscal harmonization

JEL classification: F36, H25

INTRODUCTION

The tax system shall provide a fiscal revenue for central or regional budgets. However, globalization trends provide countries to decrease tax rates, in order to attract new investments. This trend is visible in the European Union for many years and brings recently the common consolidated corporate tax base (CCCTB) formula. Nonetheless, nominal tax rates in the corporate

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income tax cannot be treated as the main instrument of thetax competition. There are many others, which are described in this exposition.

The companies, especially multinational ones, are treated as the main beneficiaries of the tax competition. Recent surveys provide information about migration of natural persons, who are looking for more friendly tax environment. This group of tax competition beneficiaries' gains on attractiveness for countries and local jurisdictions. In the European Union (EU) enlargement this problem may be significant. It must be underlined, that the tax competition in EU is negatively perceived and many restrictions are provided for member countries.

The aim of this review is to analyze various instruments used to attract the tax systems. Also different beneficiaries of the temporarily tax competition (TC) among countries and local jurisdiction require a discussion. The survey based on literature study and facts generally available.

1. TAX COMPETITION – DEFINITION AND CONSEQUENCES

Up to now there is no definition of tax competition. Literature provides many various meanings. Generally tax competition is defined by the choice of means: in tax competition, as a part of competition among jurisdictions, states face each other in trying to attract capital by offering favorable tax rules[1]. This capital may be in many forms: form direct investments (green field) to private assets of natural persons. From cash flow in portfolio investments to retirement pensions and funds for those, who move to another country during retirement. For tax jurisdiction it means, that the broader tax base is, more benefits may be generated in the country of destination.

The problem of the tax competition has remained high in Europe since the beginning of the sixties in 20th century, when the Neuman Report has been published[2]. However, the nominal rates in the corporate income taxes (CIT) decreased, different consequences of such a trend were presented. Negative fiscal externalities emerge from the independent government's competition for mobile tax base through this reductions of tax rates. Each government ignores the positive effect on other government's budgets of its tax base outflows in response to higher taxes. For this reason, tax rates and the provi-

[1] L. Gerken, J. Maerkt, G. Schick, *Double Income Taxation as a response to Tax Competition in the EU*, „Intereconomics", Vol. 36, No. 5/2001, p. 244.

[2] L.P. Feld, J.H. Heckemeyer, *FDI and Taxation: A Meta-Study*, „Journal of Economic Surveys", Vol. 25, No. 2/2011, p. 233.

sion of public good tend to be too low from an efficiency viewpoint[3]. On the other hand, it must be underlined, that statutory corporate tax rates have been strongly reduced in all countries since the mid-1980s. This downward trend is still clearly visible when using the effective average tax rate, which accounts for the simultaneous broadening of tax bases that has occurred in many countries. Moreover, although the averages of statutory and effective tax rates were almost the same for large and small countries in 1985, tax rates have fallen significantly more among the group of small countries since then. At the same time, corporate tax revenue as a percentage of GDP has risen in all of the smaller OECD countries in the sample, whereas the picture for the larger countries is somewhat more mixed. In the (weighted) OECD average, however, there is a clear increase in corporate tax collections[4]. This trend shows, that the budget revenue is not only affected by changes of tax rates, but also other macroeconomic variables have deeply impact on this value. Finally, there are also observations, that institutional aspects of tax system strongly influence on the decision of multinational enterprises. They are looking not only for the country with small tax rate, but also stable and transparent tax regulations are desirable. The transparency is even more important than nominal or effective tax burden[5].

The visible impact of a competition among countries in the level of taxation provides to a "harmful tax competition". Such a meaning was adopted by developed countries. The first report concerning this problem was issued by the European Commission[6] and OECD[7]. Since then the tax competition is perceived in a very negative way – as a method of "unfair" decreasing the tax burden. Now the risk of the harmful competition seems to be acknowledged. Many regulations are provided to prevent this phenomenon. OECD in the Report form the 2000 identified 47 harmful regimes and 35 jurisdictions operating as tax havens, and the Europeans Union's Code of Conduct Group from the 2000 listed scores of regulations with harmful features that had been implemented in EU member countries. All those activities were pre-

[3] A. Trandafir, L. Ristea, *Fiscal Equalization in Corporate Taxation – A Way of Limiting the Harmful Tax Competition in the EU*, „Education and Managenent", Vol. 210/2011, p. 428.

[4] A. Haufler, F.Staehler, *Tax Competition In A Simple Model With Heterogeneous Firms: How Larger Markets Reduce Profit Taxes*, „International Economic Review", Vol. 54, No. 2/2013.

[5] H. Wnorowski, *Wpływ podatków na wzrost gospodarczy i konkurencyjność w ujęciu instytucjonalnym*, „Gospodarka Narodowa", Nr 4/2010, p. 58.

[6] European Commission, *Towards tax co-ordination in the European Union: a package to tackle harmful tax competition*, Communication from the European Commission, COM(97) 495 final, 1997.

[7] OECD, *Harmful Tax Competition: An Emerging Global Issue*, 1998.

pared to minimize the outflow of capital from the EU countries to preferential tax regimes, without attempting to eliminate totally thetax competition. The pressure brings results. Ireland levied a 10% tax rate on corporate income in the manufacturing and financial services sectors instead of the standard rate which was 32%. This measure was a discrimination between sectors. In fact, it was largely for the benefit of foreign investors, who were major players in the low-tax sectors. It is treated as discrimination induced in favor of investments of non-residents. As a consequence of this preferential treatment, huge amounts of the foreign investments were attracted to Ireland and became a main factor in the rapid growth of the GDP in the nineties. Regarding the Irish preferential regime as a harmful strategy, the EU intervened and Ireland abandoned its dual-rate structure[8].

The presented practical trends in tax competition are contrary to theoretical issues. The economists underline positive impact of tax competition not only for the multinational companies, but also for tax jurisdictions. Tax competition also provides for means and incentives to successfully attract business and adapt to structural change in the presence of agglomeration economies and knowledge spillovers. Unfortunately empirical studies give no answer, whether tax competition is a precondition for structural changes as it fosters political innovations[9]. Different consequences and meaning of TC arise question about the real and potential beneficiaries. Also the problem of loses generated by TC is important.

2. TAX COMPETITION – BENEFICIARIES

To be the beneficiary from the tax competition, there must be acquired extra gains in relation to a no-competition environment. In fact, it is hard to determine precisely a quantitative effect of the competition. First of all, states and jurisdictions may be perceived as beneficiaries, of course only those, that try to attract investments. But the surveys are not unambiguous. The study about Africa's harmful competition, which focuses on Kenya, Uganda, Tanzania and Rwanda, shows that tax incentives are leading to very large revenue losses for the governments. What is more, those activities in fact promoting a harmful tax competition in the region, and are not needed to attract

[8] A. Haupt, W. Peters, *Restricting preferential tax regimes to avoid harmful tax competition*, „Regional Science and Urban Economics", Vol. 35, No. 5/2005.

[9] L.P. Feld, H. Zimmerman, T. Doering, *Fiscal Federalism, Decentralization and Economic Growth*, „Public Economics and Public Choice", Vol. 2007, p. 127.

foreign direct investments. In values, in total, Kenya, Uganda, Tanzania and Rwanda are losing up to US $2.8 billion a year from all tax incentives and exemptions. In fact, not all of these mechanisms are bad. Some instruments, such as VAT reductions, can help reduce a poverty. But much of the revenue loss is explained by tax incentives provided unnecessarily to attract the foreign investment. These revenue losses are depriving the countries of critical resources needed for reducing the poverty[10]. Similar losses are generated in other countries, which attract the foreign investments in a form of the tax incentives. Poland, as an emerging economy, introduced the Special Economic Zones (SEE) to draw attention of multinational companies. In the period of 1997-2010 the central budget has not received 8.8 billion PLN, because of exemption in CIT for companies with seat in the SSE[11].There is no evidence in Poland, how many PIT were flown to the central budget from the SSE employee's remuneration. Such a comparison could be an evidence of tax efficiency for the SSE in Poland, as a form of the tax incentives.

Mostly multinational companies may be treated as a beneficiary of the tax competition. Unfortunately, not all of them are able to take advantage of the tax incentives. This is dependent on the sector, in which the company operates. For example the world of an offshore financial service industry has grown rapidly in last two decades. This reflects a number of global trends, including the deregulation of domestic financial markets in many countries, explosion of a world trade and investment volume, and the globalization of the financial service industry. The size of the offshore industry is estimated to be US $ 5-6 trillion, reflecting rapid growth in the global foreign investment and trade flows, and the resultant growth in demand for the international financial services[12]. Concluding, only a group of companies may be benefit from the international tax competition, with specific conditions. Firstly the business provided shall be easily transferred internationally, what is problematic in long-term for "greenfield" investments. Secondly, the companies should not be dependent on the domestic workforce. This two conditions very deeply limit the potential group of the companies and also underlined other that tax-incentive instrument for promoting country or jurisdiction for broader group of investors.

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[10] Tax Justice Network-Africa &ActionAid International, *Tax competition in East Africa: A race to the bottom?*, April 2012, p. 4.

[11] Ernst&Young, *Specjalne Strefy Ekonomiczne po roku 2020. Analiza dotychczasowej działalności oraz perspektywy funkcjonowania*, 2011, p. 46.

[12] R. Biswas, *The Commonwealth Response to the OECD Initiative on Harmful Tax Competition*, [in:] Biswas R. (ed.), *International Tax Competition. Globalisation and Fiscal Sovereignty*, Commonwealth Secretariat, London 2002, p. 6.

Recent trends encourage the natural persons (consumers) to change the tax residency for the tax competition purpose. Last survey in the United States has shown, that migration from highly taxed states to the low ones brings significant losses in the regional budgets' revenue. New York, as a city, loses every day about US $ 11 million, what generates US $ 4 billion every year[13]. The migration is visible and states as a California, Illinois, New Jersey and Ohio lose their citizens, who move to Arizona, Texas, North Carolina and Nevada. In the European Union the freedom of movement causes similar consequences. After a tax reform proposal in France at the beginning of the 2012, which tend to rise the tax rate in PIT to 75%, many citizens moved to neighbored Belgium[14]. Extreme example was the decision of Gérard Depardieu, who resigned of France citizenship and moved to the Russia Federation. From tax point of view the 13 % of PIT tax rate in Russia is much more attractive than proposed 75% in France. Also emigration from Poland to Great Britain (UK) after accession of our county to EU, brought significant money transfer between these countries. Regarding to Polish National Bank's data, in the period of 2007-2008, immigrant transferred to Poland about 20 billion PLN every year. The money were taxed only in UK, referring to Polish-UK agreement of avoiding double taxation. Although the Polish emigration was not caused by seeking for better tax environment, presented values show the fiscal consequences of such a movement within EU.

So far, there is no complex survey of the migration within the European Union because of the tax competition among the member countries. Different beneficiaries and consequences of the TC provide many instruments to attract investors. The instruments shall be adjusted to different group of investors.

3. TAX COMPETITION – INSTRUMENTS

All the instruments of TC may be divided at least into three categories: legal, procedural and other. The most popular instrument in a legal group are tax rates. They are the simplest and often primary factor which affects the entrepreneurs' decision and always the nominal corporate tax rate brings the attention. Therefore, special contribution shall be made in the problem research analysis to the differences of the tax level rate, differences regarding tax ben-

[13] T. H. Brown, *How money walks*, Pelopidas LLC, Washington 2013.
[14] Financial Times, *Hollande orders employers to pay 75% tax*, 29th March 2013.

efits, exemptions and different model of tax income calculating[15]. Also tax breaks or tax holidays (i.e. time limited tax exemptions) or special treatment of non-residents companies may be significant. Application of all those instruments converts the nominal rate to the effective one, which reflects the real burden borne by the investors. The real problems of comparing the effective tax rate among countries provide to propose the concept of common consolidated corporate tax base (CCCTB) within EU. So far the member's country standpoint restraints the current works.

For a natural person a reduction of the nominal tax rates is due from many consequences of applied tax policies. Change of the tax-residency always allows to utilize tax reliefs and decreases dedicated to all citizen of a specified country. However for many years there is a visible trend to restrain the catalogue of different preferences, still personal income tax is the most important instrument to shape the tax policy in the level of income taxes.

It is worth to notice, that in economic theory changes of tax rates (or generally – tax burden) may be applied to different form of taxation. Generally the literature, in the context of the Zodrow-Mieszkowski-Wilson model, examines the tax levied per unit of capital (i.e., it is a unit tax). But in practice, the competition may be also in the group of ad-valorem taxes. The surveys show, that different Nash equilibrium is achieved, regarding the model of taxation. If countries are symmetric, and both private and public goods are normal, then (i) the symmetric Nash equilibrium in taxes exists and is unique in each case; and (ii) equilibrium taxes and public good provision are always lower when countries compete with ad valorem taxes[16]. The consequence is, that cutting the rates down may provide to the "race-to-the-bottom" effect, and the finally achieved equilibrium will not able to cover the public expenditures.

Procedural group covers formal obligations, which meet companies operating in the tax competition jurisdictions. The investors are going to minimize compliance costs and looking for countries with limited accounting and reporting duties. However, the jurisdictions threatened by outflow of the investors impose extra formal obligations to promote a domestic taxpayer. In this group are the barriers for not-domiciled companies to bid for public contracts, special reporting about relation with the tax heavens or even extra taxes for those, who cooperate in form of goods or service importation form low-tax

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[15] N. Sokol, *Corporate Tax Systems and Tax Competitition in the EU New Member States*, „Zagreb International Review of Economics & Business", Vol. 11, No. 2/2008, p. 84.

[16] B. Lockwood, *Competition in unit vs. ad valorem taxes*, „International Tax and Public Finance", Vol. 11, No. 6/2004, p. 763-772.

jurisdiction. In Poland there was a regulation in VAT, where the tax payers had not possibility to deduct an input tax against an output tax if the input tax was associated with service importation form the tax heavens. The European Tribunal of Justice adjudged about illegality such a regulation with the EU's directive[17]. Finally the VAT regulation was amended, however more obligations were imposed for companies in the level of income taxes. Nowadays the transfer pricing rules very broadly refer to transaction between Polish companies and their branch or other firms domiciled in tax heavens.

The last group of 'another' is the broader one and relates mainly to non-tax incentives. As an example may be an institutional influence on business providing. Instruments such a shorten time for receiving an administration decision, employees regulation, costs and time for a business registration, methods of an ownership rights protection, freedom of aninternational cooperation are those determinants, which may attract potential investors[18].Nowadays, the possibility ofa contact with the administration on-line using e-mails or webpages gains in value.This group of incentives are very important for long-term investors. They are less mobile with such an investment, what may have be positively perceive as a stability factor for the economy.

CONCLUSIONS

The tax system competition among countries and jurisdictions refers to many various beneficiaries, thus requires different instrument and tax incentives. Up to now researches are focused on influence of the tax competition only on direct investments. Recent surveys have shown, that not only the companies try to utilize the tax competition, but also the natural persons begin to migrate because of seeking more convenient tax environment. This phenomenon has already been examined in the United States, but free movement of capital, people and services in the European Union brings new threats for the fiscal stability of the member state budgets. The accession of new member states after 2004 shown considerable migration, which brought also fiscal consequences for all EU countries.

Developed economies perceive the tax competition as a harmful practice, however the financial consequences of this tendency is not obvious. Also the theory of economy does not confirm the negative results of such a competition. Globalization tends to shape the countries' tax system in order to attract

[17] C-395/09, Oasis East Sp. z o.o. v. Ministry of Finance, dated 30 September 2010.
[18] H. Wnorowski, *op. cit.*, p. 56.

the assets of the foreign taxpayers. The Africa's presented examples demonstrate it clearly. New member states, as the Poland's described case shows, also try to utilize this changes. Now it is important to verify, how in the tax level, different tax-free zones, exemptions etc. really bring benefits for the countries or they are only harmful practices.

Summarizing, the tax competition shall be perceived widely and there is necessity to include the researches concerning people migration, not only companies movement. Different beneficiaries require different instruments to minimize economic externalities caused by the tax system competition.

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